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## Attorney Liability under the Securities Laws

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# ATTORNEY LIABILITY UNDER THE SECURITIES LAWS

by Marc I. Steinberg\*

## I. INTRODUCTION

AS recent events evidence, attorneys find themselves named with increasing frequency as defendants in securities litigation. The most frequent provision invoked by plaintiffs is Section 10(b) of the Securities Exchange Act of 1934<sup>1</sup> (Exchange Act). Depending on the circumstances, attorney liability may be predicated on violation of other provisions, such as Sections 11, 12, and 17(a) of the Securities Act of 1933<sup>2</sup> (Securities Act) and Sections 14(a) and 18(a) of the Exchange Act.<sup>3</sup> Looking to the underlying situation as well as the section allegedly violated, both primary and secondary liability (such as aiding and abetting liability) may be imposed. In addition to the invocation of private rights of action, when appropriate, the Securities and Exchange Commission (SEC) may institute enforcement actions and the United States Attorney may bring criminal proceedings.

Actions also have been instituted against lawyers for allegedly violating the applicable state securities laws. Although many of these statutes are construed similar to the federal securities laws, some of the state securities provisions may have a broader reach.<sup>4</sup> In addition, attorneys have found themselves called "racketeers" based upon application of the Racketeer Influenced Corrupt Organizations Act (RICO).<sup>5</sup> This is hardly surprising

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1. 15 U.S.C. § 78j(b) (1988).

2. 15 U.S.C. §§ 77k, 77l, 77g(a) (1988).

3. 15 U.S.C. §§ 78h(a), 78r(a) (1988).

4. See, e.g., *Marshall v. Quinn-L Equities, Inc.*, 704 F. Supp. 1384 (N.D. Tex. 1988) (civil liability alleged under secondary liability provision of the Texas Securities Act against attorney). See also *Colorado v. Preblud*, 764 P.2d 822 (Colo. 1988); *Prince v. Brydon*, 307 Or. 146, 764 P.2d 1370 (1988). See generally J. LONG, *BLUE SKY LAW* (1986).

5. 18 U.S.C.A. §§ 1961-1968 (1984 & Supp. 1991). See, e.g., *Elliott v. Chicago Motor Club*, 809 F.2d 347 (7th Cir. 1986); *Butchers Union Local No. 498 v. SDC Inv., Inc.*, 788 F.2d 535 (9th Cir. 1986); *Netelkos v. Weinberg*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶

given the prospect that plaintiffs who successfully invoke civil RICO can recover treble damages and attorneys' fees.<sup>6</sup>

This article provides an overview of attorney liability under the federal securities laws.<sup>7</sup> Key aspects of the discussion will focus on such subjects as private actions under Section 10(b) of the Exchange Act, aider and abettor liability, the attorney as a "seller" under Section 12 of the Securities Act, SEC enforcement actions, and law firm procedures to protect against insider trading liability.

## II. SECURITIES ACT LIABILITY

This portion of the article will focus on three provisions of the Securities Act - Sections 11, 12, and 17(a).

### A. Section 11

Section 11(a) of the Securities Act<sup>8</sup> delineates the classes of persons who are subject to liability for a material<sup>9</sup> misstatement or omission contained in a registration statement (which includes the prospectus).<sup>10</sup> Generally, "any person acquiring such security" may bring a private cause of action for damages unless, at the time of purchase, the complainant had knowledge of the misstatement or omission.<sup>11</sup> To recover under Section 11, a plaintiff need not be in privity with the seller, can seek recovery for purchases made in the secondary markets (subject to the "tracing" requirement),<sup>12</sup> normally need not establish reliance,<sup>13</sup> and is not required to show causation (in other

93,219 (S.D.N.Y. 1987); *Procter & Gamble Co. v. Big Apple Indus. Bldgs., Inc.*, 655 F. Supp. 1179 (S.D.N.Y. 1987); *McMurtry v. Brasfield*, 654 F. Supp. 1222 (E.D. Va. 1987); *Penturelli v. Spector Cohen Gadon & Rosen*, 640 F. Supp. 868 (E.D. Pa. 1986). For further discussion, see R. MALLEN & J. SMITH, *LEGAL MALPRACTICE* §§ 9.11-9.27 (3d ed. 1989).

6. See, e.g., *H.J. Inc. v. Northwestern Bell Telephone Co.*, 492 U.S. 229 (1989); *Caplin & Drysdale v. United States*, 491 U.S. 617 (1989); *Sedima v. Imrex Co.*, 473 U.S. 479 (1985). See generally discussion and sources cited in M. STEINBERG & R. FERRARA, *SECURITIES PRACTICE: FEDERAL AND STATE ENFORCEMENT* §§ 6:33-6:39 (1985 & Supp. 1991).

7. For more extensive treatment, see, e.g., A. BROMBERG & L. LOWENFELS, *SECURITIES FRAUD AND COMMODITIES FRAUD* (1989); L. LOSS & J. SELIGMAN, *SECURITIES REGULATION* (3d ed. 1989); *SECURITIES LAW TECHNIQUES* (A. A. Sommer ed. 1985); L. SODERQUIST, *UNDERSTANDING THE SECURITIES LAWS* (2d ed. 1990); M. STEINBERG, *SECURITIES REGULATION: LIABILITIES AND REMEDIES* (1991).

8. 15 U.S.C. § 77k(a) (1988).

9. Generally, materiality is based on the concept that a reasonable investor would consider such information important in making his or her investment decision. See *Basic, Inc. v. Levinson*, 485 U.S. 224, 231 (1988); *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

10. As with other provisions invoking the federal securities laws, note that a means or instrumentality of interstate commerce must be used in connection with the offer or sale. See *Loveridge v. Dreagoux*, 678 F.2d 870, 874 (10th Cir. 1982) (holding that proof of intrastate telephone messages adequate to confer jurisdiction).

11. See Section 11(a), 15 U.S.C. § 77k(a) (1988).

12. See, e.g., *Barnes v. Osofky*, 373 F.2d 269 (2d Cir. 1967); *Kirkwood v. Taylor*, [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,877 (D. Minn. 1984); *McFarland v. Memorex Corp.*, 493 F. Supp. 631 (N.D. Cal. 1980).

13. An exception exists in situations where the plaintiff purchased the securities more than twelve months after the registration statement's effective date, provided that an "earnings statement" covering the twelve-month period has been made generally available. In such situ-

words, the defendant may avoid liability or reduce its monetary exposure by establishing that the misrepresentation or nondisclosure did not cause the loss, either totally or in part).<sup>14</sup> Although the issuer is strictly liable, other defendants in a Section 11 action have a "due diligence" defense.<sup>15</sup>

Included within the enumeration of prospective Section 11 defendants are experts who "hav[e] prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him."<sup>16</sup> Such expertised statements encompass opinions issued by counsel, including the rendering of an opinion with respect to the legality of the securities issued.<sup>17</sup> Opinions may also be provided by counsel which are used in connection with the registration statement covering such subjects as discount on capital shares, tax matters, and liquidation preferences.<sup>18</sup> With respect to the furnishing of a "comfort opinion,"<sup>19</sup> in order to avoid potential liability under Section 11, "counsel should ensure that neither the opinion nor its contents appear in the registration statement."<sup>20</sup> If a material misstatement or omission is contained in any such expertised portion of the registration statement, the expert has a due diligence defense, signifying that, after conducting a reasonable investigation, such expert had reason to believe and in fact did believe that such state-

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ations, the plaintiff must show reliance on the misrepresentation or nondisclosure contained in the registration statement, although "such reliance may be established without proof of the reading of the registration statement by such person." Section 11(a), 15 U.S.C. § 77k(a) (1988); see SEC Rule 158, 17 C.F.R. § 230.158 (1991).

14. See, e.g., *Akerman v. Orxy Communications, Inc.*, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,680 (S.D.N.Y. 1984), *aff'd*, 810 F.2d 344 (2d Cir. 1987). The statute of limitations for bringing a Section 11 right of action is contained in Section 13 of the Securities Act ("within one year after the discovery of the untrue statement or the omission, or after such discovery should have been made by the exercise of reasonable diligence . . . [but] in no event shall any such action be brought . . . more than three years after the security was bona fide offered to the public.").

15. See Section 11(b)(3), 15 U.S.C. § 77K(b)(3) (1988).

16. *Id.*

17. See Items 601(a)(5), 601(b)(5) of Regulation S-K (requiring to be filed as an exhibit "[a]n opinion of counsel as to the legality of the securities being issued, indicating whether they will, when sold, be legally issued, fully paid and non-assessable, and, if debt securities, whether they will be binding obligations of the registrant"). See generally FitzGibbon & Glazer, *Legal Opinions in Corporate Transactions: The Opinion that Stock is Duly Authorized, Validly Issued, Fully Paid and Nonassessable*, 43 WASH. & LEE L. REV. 863 (1986).

18. See Items 601(a)(6)-(8), 601(b)(6)-(8) of Regulation S-K; Cheek, *Counsel Named in a Prospectus*, 6 REV. SEC. REG. 939, 942-43 (1973) ("[I]t is likely that a court would hold counsel to be an 'expert' in the Section 11 sense with respect to his conclusions and statements as to the legality of the securities being sold, and as to such matters as tax consequences or patent validity."); Cooney, *The Registration Process: The Role of the Lawyer in Disclosure*, 33 BUS. LAW. 1329 (1978).

19. "A comfort opinion essentially is a statement that, based on counsel's participation in the preparation of the registration statement and conferences with representatives of the issuer, underwriters and public accountants, he or she has no reason to believe that the registration statement violates Section 11." M. STEINBERG, *UNDERSTANDING SECURITIES LAW* 113 (1989). See *SECURITIES UNDERWRITING: A PRACTITIONER'S GUIDE*, (K. Bialkin & W. Grant eds. 1985).

20. M. STEINBERG, *supra* note 19, at 113.

ment was accurate.<sup>21</sup>

Plaintiffs have argued that attorneys are experts within the meaning of Section 11 if they draft the registration statement or otherwise provide legal advice on disclosure issues in connection with its preparation. The courts have rejected such assertions.<sup>22</sup> As succinctly stated by one court: "To say that the entire registration statement is expertised because some lawyer prepared it would be an unreasonable construction of the statute."<sup>23</sup>

Unsuccessful attempts also have been made to hold lawyers and other collateral parties liable under Section 11 for aiding and abetting.<sup>24</sup> Rejection of this theory frequently has been premised on the fact that Section 11 contains an exhaustive enumeration of parties subject to suit. As one court reasoned, "where a statute specifically limits those who may be held liable for the conduct described by the statute, the courts cannot extend liability, under a theory of aiding and abetting, to those who do not fall within the categories of potential defendants described by the statute."<sup>25</sup>

This is not to imply that an attorney who drafts a registration statement or provides advice in connection therewith (and who is not acting as an expert within the meaning of Section 11) will necessarily avoid securities law liability. Under such circumstances, provided that the requisite elements (such as the rendering of substantial assistance and the presence of scienter) can be proved, the attorney can be held liable as an aider and abettor under Section 17(a) of the Securities Act or Section 10(b) of the Exchange Act.<sup>26</sup>

Moreover, when counsel serves as a director of the issuer, potential liability under Section 11 arises. If a material misstatement or omission is contained in the registration statement, the lawyer-director may well have an onerous burden to satisfy his or her due diligence defense. This is particularly true when the lawyer-director has another substantial relationship with the issuer, such as serving as inside or outside general counsel.<sup>27</sup> For exam-

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21. See Section 11(b)(3), 15 U.S.C. § 77K(b)(3) (1988).

22. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 386 n.22 (1983); *Ahern v. Gaussoin*, 611 F. Supp. 1465, 1482 (D. Or. 1985); *Hagert v. Glickman, Lurie, Eiger & Co.*, 520 F. Supp. 1028, 1035 (D. Minn. 1981).

23. *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 683 (S.D.N.Y. 1968).

24. See, e.g., *Quantum Overseas v. Touche Ross & Co.*, 663 F. Supp. 658, 665 (S.D.N.Y. 1987); *In re Flight Transp. Corp. Sec. Litig.*, 593 F. Supp. 612, 616 (D. Minn. 1984); *Hagert v. Glickman, Lurie, Eiger & Co.*, 520 F. Supp. 1028, 1034 (D. Minn. 1981). But see *In re Caesar's Palace Sec. Litig.*, 360 F. Supp. 366, 384 (S.D.N.Y. 1973).

