LAWYER LIABILITY UNDER THE SECURITIES LAWS: RECENT DEVELOPMENTS

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INTRODUCTION

Attorneys practicing in the securities field can incur legal liabilities in a number of ways. They can be accused of complicity in their clients' violation of disclosure requirements of Rule 10-b(5) or other parts of the securities laws. As corporate officers, they can be charged with failure to fulfill their supervisory responsibilities over others' compliance with the law. They can be accused of misusing confidential information obtained as an insider to make a profit in the stock market. Liability may come in the form of private damage actions, district court or administrative enforcement proceedings by the SEC, or even discipline by the bar of the state where the attorney is licensed to practice.

This paper provides an overview of the last several years' developments in assertions of liability against securities attorneys.

I. PRIVATE ACTIONS

A. Lawyer as Counsel to Issuer

Investors deceived by material misstatements or omissions in offerings documents had historically sued, not only the issuers, but also their attorneys, for damages under Rule 10b