25. *In re Equity Funding Corp. of Am. Sec. Litig.*, 416 F. Supp. 161, 181 (C.D. Cal. 1976). Note, however, that a lawyer or law firm may have "controlling person" liability under Section 15 for violations of Section 11 or 12 of the Securities Act. See *infra* notes 161-175 and accompanying text.

26. See *infra* notes 141-60 and accompanying text for further discussion. Cumulative remedies may be pursued, irrespective whether there is an express right of action available. Hence, an implied right of action under Section 10(b) exists for materially misleading statements contained in a registration statement. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380-86 (1983); *Chemeton Corp. v. Business Funds, Inc.*, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,541 (5th Cir. 1983); Steinberg, *The Propriety and Scope of Cumulative Remedies Under the Federal Securities Laws*, 67 CORNELL L. REV. 557 (1982).

27. See generally *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); Folk,

ple, in the seminal *BarChris* case,<sup>28</sup> in concluding that the director who also served as the company's outside counsel did not meet his due diligence defense, the court reasoned that "more was required of him in the way of reasonable investigation than could fairly be expected of a director who had no connection with this work."<sup>29</sup>

As a final comment, the performance of due diligence frequently is delegated to counsel for the issuer and to counsel for the underwriter(s). When performing such due diligence on a client's behalf, counsel at least must stand in the client's "shoes." In a given situation, "[t]he extensiveness of the investigation appropriate may range from that required of an outside director who has no other affiliation with the issuer to the extensive verification required of underwriters in the traditional public offering setting."<sup>30</sup> As noted above, although not subject to Section 11 liability, counsel conducting such due diligence on a client's behalf may be subject to suit under the securities acts' antifraud provisions. Moreover, negligent performance of due diligence services may render the attorney liable for malpractice.<sup>31</sup>

### B. Section 12

Under certain circumstances, attorneys may find themselves liable as "sellers" under Section 12 of the Securities Act.<sup>32</sup> Pursuant to Section 12(1), a purchaser of securities is entitled to rescission (or damages if the securities are no longer owned by the purchaser) against his or her seller if the seller sells the securities in violation of Section 5.<sup>33</sup> Hence, if Section 5 has been violated (namely, that an exemption from Securities Act registration has not been perfected),<sup>34</sup> the seller ordinarily is subject to strict liability, with the proviso that such defenses as the expiration of the statute of limitations<sup>35</sup> or that the plaintiff is *in pari delicto*<sup>36</sup> may be raised.

The provision more frequently invoked in this context is Section 12(2)

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*Civil Liabilities Under the Federal Securities Acts: The BarChris Case*, 55 VA. L. REV. 1 (1969); discussion *infra* notes 218-28 and accompanying text.

28. *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

29. *Id.* at 690.

30. M. STEINBERG, *supra* note 19, at 113; see T. HAZEN, *THE LAW OF SECURITIES REGULATION* 274-327 (2d ed. 1990); Frerichs, *Underwriter Due Diligence Within the Integrated Disclosure System - If It Isn't Broken, Don't Fix It*, 16 SEC. REG. L.J. 386 (1989); Spanner, *A Litigation Perspective on the Prospectus Preparation Process for an Initial Public Offering*, 16 SEC. REG. L. J. 115 (1988).

31. See discussion in R. MALLEN & J. SMITH, *supra* note 5.

32. 15 U.S.C. § 77i (1988).

33. See, e.g., *Wigand v. Flo-Tek, Inc.*, 609 F.2d 1028, 1035 (2d Cir. 1979) ("If the plaintiff owns the stock, he is entitled to rescission but not damages. If [the] plaintiff no longer owns the stock, he is entitled to damages but not rescission.").

34. Note that the burden of establishing that an exemption from Securities Act registration has been perfected is upon the party seeking to invoke the exemption. See, e.g., *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124-27 (1953).

35. See Section 13 of the Securities Act (Section 12(1) action must be brought "within one year after the violation upon which it is based [and] [i]n no event . . . more than three years after the security was bona fide offered to the public"); *supra* note 14.

36. See *Pinter v. Dahl*, 486 U.S. 622 (1988); *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299 (1985); *Ross v. Bolton*, 904 F.2d 819 (2d Cir. 1990).

which provides a purchaser with an express right of action against his or her seller for rescission (or damages if the purchaser no longer owns the securities)<sup>37</sup> where such purchaser acquired the securities by means of a materially misleading or false statement contained in a prospectus or oral communication. In a Section 12(2) action, proof of reliance need not be shown by the plaintiff.<sup>38</sup> The seller has a "quasi due diligence" defense, signifying that the seller may void liability by showing that he or she did not know, and in the exercise of reasonable care could not have known, of such misrepresentation or omission.<sup>39</sup>

Hence, attorneys may be subject to liability under Section 12 if they are deemed "sellers." Prior to the Supreme Court's decision in *Pinter v. Dahl*,<sup>40</sup> the lower courts had disagreed as to the definition of "seller" under Section 12. While some courts imposed a strict privity requirement,<sup>41</sup> most courts relaxed the privity requirement to some extent. Liability was imposed by a number of courts upon persons as "sellers" for being integrally connected with, or substantially involved in, the transaction.<sup>42</sup>

In *Pinter*, the Supreme Court rejected both of these approaches. While the decision expressly dealt with the definition of "seller" under Section 12(1), it is reasonable to conclude that the Court's analysis applies as well to Section 12(2). In this regard, however, the Court stated:

Decisions under § 12(2) addressing the "seller" question are . . . relevant to the issue presented to us in this case, and, to that extent, we discuss them here. Nevertheless, this case does not present, nor do we take a position on, the scope of a statutory seller for purposes of § 12(2).<sup>43</sup>

Nonetheless, given the statutory framework of Section 12, the lower federal courts have applied the *Pinter* analysis to actions brought under either subsection (1) or (2) of Section 12.<sup>44</sup>

In *Pinter*, the Supreme Court, looking at the language and purpose of Section 12(1), defined "seller" under that provision as extending to one "who

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37. See *supra* note 33.

38. See *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1226 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981) (for recovery purposes under Section 12(2), "a plaintiff need not prove that he ever received the misleading prospectus.").

39. *Id.* See the dissenting opinion to the denial of certiorari, 450 U.S. 1005 (Powell, J. dissenting); M. STEINBERG, *supra* note 7, § 6.02; Comment, "Reasonable Care" in Section 12(2) of the Securities Act of 1933, 48 U. CHI. L. REV. 372 (1981). For the applicable statute of limitations for Section 12(2) actions, see Section 13 of the Securities Act; *supra* note 14.

40. 486 U.S. 622 (1988).

41. See, e.g., *Collins v. Signetics Corp.*, 605 F.2d 110 (3d Cir. 1979); *McFarland v. Memorex Corp.*, 493 F. Supp. 631 (N.D. Cal. 1980).

42. See, e.g., *Davis v. Avco Fin. Servs., Inc.*, 739 F.2d 1057 (6th Cir. 1984); *Croy v. Campbell*, 624 F.2d 709 (5th Cir. 1980).

43. *Pinter*, 486 U.S. at 642 n.20.

44. See, e.g., *In re Craftmatic Sec. Litig.*, 890 F.2d 628, 635-36 (3d Cir. 1989); *Moore v. Kayport Package Express, Inc.*, 885 F.2d 531, 536 (9th Cir. 1989); *Crawford v. Glenss, Inc.*, 876 F.2d 507, 510 (5th Cir. 1989); *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 940 (7th Cir. 1989); *Capri v. Murphy*, 856 F.2d 473, 478 (2d Cir. 1988). *But see* *First Fin. Sav. Bank, Inc. v. American Bankers Ins. Co. of Florida*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶¶ 94,825, 94,835 (E.D.N.C. 1989).

successfully solicits the purchase, motivated at least in part by a desire to serve his own financial interests or those of the securities owner."<sup>45</sup> Hence, for purposes of Section 12(1), a "seller" includes: (1) one who owned the security sold to the purchaser, (2) an agent for a vendor (such as a broker) who successfully solicited the purchase, (3) one who solicited the purchase with the intent to personally benefit thereby, and (4) one who, without financial benefit to himself, solicited the purchase to serve the owner's financial interests.<sup>46</sup>

The Court's construction of "seller" permits at least two groups of "participants" to avoid Section 12(1) primary liability. First, those persons who gratuitously provide advice on investment matters to friends, family members, and acquaintances are not "sellers" so long as they are not motivated by a desire to benefit the securities owner or themselves. Second, securities professionals, such as accountants and lawyers, whose involvement is solely the performance of their professional duties (e.g., counsel rendering solely legal advice to a client), are not "sellers."<sup>47</sup>

Hence, several lower court decisions handed down since *Pinter* have held that counsel who performs solely legal services is not a Section 12 "seller."<sup>48</sup> For example, the Second Circuit has opined: "*Pinter* expressly cautioned that the draconian provisions of Section 12 must not be extended to include lawyers . . . who have performed only their usual professional functions . . ."<sup>49</sup> On the other hand, once counsel communicates to prospective investors regarding the substantive aspects of the offering, the risk of incurring "seller" status arises. "Speaking up the deal" is fraught with danger for counsel. Although "seller" status may not be imposed when counsel merely "passes along" offering documents to potential investors,<sup>50</sup> this is an unnecessary risk for counsel to incur. Even more troubling is when counsel directly solicits potential investors, either by transmitting promotional materials or by oral communication.<sup>51</sup> In such cases, courts will scrutinize

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45. *Pinter*, 486 U.S. at 647-49.

46. *Id.* at 642-49. Compare the pre-*Pinter* decision, *Junker v. Crory*, 650 F.2d 1349 (5th Cir. Unit A July 1981) (attorney whose participation was a substantial factor in causing the transaction to take place deemed a seller for § 12(2) purposes).

47. See authorities cited *infra* notes 48-53.

48. See, e.g., *Moore v. Kayport Package Express, Inc.*, 855 F.2d 531 (9th Cir. 1989); *Wilson v. Saintine Exploration & Drilling Corp.*, 872 F.2d 1124 (2d Cir. 1989); *Abell v. Potomac Ins. Co.*, 858 F.2d 1104 (5th Cir. 1988); *Sellin v. Rx Plus, Inc.*, 730 F. Supp. 1289 (S.D.N.Y. 1990); *Friedman v. Arizona World Nurseries*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,902 (S.D.N.Y. 1990); *Marshall v. Quinn-L Equities, Inc.*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,812 (N.D. Tex. 1989); *Commins v. Johnson & Higgins, Inc.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,092 (N.D. Cal. 1988).

49. *Wilson*, 872 F.2d at 1127; accord *Moore*, 885 F.2d at 537 n.5 ("Courts generally agree that merely performing professional services, without actively soliciting a purchase of the underlying securities, does not give rise to liability under Section 12.")

50. *Moore*, 885 F.2d at 536-37 (attorney mailing of private placement memorandum to prospective investor pursuant to promoter's request "cannot under any view be considered the kind of solicitation necessary under *Pinter*").

51. See *Capri v. Murphy*, 856 F.2d 473 (2d Cir. 1988); *In re Professional Fin. Management, Ltd.*, 692 F. Supp. 1057 (D. Minn. 1988).



the specifics of the attorney's conduct, including the underlying motivation, to ascertain whether counsel solicited the purchase with the intent "to serve his own financial interests or those of the securities owner."<sup>52</sup> Given the ramifications, counsel would be prudent to confine his or her role to solely that of rendering legal services.<sup>53</sup>

The Supreme Court in *Pinter* did not resolve whether secondary liability may be imposed under Section 12.<sup>54</sup> Although a few courts have approved of such liability based largely upon an aiding and abetting rationale,<sup>55</sup> the majority of courts have rejected the imposition of secondary liability as inappropriate under Section 12.<sup>56</sup> Hence, in view of *Pinter* and lower federal court decisions limiting the liability of attorneys under Section 12, plaintiffs alleging federal securities law violations ordinarily must seek relief under Section 10(b) of the Exchange Act. Unlike a Section 12 claim, a plaintiff has a more difficult burden to succeed in a Section 10(b) action, having to prove such elements as the defendant's scienter and causation.<sup>57</sup>

### C. Section 17(a)

Section 17(a) is the Securities Act's antifraud provision.<sup>58</sup> Unlike Section 10(b) of the Exchange Act which applies to deception or manipulation in the purchase or sale of securities, Section 17(a)'s scope is confined to proscribed activity in the offer or sale context. Today, Section 17(a) is invoked most frequently in SEC enforcement actions. This is due to the development that an increasing number of courts decline to recognize the existence of a private right of action under this section.<sup>59</sup>

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52. *Pinter*, 486 U.S. at 647-49. See Voyles & Teeter, *Section 12 Liability: Attorneys Not Completely Off the Hook*, BUS. LAW. UPDATE 7, 10 (Nov.-Dec. 1990) ("Practically speaking, even though the attorney does not receive compensation for his solicitation efforts, any participation in the direct solicitation of potential investors will make it difficult to prove he was not motivated by his own financial interests or those of his client.").

53. For legal scholarship in the aftermath of *Pinter*, see Klock, *Death of a Theory: Pinter v. Dahl and the Scope of Liability Under Section 12(2) of the Securities Act*, 17 SEC. REG. L.J. 408 (1990); Prentice, *Section 12 of the 1933 Act: Establishing the Statutory Seller*, 40 ALA. L. REV. 417 (1989); Reece, *Would Someone Please Tell Me the Definition of the Term "Seller": The Confusion Surrounding Section 12(2) of the Securities Act of 1933*, 14 DEL. J. CORP. L. 35 (1989); Comment, *The Reduction in Seller Liability Under the Securities Act of 1933: Good News for Securities Professionals*, 46 WASH. & LEE L. REV. 629 (1989).

54. *Pinter*, 486 U.S. at 648 n.24.

55. See *deBruin v. Andromeda Broadcasting Sys.*, 465 F. Supp. 1276 (D. Nev. 1979); *In re Caesars Palace Securities Litigation*, 360 F. Supp. 366 (S.D.N.Y. 1973).

56. See, e.g., *In re Craftmatic Sec. Litig.*, 890 F.2d 628 (3d Cir. 1989); *Schlifke v. Seafirst Corp.*, 866 F.2d 935 (7th Cir. 1989); *Wilson v. Saintine Exploration and Drilling Corp.*, 872 F.2d 1124 (2d Cir. 1989); *Davis v. Avco Fin. Servs.*, 739 F.2d 1067 (6th Cir. 1984); *In re Worlds of Wonder Sec. Litig.*, 721 F. Supp. 1140 (N.D. Cal. 1989).

57. See *Significant 1989 Court Decisions*, 45 BUS. LAW. 1281, 1285-86 (1990).

Note that, irrespective of whether aiding and abetting liability may be imposed under Section 12, potential liability as a controlling person pursuant to Section 15 still exists. See, e.g., *In re ZZZZ Best Sec. Litig.*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,881 (C.D. Cal. 1990) (law firm may be liable as a "controlling person"). See *infra* notes 161-75 and accompanying text.

58. 15 U.S.C. § 77q(a) (1988).

59. See, e.g., *Bath v. Bushkin, Gaims, Gains and Jonas*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,458 (10th Cir. 1990); *In re Washington Public Power Supply Securities*

Regarding the scope of Section 17(a), the Supreme Court held in *United States v. Naftalin*<sup>60</sup> that the provision applies to both the initial and secondary trading markets.<sup>61</sup> *Naftalin's* effect thus is to subject fraudulent conduct involving the offer or sale of securities, even if occurring in the aftermarket, to the prohibitions of both Section 10(b) and Section 17(a).<sup>62</sup>

In this regard, the Supreme Court's holding in *Aaron v. SEC*<sup>63</sup> is instructive. There, the Court stated that the Commission need only prove the defendant's negligence for a violation of Section 17(a)(2) or 17(a)(3) (but must establish scienter for a Section 10(b) or Section 17(a)(1) violation).<sup>64</sup> In view of this holding, Section 17(a) arguably becomes a more attractive enforcement weapon to the SEC than Section 10(b) in the "offer or sale" context.<sup>65</sup>

If an enforcement action is instituted against an attorney and if a consent settlement is being negotiated, it may well be in the attorney's interests to seek to limit the violations alleged in the SEC's complaint and accompanying order to those of Section 17(a)(2) and 17(a)(3). Because negligent conduct may constitute a violation of these subsections, the attorney can avoid the adverse impressions of having consented to a violation that contains scienter as a necessary element.<sup>66</sup>

### III. EXCHANGE ACT LIABILITY

Attorneys may be subject to liability under Section 10(b)<sup>67</sup> either as primary violators or as aider and abettors. Principles of aiding and abetting liability are discussed at a later point in this article.<sup>68</sup> Although relatively uncommon, attorneys also may find themselves alleged violators of other Exchange Act provisions, such as Section 14(a).<sup>69</sup>

#### A. Section 10(b)

The most common situation where attorneys may be held liable as primary violators of Section 10(b) and Rule 10b-5<sup>70</sup> is by the rendering of mate-

Litigation, 823 F.2d 1349 (9th Cir. 1987); *Newcome v. Esrey*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,106 (4th Cir. 1988); *Landry v. All American Assurance Co.*, 688 F.2d 381 (5th Cir. 1982); sources cited in Steinberg, *Securities Regulation: Liabilities and Remedies* § 6.03[2] (1991).

60. 441 U.S. 768 (1979).

61. *Id.* at 777-78. The Court also held that the protection afforded by Section 17(a) extends beyond actual purchasers to include financial intermediaries and that the "in" language of the section is sufficiently broad to cover the type of fraud alleged in that case. *Id.* at 772-77.

62. See Steinberg, *Section 17(a) of the Securities Act After Naftalin and Redington*, 68 GEO. L.J. 163 (1979).

63. 446 U.S. 680 (1980).

64. *Id.* at 689-97.

65. See Steinberg, *supra* note 19, at 163.

66. See discussion in M. STEINBERG & R. FERRARA, *supra* note 6, § 3:01 et seq. For further discussion, see *infra* notes 186-202 and accompanying text.

67. 15 U.S.C. § 78j(b) (1988).

68. See *infra* notes 141-60 and accompanying text. Steinberg, *Attorney Liability for Client Fraud*, 1991 COLUM. BUS. L. REV. 1.

69. 15 U.S.C. § 78n(a) (1988).

70. 17 C.F.R. § 240.10b-5 (1990).

rially false or misleading opinion letters.<sup>71</sup> Primary liability also may be imposed where an attorney, by oral communication or other means, makes material misrepresentations and half-truths.<sup>72</sup> A number of these actions seemingly arise in situations when counsel has a financial interest in the venture.<sup>73</sup>

To bring a successful Section 10(b) action, the plaintiff seeking monetary damages must establish several elements, including that: he or she is a purchaser or seller of the securities;<sup>74</sup> manipulation or deception (rather than "solely" breach of fiduciary duty)<sup>75</sup> occurred in connection with the purchase or sale;<sup>76</sup> the misrepresentation or nondisclosure was material;<sup>77</sup> the defendant acted with the requisite scienter,<sup>78</sup> constituting at least "reckless" conduct;<sup>79</sup> when called for, affirmatively prove that the plaintiff relied<sup>80</sup> and exercised due diligence,<sup>81</sup> there exists the requisite causation between the defendant's violation and the plaintiff's loss;<sup>82</sup> and he or she suffered damages and the amount of such damages incurred.<sup>83</sup> In addition, where liability is premised upon silence, the plaintiff must establish that the principal alleged violator breached a duty to disclose.<sup>84</sup> The defendant has a number of defenses, including the expiration of the statute of limitations<sup>85</sup> and equitable defenses, such as laches, waiver, and *in pari delicto*.<sup>86</sup> As an

71. See *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1125 (5th Cir. 1988); *Cronin v. Midwestern Dev. Auth.*, 619 F.2d 856, 862 (10th Cir. 1980); *SEC v. Spectrum, Ltd.*, 489 F.2d 535, 541-42 (2d Cir. 1973).

72. See, e.g., *Levine v. Diamantheset, Inc.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,241 (N.D. Cal. 1989).

73. See, e.g., *Griffin v. McNiff*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,452 (S.D.N.Y. 1990). See also MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.8 (1989); MODEL CODE OF PROFESSIONAL RESPONSIBILITY Disciplinary Rule 5-101 (1980); Nelson, *Firms Reconsider Involvement in Client Ventures*, Legal Times, Dec. 5, 1983, at 28.

74. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

75. See *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).

76. See *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6 (1971); *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 390 (2d Cir. 1984).

77. See *Basic, Inc. v. Levinson*, 48 U.S. 224 (1988); *TSC Indus. Inc. v. Northway, Inc.*, 426 U.S. 438 (1976) (signifying that a reasonable investor would deem such information important in making his or her investment decision).

78. See *Aaron v. SEC*, 446 U.S. 680 (1980); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

79. See, e.g., *Sunstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1039-40 (7th Cir. 1977); discussion *infra* notes 90-101 and accompanying text.

80. See, e.g., *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972).

81. See, e.g., *Dupuy v. Dupuy*, 551 F.2d 1005, 1020 (5th Cir. 1977).

82. See, e.g., *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 239 (2d Cir. 1974).

83. See generally M. KAUFMAN, *SECURITIES LITIGATION: DAMAGES* (1989).

84. See, e.g., *Chiarella v. United States*, 445 U.S. 222 (1980); *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1124-26 (5th Cir. 1988).

85. There is no statute of limitations contained in the Exchange Act that expressly applies to Section 10(b) claims. The Supreme Court resolved this issue in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 111 S. Ct. 2773 (1991). There, the Court adhered to a uniform statute of limitations for Section 10(b) litigation, holding that the action must be initiated within one year after discovery of the facts constituting the violation and in no event more than three years after the violation's occurrence. Moreover, the Court ruled that tolling principles do not apply to the Section 10(b) statute of limitations.

86. See *Pinter v. Dahl*, 486 U.S. 622 (1988); *Bateman Eichler, Hill Richards, Inc. v. Ber-*

additional point, although indemnification has been viewed as frustrating the policies and statutory underpinnings of the securities acts and, hence, is generally prohibited in this context,<sup>87</sup> an overwhelming majority of courts recognize a right to contribution under Section 10(b).<sup>88</sup> The discussion that follows looks at two critical elements of a Section 10(b) action, scienter and reliance.<sup>89</sup>

### 1. *Scienter*

With regard to the requisite mental state for Section 10(b) culpability purposes, the Supreme Court held in *Ernst & Ernst v. Hochfelder*<sup>90</sup> that scienter must be proved in private damages actions. The Court asserted that permitting negligent conduct to be actionable in such suits would "nullify the effectiveness of the carefully drawn procedural restrictions" placed upon express actions created by the securities acts.<sup>91</sup> Insofar as actions brought by the SEC, the Supreme Court subsequently held in the *Aaron* case that "scienter is an element of § 10(b) and Rule 10b-5, regardless of the identity of the plaintiff or the nature of the relief sought."<sup>92</sup>

The Supreme Court defined scienter as "a mental state embracing intent to deceive, manipulate or defraud"<sup>93</sup> which may be established by "knowing or intentional misconduct."<sup>94</sup> Although the Court declined to determine

ner, 472 U.S. 299 (1985); *Hecht v. Harris, Upham & Co.*, 430 F.2d 1202 (9th Cir. 1970); M. STEINBERG, *supra* note 19, at 127-29.

87. See, e.g., *Heizer Corp. v. Ross*, 601 F.2d 300, 304 (7th Cir. 1979) (and cases cited therein).

88. See, e.g., *Huddleston v. Herman & MacLean*, 640 F.2d 534 (5th Cir. Unit A March 1981), *aff'd on other grounds*, 459 U.S. 375 (1983); *Laventhol, Krekstein, Horwath & Horwath v. Horwath*, 637 F.2d 672 (9th Cir. 1980); see *Goodman, Belgium & McDonald, Contribution and Partial Settlement in Federal Securities Cases*, 4 *INSights* No. 5, at 15 (May 1990); *Loewenstein, Implied Contribution Under the Federal Securities Laws: A Reassessment*, 1982 *DUKE L.J.* 543 (1982); *Comment, Allocation of Damages Under the Federal Securities Laws*, 60 *WASH. U.L.Q.* 211 (1982).

Note that Section 11(f) of the Securities Act contains an express right to contribution. On the other hand, some recent cases decline to imply a right of contribution under Section 12(2). See, e.g., *Baker, Watts & Co. v. Miles & Stockridge*, 876 F.2d 1101 (4th Cir. 1989) (and cases cited therein).

89. For a superb analytical treatise of Section 10(b), see A. BROMBERG & L. LOWENFELS, *SECURITIES FRAUD & COMMODITIES FRAUD* (1990).

90. 425 U.S. 185 (1976).

91. *Id.* at 210 (referring to Sections 11, 12(2), and 15 of the Securities Act, Sections 9, 18, and 20 of the Exchange Act).

92. *Aaron v. SEC*, 446 U.S. 680, 691 (1980).

93. *Hochfelder*, 425 U.S. at 193 n.12.

94. *Id.* at 197. Note that in bringing such actions, plaintiff's counsel should be careful to avoid Rule 11 sanctions under the Federal Rules of Civil Procedure. Such sanctions have been levied against counsel instituting non-meritorious securities fraud actions on behalf of their clients. See *Crookam v. Riley*, [1990 Transfer Binder] *Fed. Sec. L. Rep. (CCH)* ¶ 95,479 (8th Cir. 1990); *MacMillan, Inc. v. American Express Co.*, [1989 Transfer Binder] *Fed. Sec. L. Rep. (CCH)* ¶ 94,368 (S.D.N.Y. 1989); *Feinman v. Schulman Berlin & Davis*, [1988-1989 Transfer Binder] *Fed. Sec. L. Rep. (CCH)* ¶ 94,184 (S.D.N.Y. 1989); *Storage Technology Partners II v. Storage Technology Corp.*, [1987-1988 Transfer Binder] *Fed. Sec. L. Rep. (CCH)* ¶ 93,580 (D. Colo. 1988). See also *Pavelic & LeFlore v. Marvel Entertainment Group*, 493 U.S. 120 (1989) (holding that Rule 11 sanctions may be levied only against the individual lawyer signing the motion or pleading and not the lawyer's firm).

whether reckless conduct provided the requisite scienter under Section 10(b),<sup>95</sup> the lower federal courts have nearly unanimously held that primary liability may be predicated on such culpability. Although a number of formulations have been espoused,<sup>96</sup> the majority view adheres to the "highly reckless" standard.<sup>97</sup> Under this standard, conduct is deemed reckless so as to constitute scienter if such conduct represents "an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it."<sup>98</sup>

An application of this standard may be seen from the Third Circuit's decision in *Eisenberg v. Gagnon*.<sup>99</sup> In the opinion letter context, an attorney is reckless within the meaning of Section 10(b) "[w]hen the opinion [rendered] is based on underlying materials which on their face or under the circumstances suggest that they cannot be relied on without further inquiry . . ."<sup>100</sup> In such circumstances, counsel's "failure to investigate further may support an inference that [at the time counsel] expressed the opinion [such attorney had] no genuine belief that [he or she] had the information on which [to] predicate that opinion."<sup>101</sup>

## 2. Reliance

Turning to Section 10(b)'s reliance requirement, this element has surfaced as an issue in several attorney liability cases.<sup>102</sup> In *Affiliated Ute Citizens v. United States*,<sup>103</sup> the Supreme Court held that, in a case involving primarily a failure to disclose, "positive proof of reliance is not a prerequisite to recovery."<sup>104</sup> As interpreted by subsequent courts, upon proof of the materiality of the nondisclosure,<sup>105</sup> the plaintiff enjoys a presumption of reliance which can be rebutted by the defendant.<sup>106</sup> This presumption applies only to omission cases, thereby requiring the plaintiff normally to prove reliance in cases

95. *Hockfelder*, 425 U.S. at 193 n.12.

96. *See, e.g.*, *Lanza v. Drexel & Co.*, 418 F.2d 1277, 1306 n.98 (2d Cir. 1973) (en banc).

97. *See, e.g.*, *Hollinger v. Titan Capital Corp.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,500 (9th Cir. 1990) (en banc) (collecting cases).

98. *Id.* at 97,595 (quoting *Sunstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1039-40 (7th Cir. 1977)).

99. 766 F.2d 770 (3d Cir. 1985).

100. *Id.* at 776.

101. *Id.*

102. *See, e.g.*, *DuPont v. Brady*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,376 (2d Cir. 1987); *T.J. Rainey & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Auth.*, 717 F.2d 1330 (10th Cir. 1983); *Roberts v. Heim*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,431 (N.D. Cal. 1990); *Cammer v. Bloom*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,211 (D.N.J. 1990).

103. 406 U.S. 128 (1972).

104. *Id.* at 153-54. Note that such reliance must be reasonable. *See Roberts v. Heim*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,431 (N.D. Cal. 1990) (sophisticated investor could reasonably rely on opinions rendered by a law firm in a confidential offering memorandum).

105. *See, e.g.*, *Kramer v. Security Gas & Oil, Inc.*, 672 F.2d 766, 769 (9th Cir. 1982).

106. *See, e.g.*, *DuPont v. Brady*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,376 (2d Cir. 1987) (applying principle in case involving defendant law firm).

involving affirmative misrepresentation.<sup>107</sup> In this regard, although most courts have found the presumption appropriate in cases of "half-truths" under Rule 10b-5(2),<sup>108</sup> a few courts hold a contrary view. For example, in *Huddleston v. Herman & MacLean*,<sup>109</sup> the Fifth Circuit held that the presumption of reliance in the plaintiff's favor applies only to cases involving "primarily a failure to disclose, implicating the first or third subparagraph of . . . Rule [10b-5] [and not to cases involving] primarily a misstatement or failure to state a fact necessary to make those statements not misleading, classified under the second subparagraph of the Rule."<sup>110</sup>

The *Huddleston* analysis appears misplaced. Looking at the language of Rule 10b-5(2), the omission component of a half-truth is the principal element. Moreover, for a court to determine whether each individual case involves primarily half-truths or "pure" nondisclosures would necessarily present a difficult procedural task. These cases would frequently involve conjecture, the very consequence the *Affiliated Ute* presumption rationale was intended to avoid.<sup>111</sup> Lastly, in many cases, the burden placed on a plaintiff to show positive proof of reliance would be equally as rigorous irrespective of whether pure nondisclosures or half-truths are implicated. Accordingly, pure nondisclosures and half-truths should be deemed equivalent for Rule 10b-5 presumption of reliance purposes.<sup>112</sup>

Plaintiffs also may enjoy a presumption of reliance by invoking the "fraud on the market" theory. This theory postulates that investors assume that the market price of a security is determined by the available material information and that no unsuspected fraudulent conduct has affected the price. The use of this theory to apply a rebuttable presumption of reliance received Supreme Court approbation in *Basic, Inc. v. Levinson*.<sup>113</sup>

In *Basic*, the Court quoted a lower court decision which explained the rationale of the fraud on the market theory in the following terms:

In face-to-face transactions, the inquiry into an investor's reliance upon information is into the subjective pricing of that information by that investor. With the presence of a market, the market is interposed between seller and buyer and, ideally, transmits information to the inves-

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107. See, e.g., *Gower v. Cohn*, 643 F.2d 1146, 1157 (5th Cir. Unit B May 1981).

108. See, e.g., *Continental Grain, Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409, 411-12 (8th Cir. 1979); *Holmes v. Bateson*, 583 F.2d 545, 558 (1st Cir. 1978); *Chelsea Assocs. v. Rapanos*, 527 F.2d 1266, 1271-72 (6th Cir. 1975).

109. 640 F.2d 534 (5th Cir. Unit A March 1981), *aff'd on other grounds*, 459 U.S. 375 (1983).

110. *Id.* at 548. *Accord* *Cavalier Carpets, Inc. v. Caylor*, 746 F.2d 749 (11th Cir. 1984).

111. See Memorandum of the SEC, *Amicus Curiae*, on Petition for Rehearing and Rehearing en Banc at 21-24, *Huddleston v. Herman & MacLean*, 640 F.2d 534 (5th Cir. 1981). See generally Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584 (1975).

112. Moreover, the plaintiff may satisfy this requirement through "indirect" or "third party" reliance. See, e.g., *Panzirer v. Wolf*, 663 F.2d 365, 367 (2d Cir. 1981), *vacated as moot*, 459 U.S. 1027 (1982) ("We find no support in the law for the district court's distinction between primary and secondary reliance."); *Walsh v. Butcher & Sherrerd*, 452 F. Supp. 80 (E.D. Pa. 1978).

113. 485 U.S. at 242-49.

tor in the processed form of a market price. Thus the market is performing a substantial part of the valuation process performed by the investor in a face-to-face transaction. The market is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.<sup>114</sup>

The Supreme Court's decision in *Basic* recognized the reality of the modern securities markets involving the trading of hundreds of millions of shares on a daily basis, and that most ordinary investors do not read corporate reports or press releases. Acknowledging the presence of impersonal trading markets, the Court relied in part on economic theory and empirical studies to support its holding. In so ruling, the Court promoted the use of the class action to redress Section 10(b) violations. If the Court had required positive proof of individualized reliance from each plaintiff, individual issues may have predominated over the common ones, thereby precluding the pursuit of class actions in this context. Hence, the Court's decision looked to policy grounds as well to help ensure that ordinary investors have a viable recourse when they are defrauded in the impersonal trading markets.<sup>115</sup> Accordingly, the Court concluded:

An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.<sup>116</sup>

Post-*Basic*, the fraud on the market theory has been frequently invoked by the lower courts.<sup>117</sup> As seen from both the majority opinion and Justice White's dissent,<sup>118</sup> however, the presumption of reliance is rebuttable. For example, in the *Apple Computer Securities Litigation*,<sup>119</sup> the Ninth Circuit concluded that the materially misleading statements had been corrected in the market due to extensive coverage by the press. Hence, because the press had comprehensively documented problems with the products manufactured by the defendant, the information was made "credibly available" to the market by other sources.<sup>120</sup>

A more expansive version of the fraud on the market theory applies the

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114. *Id.* at 990 (quoting *In re LTV Sec. Litig.*, 88 F.R.D. 134, 143 (N.D. Tex. 1980)).

115. *Basic*, 485 U.S. at 242-49.

116. *Id.* at 246-49.

117. *See, e.g.*, *Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356 (5th Cir. 1987), *cert. denied* 485 U.S. 959 (1988); *Steiner v. Southmark Corp.*, 734 F. Supp. 269 (N.D. Tex. 1990) (alleged accountant liability); *Cytryn v. Cook*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,409 (N.D. Cal. 1990); *Cammer v. Bloom*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,211 (D.N.J. 1990) (alleged attorney liability).

118. *See Basic*, 485 U.S. at 253-57. (White, J., concurring in part and dissenting in part).

119. *In re Apple Computer Sec. Litig.*, 886 F.2d 1109 (9th Cir. 1989).

120. *Id.* at 1115. The court nonetheless stressed the limits of its holding: "In order to avoid Rule 10b-5 liability, any material information which insiders fail to disclose must be transmitted to the public with a degree of intensity and credibility sufficient to effectively counterbalance any misleading impression created by the insiders' one-sided representations." *Id.* at 1116. *See also Freeman v. Laventhol & Horwath*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,490 (6th Cir. 1990) (refusing to apply theory because security was not traded in an effective market).

theory to the offering context where no active trading market exists for the issuer's stock. The leading case is *Shores v. Sklar*<sup>121</sup> in which the Fifth Circuit sitting *en banc* adopted the theory, with ten judges dissenting. The Supreme Court has yet to rule on the theory's validity in this context.

In *Shores*, the plaintiff purchased bonds without reading the offering circular. He alleged in a Section 10(b) cause of action that the defendants had perpetrated a fraudulent scheme on the investment community by bringing unmarketable securities onto the open market. Invoking the fraud on the market theory, the court held that an investor is entitled to rely on the integrity of the market to the extent that the securities offered for sale are entitled to be in the market place. To recover under this theory, the plaintiff must establish that the bonds would never have been issued or marketed. Proof that the bonds would have been offered at a lower price is not sufficient.<sup>122</sup> Thus, "the fraudulent scheme [must be] so pervasive that without it the issuer would not have issued, the dealer could not have dealt in, and the buyer could not have bought [the securities], because they would not have been offered at any time."<sup>123</sup> A number of courts subsequent to *Shores*, including in cases involving attorneys as defendants,<sup>124</sup> have adopted that decision's rationale.<sup>125</sup>

### B. Other Exchange Act Provisions

Although of far less frequent application, attorneys may be subject to liability under other provisions of the Exchange Act. For example, Section 18(a)<sup>126</sup> provides for an express damages remedy when an investor purchases or sells a security in reliance upon a materially false or misleading statement that is contained in a report or document filed with the SEC under the Exchange Act, with the proviso that such statement affects the price of the security.<sup>127</sup> "Because of Section 18(a)'s strict reliance and causation requirements, a suit based solely on Section 18(a) evidently has never succeeded."<sup>128</sup> Nonetheless, given that an increasing number of investors are receiving a registrant's Annual Report on Form 10-K, it is plausible that a legal opinion contained in such a document may give rise to liability, pro-

121. 647 F.2d 462 (5th Cir. May 1981) (*en banc*).

122. *Id.* at 469-71.

123. *Id.* at 464 n.2.

124. See, e.g., *T.J. Raney & Sons, Inc. v. Fort Cobb, Oklahoma Irrigation Fuel Auth.*, 717 F.2d 1330 (10th Cir. 1983); *Rose v. Arkansas Valley Envtl. Util. Auth.*, 562 F. Supp. 1180 (W.D. Mo. 1983). See also *Abell v. Potomac Ins. Co.*, 858 F.2d 1104 (5th Cir. 1988) (fraud-on-the-market theory not applied as *Shores* criteria not met).

125. See, e.g., *Ross v. Bank S., N.A.*, 885 F.2d 723 (11th Cir. 1989); *Gorsey v. I.M. Simon & Co.*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,996 (D. Mass. 1990); *Stinson v. Van Valley Dev. Corp.*, 719 F. Supp. 362 (E.D. Pa. 1989). But see *Peil v. Speiser*, 806 F.2d 1154, 1161 n.10 (3d Cir. 1986) ("While this presumption [of reliance] is plausible in developed markets, it may not be in the case of a newly issued stock."). See generally Carney, *The Limits of the Fraud on the Market Theory*, 44 BUS. LAW. 1259 (1989).

126. 15 U.S.C. § 78r(a) (1988).

127. Section 18(a) contains a "good faith" defense. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 211-12 n.31 (1976).

128. M. STEINBERG, *supra* note 19, at 142 n.90.



vided, of course, that the requirements of Section 18(a) are satisfied.<sup>129</sup>

Other remedies include Sections 14(a), 14(e), 20(a), and 29(b).<sup>130</sup> Of these remedies in the attorney liability context, Section 14(a), other than Section 20(a), is likely to be the one most frequently invoked. Section 14(a) and, more particularly Rule 14a-9<sup>131</sup> promulgated thereunder, proscribe the solicitation of proxies which contain materially false or misleading statements. As the Supreme Court has held, there exists a private right of action under Section 14(a) and Rule 14a-9.<sup>132</sup> Generally, provided that the materiality of the misstatement or omission is shown and that such misstatement or omission had "a significant propensity to affect the voting process," individual proof of reliance is not required.<sup>133</sup>

Opinions rendered by attorneys may be contained in proxy statements and thereby come within Section 14(a)'s reach. The attractiveness of the Section 14(a) remedy, even in situations where Section 10(b) may be invoked, is that a number of courts hold that negligent conduct is sufficient for culpability purposes.<sup>134</sup> This view is by no means unanimous. For example, the Sixth Circuit, in requiring that scienter be proven in a Section 14(a) action against accountants, reasoned:

Federal courts created the private right of action under Section 14, and they have a special responsibility to consider the consequences of their rulings and to mold liability fairly to reflect the circumstances of the parties. Although we are not called on in this case to decide the standard of liability of the corporate issuer of proxy material, we are influenced by the fact that the accountant here, unlike the corporate issuer,

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129. Note that this analysis also would apply when such opinions are contained in proxy statements filed with the SEC. In such cases, however, a plaintiff would prefer to invoke the more attractive Section 14(a) remedy. See *infra* notes 132-36 and accompanying text.

130. See 15 U.S.C.A. §§ 78n(a), (c), 78t(a), 78cc(b) (West 1981 & Supp. 1991). Section 14(e) prohibits deceptive conduct in connection with a tender offer. Section 29(b) provides for a right of rescission in certain situations. Section 20(a) deals with controlling person liability and is discussed *infra* notes 161-75 and accompanying text. See M. STEINBERG, *supra* note 7, §§ 9.03[7], 9.03[8], 11.08[3].

131. 17 C.F.R. 240.14a-9 (1991).

132. *J. I. Case v. Borak*, 377 U.S. 426 (1964). See *Virginia Bankshares, Inc. v. Sandberg*, 111 S. Ct. 2749 (1991).

133. *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 384-85 (1970). With respect to the issue of causation, see *Virginia Bankshares, Inc. v. Sandberg*, 111 S. Ct. 2749 (1991).

134. See, e.g., *Shidler v. All Am. Life & Fin. Corp.*, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,326 (8th Cir. 1985); *Gould v. American-Hawaiian S.S. Co.*, 535 F.2d 761, 777-78 (3d Cir. 1976); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1300-01 (2d Cir. 1973). For example, the Third Circuit in *Gould* reasoned:

The language of Section 14(a) and Rule 14a-9(a) contains no suggestion of a scienter requirement, merely establishing a quality standard for proxy material. The importance of the proxy provision to informed voting by shareholders has been stressed by the Supreme Court, which has emphasized the broad remedial purpose of the section, implying a need to impose a high standard of care on the individuals involved. And, unlike Sections 10(b) and 18 of the Act, which encompass activity in numerous and diverse areas of securities markets and corporate management, Section 14(a) is specially limited to materials used in soliciting proxies. Given all of these factors the imposition of a standard of due diligence as opposed to actual knowledge or gross negligence is quite appropriate.

*Gould*, 535 F.2d at 777-78.

does not directly benefit from the proxy vote and is not in privity with the stockholder. Unlike the corporate issuer, the preparation of financial statements to be appended to proxies and other reports is the daily fare of accountants, and the accountant's potential liability for relatively minor mistakes would be enormous under a negligence standard.<sup>135</sup>

Nonetheless, a number of courts disagree with the Sixth Circuit's rationale and apply a negligence standard against all primary defendants in a Section 14(a) action, including professionals.<sup>136</sup>

#### IV. SECONDARY LIABILITY

Secondary liability may be imposed against attorneys and their law firms in both private suits and SEC enforcement actions. Aiding and abetting principles normally arise in the Section 10(b) setting and less frequently under Section 17(a).<sup>137</sup> Occasionally, conspiracy is also alleged.<sup>138</sup> Law firms must also be wary of being charged with controlling person<sup>139</sup> and *respondeat superior* liability.<sup>140</sup>

##### A. Aiding and Abetting Liability

Although the Supreme Court has thus far declined to resolve the issue,<sup>141</sup> the lower federal courts have universally held that aiding and abetting liability is appropriate under the federal securities laws.<sup>142</sup> Although the exact content of the various elements giving rise to aiding and abetting liability is still being refined by the courts,<sup>143</sup> the cases generally set forth three prerequisites to the imposition of such liability:

(1) the existence of a securities law violation by the primary (as opposed to the aiding and abetting) party;

135. *Adams v. Standard Knitting Mills*, 623 F.2d 422, 428 (6th Cir. 1980); *accord Zatkin v. Primuth*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,832 (S.D. Cal. 1982).

136. *See Herskowitz v. Nutri/System, Inc.*, 857 F.2d 179 (3d Cir. 1988) (negligence standard applied to fairness opinion furnished by investment banker); *see also Bertoglio v. Texas Int'l Co.*, 488 F. Supp. 630 (D. Del. 1980); Comment, *Proxy Regulation: Ensuring Accurate Disclosure Through a Negligence Standard*, 56 NOTRE DAME LAW. 579 (1981).

Note that, if solely injunctive relief is sought in the proxy context, a court may order such relief based on the objective sufficiency of the disclosure document(s). *See Ash v. LFE Corp.*, 525 F.2d 215, 220 (3d Cir. 1975).

137. *See infra* notes 141-60, 191-202 and accompanying text.

138. *See, e.g., Danca v. Wakefield Ready-Mixed Concrete Co., Inc.*, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,361 (D. Mass. 1987) (lawyer may be held as a conspirator in connection with an alleged securities fraud).

139. *See infra* notes 161-75 and accompanying text. Note that individual lawyers also may be held liable as controlling persons if they, for example, are deemed to control the defendant board of directors.

140. *See infra* notes 176-85 and accompanying text.

141. *See, e.g., Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 191 n.7 (1976).

142. *See, e.g., SEC v. Washington County Util. Dist.*, 676 F.2d 218, 223-27 (6th Cir. 1982); *SEC v. Falstaff Brewing Corp.*, 629 F.2d 62, 72 (D.C. Cir. 1980); *ITT v. Cornfield*, 619 F.2d 909, 922 (2d Cir. 1980).

143. *See* the different formulations discussed in Bromberg & Lowenfels, *Aiding and Abetting Securities Fraud: A Critical Examination*, 52 ALBANY L. REV. 637, 661-68 (1988); *infra* note 144.

- (2) "knowledge" of this violation on the part of the aider and abettor; and  
 (3) "substantial assistance" by the aider and abettor in the achievement of the primary violation.<sup>144</sup>

Securities attorneys all too often find themselves alleged to be aiders and abettors of their client's or a third party's securities fraud.<sup>145</sup> With respect to whether the alleged aider and abettor had the requisite "knowledge" for culpability purposes, several courts hold that reckless conduct suffices where there is a fiduciary or comparable duty owed to the complainant.<sup>146</sup> On the other hand, according to some courts, where no such duty exists, the imposition of aider and abettor liability "requires something closer to an actual intent to aid in a fraud."<sup>147</sup> Nonetheless, recklessness may suffice where the alleged aider and abettor derives economic benefits from the wrongdoing<sup>148</sup> or has reason to foresee that third parties will be relying on his or her conduct.<sup>149</sup>

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144. *ITT v. Cornfield*, 619 F.2d 909, 922 (2d Cir. 1980); see *Manufacturers Hanover Trust Co. v. Drysdale Sec. Corp.*, 801 F.2d 13 (2d Cir. 1986). For a somewhat different formulation applied by several courts, see *SEC v. Coffey*, 493 F.2d 1304 (6th Cir. 1974): "[A] person may be held as an aider and abettor only if some other party has committed a securities law violation, if the accused party had general awareness that his role was part of an overall activity that is improper, and if the accused aider-abettor knowingly and substantially assisted the violation." *Id.* at 1316. See *SEC v. Rogers*, 790 F.2d 1450 (9th Cir. 1986); *Clery v. Perfettune, Inc.*, 700 F.2d 774, 778-80 (1st Cir. 1983).

The Seventh Circuit apparently has the most restrictive standard for imposing aiding and abetting liability. See *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 495 (7th Cir. 1986) (requiring the plaintiff to "show that each person alleged to be an aider, abettor, or conspirator himself committed one of the 'manipulative or deceptive' acts or otherwise met the standards of direct liability"). For a critical assessment of the Seventh Circuit's approach, see Feldman, *The Breakdown of Securities Fraud Aiding or Abetting Liability: Can a Uniform Standard Be Resurrected?*, 19 SEC. REG. L.J. 45 (1991).

145. For fairly recent cases involving lawyers alleged to be aiders and abettors under Section 10(b), see, e.g., *Renovitch v. Kaufman*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,313 (7th Cir. 1990); *Moore v. Kayport Package Express, Inc.*, 885 F.2d 531 (9th Cir. 1989); *Abell v. Potomac Ins. Co.*, 858 F.2d 1104 (5th Cir. 1988); *Moore v. Fenex, Inc.*, 809 F.2d 297 (6th Cir. 1987); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490 (7th Cir. 1986); *Mercer v. Jaffe, Snider, Raitt and Heuer, P.C.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,455 (W.D. Mich. 1990); *Ackerman v. Schwartz*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,009 (N.D. Ind. 1990); *In re National Smelting of New Jersey, Inc. Bondholders' Litig.*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,898 (D.N.J. 1990); *Shumate v. McNiff*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,897 (S.D.N.Y. 1990); *In re Citisource, Inc. Sec. Litig.*, 694 F. Supp. 1069 (S.D.N.Y. 1988); *SEC v. Electronics Warehouse, Inc.*, 689 F. Supp. 53 (D. Conn. 1988), *aff'd*, 891 F.2d 457 (2d Cir. 1989); *Lubin v. Sybedon Corp.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,934 (S.D. Cal. 1988); *Andreo v. Friedlander, Gaines, Cohen, Rosenthal & Rosenberg*, 660 F. Supp. 1362 (D. Conn. 1987).

146. See, e.g., *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 44 (2d Cir. 1988). A comparable duty, for example, exists where the alleged aider and abettor owes a disclosure obligation to the complainants. See *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1126 (5th Cir. 1988); *SEC v. Electronics Warehouse, Inc.*, 689 F. Supp. 53, 60 (D. Conn. 1988), *aff'd*, 891 F.2d 457 (2d Cir. 1989) ("Where there is a duty of disclosure to the defrauded party, reckless conduct satisfies the scienter requirement for aider and abettor liability.") (citing cases).

147. See, e.g., *Edwards & Hanley v. Wells Fargo Sec. Clearance Corp.*, 602 F.2d 478, 485 (2d Cir. 1979).

148. See, e.g., *Walck v. American Stock Exch., Inc.*, 687 F.2d 778, 791 n.18 (3d Cir. 1982).

149. See, e.g., *Oleck v. Fischer*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,898

For example, in one such case involving attorneys charged with aiding and abetting under Section 10(b), the court asserted that "it is reasonably foreseeable that investors would rely on the expertise of the professionals that draft offering memoranda and tax opinions."<sup>150</sup> As a consequence, the defendant attorneys assumed "the obligation to not act in reckless disregard of the truth when they [undertook] the drafting of such documents."<sup>151</sup> In another case, the court concluded that attorneys are subject to liability as aiders and abettors on a recklessness standard "if it is reasonably foreseeable that potential investors will rely on documents they draft, they omit material information or include erroneous information in reckless disregard of the truth."<sup>152</sup> The courts also have made clear, however, that merely preparing offering documents or serving as special counsel does not by itself warrant an inference that the attorney acted with the requisite degree of reckless conduct sufficient to impose liability.<sup>153</sup>

In those jurisdictions where there must exist a fiduciary or comparable duty in order to impose liability on an aider and abettor for reckless conduct, plaintiffs frequently will have a difficult task in successfully bringing Section 10(b) actions against attorneys (unless such attorneys themselves engaged in misrepresentations and omissions, such as in the issuance of a fraudulent opinion letter).<sup>154</sup> Where an attorney in these jurisdictions owes no duty to the complainant and performs solely his or her normal tasks "constituting the daily grist of the mill,"<sup>155</sup> conscious intent to aid the violation must be shown.<sup>156</sup> As the Fifth Circuit stated in *Abell v. Potomac Insurance Co.*,<sup>157</sup> where the defendant law firm owed no independent duty to the plaintiff and rendered only customary legal services, clear proof of intent to violate the securities law must be shown.<sup>158</sup> To establish such intent, plaintiffs must

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(S.D.N.Y. 1979), *aff'd on other grounds*, 623 F.2d 791 (2d Cir. 1980); cases cited in notes 150-153 *infra*.

150. *Andreo v. Friedlander, Gaines, Cohen, Rosenthal & Rosenberg*, 660 F. Supp. 1362, 1368 (D. Conn. 1987).

151. *Id.*

152. *SEC v. Electronics Warehouse, Inc.*, 689 F. Supp. 53, 60 (D. Conn.), *aff'd*, 891 F.2d 457 (2d Cir. 1989) (citing *Morgan v. Prudential Group, Inc.*, 527 F. Supp. 957, 961 (S.D.N.Y. 1981), *aff'd*, 729 F.2d 1443 (2d Cir. 1983) (attorney alleged as aider and abettor)).

153. *See In re Citisource, Inc. Sec. Litig.*, 694 F. Supp. 1069, 1083 (S.D.N.Y. 1988) (observing that although "a certain degree of involvement in the affairs of an issuer and/or its principals might warrant . . . an inference [of recklessness], the mere fact of one's status as special counsel does not, by itself, indicate that degree") (citing *Vereins-Und Westbank AG v. Carter*, 639 F. Supp. 620 (S.D.N.Y. 1986)); *Mendelsohn v. Capital Underwriters, Inc.*, 490 F. Supp. 1069 (N.D. Cal. 1979).

154. *See, e.g., Renovitch v. Kaufman*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,313 (7th Cir. 1990); *Abell v. Potomac Ins. Co.*, 858 F.2d 1104 (5th Cir. 1988); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490 (7th Cir. 1986).

155. *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 96 (5th Cir. 1975).

156. *Id.* at 97 ("Conversely, if the method or transaction is atypical or lacks business justification, it may be possible to infer the knowledge necessary for aiding and abetting liability." In addition, "the assistance must be substantial before liability can be imposed under [Rule] 10b-5.").

157. 858 F.2d 1104 (5th Cir. 1988).

158. *Id.* at 1127-28.

prove more than that danger signs were ignored.<sup>159</sup> Given the difficulty of proving such conscious intent, the *Abell* decision should please the defense bar.<sup>160</sup>

### B. Controlling Person Liability

Individual attorneys and law firms may be held liable as "controlling persons" under the federal securities laws. For example, law firms and individual partners, depending on the circumstances, may be deemed controlling persons of fellow lawyers in such firms who commit primary violations.<sup>161</sup> Moreover, counsel may be deemed a controlling person because of the influence he or she exerts over certain primary defendants, such as members of a company's board of directors.<sup>162</sup> Likewise, a particular issuer may be under the control of a law firm.<sup>163</sup> However, it should be recognized that the circumstances in which attorneys that provide legal advice and draft disclosure documents are held to be controlling persons of their clients and affiliated persons should be rare. This is due to the fact, as recognized by the Seventh Circuit, that the "ability to persuade and give counsel is not the same thing as 'control,' which almost always means the practical ability to direct the actions" of the persons given such legal advice.<sup>164</sup>

Turning to the applicable legal standards, Section 15 of the Securities Act imposes joint and several liability on any person who controls a person liable under Section 11 or 12 "unless the controlling person had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."<sup>165</sup> Section 20(a) of the Exchange Act provides that "every person who . . . controls any person liable under any provision of this title . . . shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."<sup>166</sup> As has been pointed out, "[t]he reason for this difference in language is hard to fathom, especially since Section 15 of the 1933 Act was amended in the bill which enacted the

159. *Id.* at 1128.

160. See generally Bromberg & Lowenfels, *Aiding and Abetting Securities Fraud: A Critical Examination*, 52 ALBANY L. REV. 637 (1988); Humphreys, *Aiding and Abetting Liability of Accountants in Securities Fraud Cases*, 17 SEC. REG. L.J. 375 (1990); Kuehnle, *Secondary Liability Under the Federal Securities Laws - Aiding and Abetting, Conspiracy, Controlling Person and Agency: Common-Law Principles and the Statutory Scheme*, 14 J. CORP. L. 313 (1988).

161. See generally *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945 (5th Cir. Feb. 1981). Law firms should be especially careful in the insider trading context. See *infra* notes 221-230 and accompanying text.

162. See, e.g., *Seidel v. Public Serv. Co. of New Hampshire*, 616 F. Supp. 1342 (D.N.H. 1985).

163. See, e.g., *In re ZZZZ Best Sec. Litig.*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,881 (C.D. Cal. 1990).

164. *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 494 (7th Cir. 1986).

165. 15 U.S.C. § 77o (1988).

166. 15 U.S.C. § 78c(a) (1988 & Supp. I 1989).

1934 Act, and harder still to interpret."<sup>167</sup>

The term "control" is not defined in the securities acts. Pursuant to rule, however, the SEC has defined the term to encompass "the possession, directly or indirectly, of the power to cause the direction of the management and policies of a person . . ." <sup>168</sup> The courts are generally in accord with this standard. Hence, the Fifth Circuit held that control was established when the defendant "had the requisite power to directly or indirectly control or influence corporate policy."<sup>169</sup> Examining the case law in other circuits, the Third Circuit similarly opined that, in determining whether one is a controlling person, the courts "have given heavy consideration to the power or potential power to influence and control the activities of a person as opposed to the actual exercise thereof."<sup>170</sup>

As stated above, Section 20(a) absolves the controlling person of liability if he or she acted in good faith and did not directly or indirectly induce the violation. The statutory language appears clear in placing the burden of proof on the controlling person to establish the good faith defense. This view has been overwhelmingly adopted.<sup>171</sup>

The requisite conduct sufficient to meet the good faith defense should depend on the particular facts and circumstances.<sup>172</sup> Although negligence is not sufficient to impose liability,<sup>173</sup> a more relaxed form of reckless conduct should suffice.<sup>174</sup> In determining whether the controlling attorney or law firm acted "recklessly," the courts should look to the customary norms and realistic practicalities of the legal profession.<sup>175</sup>

### C. Respondeat Superior Liability

Under the common law doctrine of *respondeat superior*, a principal is liable for the torts committed by its employee when such agent acts within the course and scope of his or her employment and with actual or apparent authority.<sup>176</sup> The issue arises whether this common law principle is an appro-

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167. R. JENNINGS & H. MARSH, *SECURITIES REGULATION* 1143 (5th ed. 1982).

168. Rule 405, 17 C.F.R. § 230.405 (1991).

169. *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 958 (5th Cir. Feb. 1981).

170. *Rochez Bros., Inc. v. Rhoades*, 527 F.2d 880, 890-91 (3d Cir. 1975).

171. See, e.g., *Hollinger v. Titan Capital Corp.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,500, at 97,600 (9th Cir. 1990) (en banc) (and cases cited therein) (holding, *inter alia*, that broker-dealer is controlling person of independent contractors and that broker-dealer has burden to show that it "maintained and enforced a reasonable and proper system of supervision and internal control").

172. See Note, *The Burden of Control: Derivative Liability Under Section 20(a) of the Securities Exchange Act of 1934*, 48 N.Y.U. L. REV. 1019, 1036 (1973).

173. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 209 n.28 (1976).

174. See *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 960 (5th Cir. Feb. 1981) ("Under our holding, the degree of recklessness required for liability under the controlling person doctrine is less than for noncontrolling persons under [previous decisions] which spoke of a severe form of recklessness.").

175. See M. STEINBERG, *supra* note 7, § 10.03; Staudt, "Controlling" Securities Fraud: Proposed Liability Standards for Controlling Persons Under the 1933 and 1934 Securities Acts, 72 MINN. L. REV. 930 (1988).

176. See *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1119 (5th Cir.

prate basis for imposing vicarious liability against law firms under the federal securities laws.

Generally speaking, a fairly small number of courts preclude *respondeat superior* liability, reasoning that to hold otherwise would effectively nullify the controlling person provisions.<sup>177</sup> Nonetheless, the overwhelming majority view is that agency principles may be applied to hold employers liable under the securities laws for the proscribed conduct of their employees (while acting within the scope of their employment).<sup>178</sup> *Respondeat superior* liability also has been imposed in SEC administrative<sup>179</sup> and injunctive<sup>180</sup> proceedings.

These courts reason that confining such liability to that provided by the controlling person provisions "would contradict the pervasive application of agency principles in nearly all other areas of the law."<sup>181</sup> As importantly, by enacting the controlling person provisions, Congress intended to supplement, rather than supplant, common law agency principles so as to reach classes of persons who have no agency or employment relationship with the individual who actually committed the proscribed acts.<sup>182</sup>

It bears mentioning that several courts that have embraced the propriety of *respondeat superior* liability thus far have declined to address the application of this doctrine outside of the broker-dealer or similar context.<sup>183</sup> Language contained in a number of decisions, however, indicates that the doctrine of *respondeat superior* may be invoked against law firms based on the actions of its employees in certain situations. For example, the Third Circuit found application of the doctrine appropriate where a stringent duty to supervise employees exists which arises from the investing public's trust and confidence in the firm involved. Hence, in *Sharp v. Coopers &*

1980). See also RESTATEMENT (SECOND) OF AGENCY §§ 219(1), 257, 258, 261; Seavey, *Speculations as to "Respondeat Superior"*, 1934 HARV. LEGAL ESSAYS 433.

177. See, e.g., *Haynes v. Anderson & Strudwick, Inc.*, 508 F. Supp. 1303 (E.D. Va. 1981).

178. See, e.g., *In re Atlantic Fin. Management, Inc. Sec. Litig.*, 784 F.2d 29, 32-34 (1st Cir. 1986); *Henrickson v. Henrickson*, 640 F.2d 880, 887-88 (7th Cir. 1981); *Marbury Management, Inc. v. Kohn*, 629 F.2d 705, 716 (2d Cir. 1980).

An exception to this principle applies in cases arising under Section 20A of the Exchange Act. In such cases, contemporaneous traders seeking damages based on alleged insider trading violations cannot invoke the doctrine of *respondeat superior* against the insider trader's employer, such as a law firm.

179. See, e.g., *In re Suttro Brothers & Co.*, 41 S.E.C. 470 (1963); *In re Cady Roberts & Co.*, 40 S.E.C. 907 (1961); *In re H.F. Schroeder & Co.*, 27 S.E.C. 833 (1948). See also *In re Carter*, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847 (SEC 1981) (law firm not named in the administrative complaint).

180. See, e.g., *SEC v. Management Dynamics, Inc.*, 515 F.2d 801, 812 (2d Cir. 1975).

181. See *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F.2d 1111, 1118 (5th Cir. 1980). Courts also rely on Section 16 of the Securities Act and Section 28(a) of the Exchange Act which provide that the rights and remedies provided by the respective Acts shall be in addition to any and all rights and remedies that may exist at law or in equity.

182. *Id.*

183. See, e.g., *Hollinger v. Titan Capital Corp.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,500 (9th Cir. 1990) (en banc). The language in *Hollinger*, on the other hand, is quite broad. See *id.* at 97,600-01 ("holding that § 20(a) was intended to supplement . . . the common law theory of *respondeat superior* as a basis for vicarious liability in securities cases").

*Lybrand*,<sup>184</sup> the court imposed *respondeat superior* liability upon an accounting firm for a tax opinion letter fraudulently drafted by an employee and ultimately signed by a partner in the partnership name, reasoning:

When the firm's public representations are designed to influence the investing public, the firm should not be shielded from compensating persons who suffered from reckless or knowing acts by its employees. Otherwise, it could immunize itself from liability by constructing a "Chinese wall" between its employees and partners, allowing only the former to draft opinion letters. Partners, with their greater experience and knowledge, would have a strong incentive to avoid using their expertise to benefit the investors to whom opinion letters are directed. This incentive can be reversed only by recognizing an absolute duty on the part of the firm, which acts through its partners, to supervise employees closely whenever its representations are designed to influence the investing public. Protection of investors is, after all, the primary purpose of the securities laws.<sup>185</sup>

## V. SEC ENFORCEMENT

The SEC has instituted both administrative and judicial enforcement actions against attorneys. A number of these actions are addressed earlier in this article.

### A. SEC Actions for Injunctive Relief

The law is clear that the SEC must show more than a violation of the securities laws in order to procure injunctive relief.<sup>186</sup> In addition, the SEC must show a "reasonable likelihood" that, absent the ordering of an injunction, the defendant will engage in future violations.<sup>187</sup> More recently, due to judicial recognition of the adverse collateral consequences that an injunction would impose,<sup>188</sup> courts have been more reluctant to grant such relief.<sup>189</sup> Nonetheless, the SEC has successfully obtained injunctive relief against attorneys in certain situations.<sup>190</sup>

Although the Supreme Court's decision in *Aaron* was briefly addressed

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184. 649 F.2d 175 (3d Cir. 1981).

185. *Id.* at 184. See generally Ferrara & Sanger, *Derivative Liability in Securities Law: Controlling Person Liability, Respondeat Superior, and Aiding and Abetting*, 40 WASH. & LEE L. REV. 1007 (1983); Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CALIF. L. REV. 80 (1981); Marshall, *Control Person Liability*, 13 REV. SEC. REG. 927 (1980).

186. See *Aaron v. SEC*, 446 U.S. 680, 700-01 (1980).

187. See, e.g., *SEC v. Bonastia*, 614 F.2d 908, 912 (3d Cir. 1980).

188. See generally M. STEINBERG & R. FERRARA, *supra* note 6, §§ 5:10-5:13; Andre, *The Collateral Consequences of SEC Injunctive Relief: Mild Prophylactic or Perpetual Hazard?*, 1981 U. ILL. L. REV. 625.

189. See, e.g., *SEC v. Caterinicchia*, 613 F.2d 102 (5th Cir. 1980); Eisenberg, *SEC Injunctive Actions*, 14 REV. SEC. REG. 901 (1987); Steinberg, *SEC and Other Permanent Injunctions - Standards for Their Imposition, Modification and Dissolution*, 66 CORNELL L. REV. 27 (1980).

190. See, e.g., *SEC v. Coven*, 581 F.2d 1020 (2d Cir. 1978); *SEC v. Electronics Warehouse, Inc.*, 689 F. Supp. 53 (D. Conn. 1988), *aff'd*, 891 F.2d 457 (2d Cir. 1989). But see *SEC v. Haswell*, 654 F.2d 698 (10th Cir. 1981), and *SEC v. National Student Mktg. Corp.*, 457 F. Supp. 682 (D.D.C. 1978), where the SEC failed to obtain injunctive relief against the subject



earlier in the article, the case is worthy of further comment. There, the Court held that the SEC must prove scienter in civil enforcement actions to enjoin violations of Section 10(b) of the Exchange Act, Rule 10b-5 promulgated thereunder, and Section 17(a)(1) of the Securities Act, but need not prove scienter for violations of Section 17(a)(2) and 17(a)(3).<sup>191</sup> With respect to the issuance of an injunction "upon a proper showing" for violations of Section 17(a)(2) or 17(a)(3), the Court pointed out that "nothing on the face of § 20(b) of the 1933 Act or § 21(d) of the 1934 Act purports to impose an independent requirement of scienter."<sup>192</sup>

Based on *Aaron* and certain lower court decisions, an argument can be made that if the primary violation does not require scienter, neither does the secondary violation. Two Second Circuit decisions supporting this proposition are *SEC v. Coven*<sup>193</sup> and *SEC v. Spectrum, Ltd.*<sup>194</sup> Both of these cases involved attorneys who had injunctions ordered against them. In view of the "knowledge" requirement for aiding and abetting liability, which apparently requires at least recklessness,<sup>195</sup> these cases may no longer be good law insofar as the requisite mental state is concerned. On the other hand, the Supreme Court in *Aaron* premised its decision on the relevant statutory language. Applying this rationale, an argument may be set forth that scienter is not required in SEC injunctive actions brought against secondary parties for alleged violations of Section 17(a)(2) and 17(a)(3) of the Securities Act as well as other provisions with similar statutory language.<sup>196</sup>

The better approach is that, in all practicality, injunctions issued against attorneys normally should be based on at least reckless conduct, irrespective of the statutory provision violated. As the *Aaron* court pointed out, "the degree of intentional wrongdoing evident in a defendant's past conduct" is an important factor in determining whether the SEC has "establish[ed] a sufficient evidentiary predicate to show that such future violation may occur."<sup>197</sup> The presence or lack of scienter is "one of the aggravating or mitigating factors to be taken into account" in a court's exercise of its equitable jurisdiction.<sup>198</sup> A concurring opinion departed somewhat from the majority's rationale, asserting that the SEC "will almost always" be required to show that the defendant's past conduct was more culpable than negli-

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attorneys. See generally Mathews, *SEC Injunctive Proceedings Against Attorneys*, 36 BUS. LAW. 1819 (1981).

191. *Aaron*, 446 U.S. at 689-95.

192. *Id.* at 696.

193. 581 F.2d 1020, 1029 (2d Cir. 1978). In holding that the subject lawyer aided and abetted a violation of Section 17(a) of the Securities Act, the court asserted that the lawyer "should have been able to conclude that his letter was likely to be used in furtherance of illegal activity."

194. 489 F.2d 535 (2d Cir. 1973) (holding that attorney's negligently prepared opinion letter supports the imposition of aiding and abetting liability under Section 5 of the Securities Act).

195. See *supra* notes 141-60 and accompanying text.

196. But see Mathews, *supra* note 190, at 1826 (arguing proof of recklessness required).

197. *Aaron*, 446 U.S. at 700-01.

198. *Id.*

gence.<sup>199</sup> The concurring opinion concluded that “[a]n injunction is a drastic remedy, not a mild prophylactic, and should not be obtained against one acting in good faith.”<sup>200</sup> Particularly in the case of professionals who have previously had unblemished records, this approach makes a great deal of sense.<sup>201</sup> A different result should follow, however, if the attorney incurred corporate or securities law liability in the fairly recent past.<sup>202</sup>

As an additional point, the SEC, as part of the settlement negotiation process in both administrative and judicial proceedings, has induced law firms to agree to certain undertakings. These may include implementing more effective internal law firm procedures and adopting certain policies with respect to retention of prospective clients.<sup>203</sup> For example, in one Rule 2(e) proceeding, the law firm stipulated that it would adopt the following procedures:

(1) Every two weeks, members of the firm will 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 will 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 . . . (3) An appropriate “engagement letter” will be sent to all interested parties, emphasizing that the firm’s duty is to the issuer and bondholders . . . (4) The firm will require that it receive independently-audited financial statements, representations from appropriate 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>204</sup>

199. *Id.* at 703 (Burger, C.J., concurring).

200. *Id.*

201. *See* SEC v. Haswell, 654 F.2d 688 (10th Cir. 1981) (injunction not ordered against lawyer).

202. *See* language in SEC v. Murphy, 626 F.2d 633, 654-57 (9th Cir. 1980).

203. *See, e.g.,* SEC v. Cohen, SEC Litigation Release No. 9050 (D.D.C. 1980); *In re Keating, Muething & Klekamp*, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,124 (SEC 1979); SEC v. National Student Mktg. Corp., [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,027 (D.D.C. 1977).

204. *In re Ferguson*, Securities Act Release No. 5523, 5 SEC Docket 37 (1974). As another example, in SEC v. Cohen, SEC Litigation Release No. 9050 (D.D.C. 1980), the law firm agreed that it would, in its role as counsel in tax shelter private offerings, exercise due care to assure themselves that:

(1) Any offering circulars they prepare will contain full and fair disclosure of all material facts and risks so that the offering document is not materially false and misleading; and

(2) Any tax opinions they prepare will contain full and fair disclosure of all facts which bear upon the tax conclusions, and that the firm will have a reasonable basis for relying upon the disclosed facts in issuing such tax opinions. Further, the firm represented that within 45 days it would adopt and maintain procedures to implement the above-described undertakings.

*Id.* *See* Ferrara & Steinberg, *The Liability of Tax Practitioners - An SEC Staff Perspective*, in MAJOR TAX PLANNING (1981).

### B. SEC Administrative Proceedings

As discussed above, the SEC has procured certain undertakings by law firms in administrative proceedings. Such undertakings also have been agreed to in SEC Rule 2(e) proceedings.<sup>205</sup> Moreover, on fairly rare occasions, the SEC elects to issue a Section 21(a) Report<sup>206</sup> rather than institute an enforcement proceeding. One such Section 21(a) Report involved bond counsel who, in the Commission's view, performed in an unacceptable manner. Asserting that counsel's inquiry was "totally inadequate and facilitated the bond closing and bond sales to the public," the Commission, drawing on ABA Formal Opinion 335,<sup>207</sup> stated: "Unless lawyers, carefully and competently ascertain the relevant facts and make a reasonable inquiry of their clients to obtain facts not within their personal knowledge, their opinions may facilitate fraudulent transactions in securities. This is so particularly as the investing public looks to the lawyer's opinion as a safeguard against violations of the federal securities laws."<sup>208</sup>

In connection with the bringing of administrative enforcement actions, Section 15(c)(4) of the Exchange Act grants the SEC authority to bring proceedings against any person who was a "cause" of a registrant's failure to comply with certain Exchange Act reporting obligations, including the proxy and tender offer statutory provisions and SEC rules prescribed thereunder.<sup>209</sup> As a consequence, the SEC may institute Section 15(c)(4) proceedings against certain "access" persons, such as securities counsel, who are a "cause" of a "failure to comply."<sup>210</sup>

The *Kern* matter, which the Commission ultimately dismissed, raised significant issues with respect to the proper scope of Section 15(c)(4) proceed-

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205. See 17 C.F.R. § 201.2(e); see *In re Keating*, Muething & Klekamp, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,124 (SEC 1979).

206. A key SEC Release explaining the Commission's policy positions in utilizing the Section 21(a) Report mechanism is reported at [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,014 (SEC 1979) ("Albert's Inc." Release). See M. STEINBERG & R. FERRARA, *supra* note 6, § 4:16 ("Although a Section 21(a) report is not actually an adjudicatory type of proceeding, it is used by the SEC as a substitute for administrative disciplinary or civil injunctive suits in marginal, noneregious cases . . .").

207. ABA Formal Opinion 335, 60 A.B.A.J. 488 (1974). See Rice & Steinberg, *Legal Opinions in Securities Transactions*, 16 J. CORP. L. — (1991) (forthcoming).

208. Attorney's Conduct in Issuing an Opinion Letter Without Conducting an Inquiry of Underlying Facts Failed to Comport with Applicable Standards of Conduct, Securities Exchange Act Release No. 17831, 22 SEC Docket 1200, 1202 (1981). See generally Timmeny, *Responsibilities of Lawyers in Connection with the Sale of Municipal Securities*, 36 BUS. LAW. 1799 (1981); National Association of Bond Lawyers Committee on Professional Responsibility, *The Function and Professional Responsibilities of Bond Counsel*, 16 URBAN LAW. 489 (1984).

209. 15 U.S.C.A. § 78o(c)(4) (West 1981 & Supp. 1991). Under Section 15(c)(4) of the Exchange Act, in regard to any person subject to the provisions of Section 12, 13, 14 or 15(d) of that Act who fails to comply with any such provision, or rule or regulation promulgated thereunder, "the Commission may publish its findings and issue an order requiring such person to comply with such provision or such rule or regulation thereunder upon such terms and conditions and within such time as the Commission may specify in such order."

210. See Levine, *Insider Trading Act Broadens Enforcement Scope*, Legal Times, Sept. 10, 1984, at 17.

ings.<sup>211</sup> In that proceeding, the administrative law judge (ALJ) held that the subject attorney was a "cause" of the target corporation's (Allied) failure to amend promptly its Schedule 14D-9 to reflect subsequent material developments, thereby contributing to the company's failure to comply with Section 14(d)(4) of the Exchange Act and Rule 14d-9 thereunder. The standard of culpability under Section 15(c)(4) for finding the attorney to be a "cause" of the violation, according to the ALJ, is negligence.<sup>212</sup> Although finding the attorney in violation, the ALJ declined to direct future compliance with respect to issuers other than Allied due to which Section 15(c)(4)'s language indicates that such future compliance must be connected with the particular issuer (i.e., Allied) involved, hence rendering "an order of general future compliance . . . beyond the scope of Section 15(c)(4)."<sup>213</sup> Because the attorney had no current relationship with Allied (which was no longer a publicly-held company) and had no control in regard to the company's future compliance, the issuance of an order compelling the attorney to effect Allied's compliance "would be a futile gesture."<sup>214</sup>

On appeal to the SEC, the Commission affirmed the ALJ's determination to discontinue the proceedings on the basis that Section 15(c)(4) does not provide authority for orders of general future compliance.<sup>215</sup> Irrespective of the SEC's determination, it should be pointed out that the attorney was not acting only in the role of rendering legal advice to the client. Rather, according to the facts as found by the ALJ, Kern, who also was a director of Allied, "assumed sole responsibility for determining when an amendment to Allied's Schedule 14D-9 would be filed."<sup>216</sup> Based on this finding, the ALJ reasoned:

In the usual relationship of lawyer and client Kern would have had only the responsibility of giving legal advice to [executive] officers of Allied who in turn would have made the decisions whether amendments to Allied's Schedule 14D-9 were required. When Kern accepted discretionary authority to make those decisions he also accepted the responsibility the Allied officers had for compliance with Rule 14d-9 and cannot be heard now to complain that his legal judgments are being second-guessed in these proceedings.<sup>217</sup>

Some authorities contend that the *Kern* matter was an attempt by the enforcement division to use Section 15(c)(4) in lieu of a civil injunctive action. Moreover, it is asserted that allegations that an attorney violated the federal securities laws should be determined in a federal district court rather

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211. [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,815 (SEC 1991), *aff'd*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342 (ALJ 1988). Note that the Commission affirmed "solely the [ALJ's] determination to discontinue these proceedings." [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,815.

212. [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342, at 89,591.

213. *Id.*

214. *Id.* at 89,595.

215. [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,815 (SEC 1991).

216. [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342 at 89,587.

217. *Id.* at 89,592.

than in an administrative proceeding.<sup>218</sup> Although these contentions have merit, they overlook Kern's active and exclusive role in the disclosure process. This is an important factor. By accepting this status, Kern was doing more than passively rendering legal advice. Indeed, he became the sole determiner of his client's securities law disclosure obligations. The *Kern* proceeding thus illustrates that serving as both director and counsel may incur unnecessary risk.<sup>219</sup>

In view of the SEC's resolution of Section 15(c)(4)'s scope in *Kern*, the Commission may abandon that provision as an enforcement mechanism against attorneys. This is due to the passage of the Securities Law Enforcement Remedies Act of 1990<sup>220</sup> which, among other provisions, gives the SEC administrative cease and desist authority to proceed against any person based on a violation of any statute or rule of the federal securities laws. In connection with the issuance of such cease and desist orders, the SEC has authority to require that measures be implemented to ensure future compliance.<sup>221</sup> Moreover, such cease and desist authority extends to those who are a "cause" of the violation, including those who "should have known" that their conduct "would contribute" to any such violation.<sup>222</sup> Needless to say, such language provides the Commission with broad discretion to proceed against securities counsel as it deems appropriate. In this regard, counsel can minimize liability exposure by confining his or her role to that of a legal advisor (and not taking part in business decisions).<sup>223</sup>

## VI. INSIDER TRADING

The SEC and U.S. Attorney have instituted a number of actions against lawyers for insider trading.<sup>224</sup> As the Supreme Court has pointed out, attorneys retained by a corporation are treated as insiders with respect to the information received due to their relationship with their client: "The basis

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218. See Block, Levine & Feig, *The Kern Decision: An Opportunity for the SEC to Address Section 15(c)(4) Proceedings and Administrative Proceedings Against Lawyers Generally*, 3 INSIGHTS No. 3, at 23 (Feb. 1989). See also *Lawyers Say SEC Should Limit Use of Proceedings Under Section 15(c)(4)*, 22 Sec. Reg. & L. Rep. (BNA) 1263 (1990).

219. The issue of counsel serving as a director on the client's board is discussed in M. STEINBERG, *CORPORATE INTERNAL AFFAIRS* 266-67 (1983).

220. Public Law 101-429. See Martin, Mirvis & Herlihy, *SEC Enforcement Powers and Remedies Are Greatly Expanded*, 19 SEC. REG. L.J. 19 (1991).

221. Indeed, in the *Kern* proceeding, the SEC remarked that "for the future, the passage of [the 1990 legislation] renders moot the issue of the Commission's general power." [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,815.

222. See Securities Act § 8A(a), 15 U.S.C.A. § 77h-1(a) (West Supp. 1991); Exchange Act § 21C(a), 15 U.S.C.A. § 78u-3(a) (West Supp. 1991); Investment Company Act § 9(F)(1), 15 U.S.C.A. 80a-9(f)(1) (West Supp. 1991); Investment Advisers Act § 203(k)(1), 15 U.S.C.A. 80b-3(k)(1) (West Supp. 1991).

223. See *To Our Clients from Pitt & Johnson of Fried, Frank, Harris, Shriver & Jacobson*, "The Securities Law Enforcement Remedies Act of 1990: A New Era in Enforcement," at 6 (July 1990).

224. See, e.g., *United States v. Grossman*, 843 F.2d 78 (2d Cir. 1988); *SEC v. Bluestone*, 22 Sec. Reg. & L. Rep. (BNA) 1231 (E.D. Mich. 1990); *SEC v. O'Hagen*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,852 (D. Minn. 1989); *United States v. Elliott*, 711 F. Supp. 425 (N.D. Ill. 1989).

for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to information solely for corporate purposes."<sup>225</sup> In these circumstances, when such an attorney improperly trades or tips, he or she will be held liable as an insider. As an alternative rationale, the misappropriation theory may be invoked to hold such attorneys liable. Stated succinctly, by misappropriating valuable nonpublic information entrusted to them with the utmost confidentiality, such attorneys who trade or tip engage in deceptive conduct in violation of the securities laws.<sup>226</sup>

As several authorities point out, law firms should be concerned with their liability exposure in this context.<sup>227</sup> Pursuant to Section 21A(b) of the Exchange Act, a controlling person, which (depending on the circumstances) would include a law firm, may be subject to penalties up to \$1 million or three times the amount of any profits realized or losses avoided if such person "knew or recklessly disregarded the fact that such controlled person was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before they occurred."<sup>228</sup>

Given the extent of insider trading that has been engaged in by law firm personnel, it would be prudent for law firms to adopt and enforce formal insider trading policies. SEC Chairman Richard Breeden has urged law firms to implement such policies.<sup>229</sup> The procedures prescribed must fit a specific firm's characteristics. While a straightforward policy statement may be appropriate for a law firm not ordinarily practicing commercial law,<sup>230</sup> the following elements should be arguably present in policies adopted by firms engaged in the practice of corporate and securities law: "(1) The statement should enunciate the basic policy against insider trading; (2) [it] should make clear that it prohibits not only trading but also tipping; (3) the policy should apply to both client and nonclient securities; and (4) [it should designate] the persons administering the policy and [those persons] available to answer questions regarding it."<sup>231</sup> In addition, the policy should be distrib-

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225. *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983); see *Chiarella v. United States*, 445 U.S. 222 (1980).

226. See, e.g., *United States v. Grossman*, 843 F.2d 78 (2d Cir. 1988); *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981). For further discussion, see D. Langevoort, *Insider Trading Handbook* (1990); M. STEINBERG, *supra* note 7, § 3.01 et seq. (and sources cited therein).

227. See Barron, *Model Memoranda*, 17 SEC. REG. L.J. 195 (1989); Eisenberg, *Protecting Against Insider Trading Liability*, 22 REV. SEC. & COMM. REG. 87 (1989); Phillips, *Insider Trading Controls for Law Firms*, 23 REV. SEC. & COMM. REG. 113 (1990); *Protecting Your Firm*, A.B.A.J., at 43 (March 1988); *Law Firms Need Policies on Confidentiality*, BUS. LAW. UPDATE 3 (Sept.-Oct. 1988).

228. See Section 21A(b) of the Exchange Act. See generally Aldave, *The Insider Trading and Securities Fraud Enforcement Act of 1988: An Analysis and Appraisal*, 52 ALBANY L. REV. 893 (1988); Friedman, *The Insider Trading and Securities Fraud Enforcement Act of 1988*, 68 N.C.L. REV. 465 (1990); Lavoie, *The Insider Trading and Securities Fraud Enforcement Act of 1988*, 22 REV. SEC. & COMM. REG. 1 (1989).

229. See 22 Sec. Reg. & L. Rep. (BNA) 1375 (1990).

230. See Eisenberg, *supra* note 227, at 88.

231. Phillips, *supra* note 227, at 115.

uted to all law firm personnel who should sign acknowledgments that they have read and understand the policy. Education programs should be held, and law firm personnel should affirm on a periodic basis that they adhere to the policy.<sup>232</sup>

## VII. CONCLUSION

This article has provided an overview of the potential liability of attorneys under the securities laws. The subjects addressed have focused on attorney liability exposure under primary and secondary theories. Although Section 10(b) of the Exchange Act is the provision most frequently invoked in this context, several other sections also may apply. Given the increasing number of lawsuits against attorneys, the securities laws will continue to be vigorously utilized by plaintiffs' counsel to seek recovery for their allegedly aggrieved clients.<sup>233</sup>

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232. *Id.* See Eisenberg, *supra* note 227, at 88-89.

233. See DeBenedictis, *Lawyer Deep Pockets*, 76 A.B.A.J. at 34 (Jan. 1990).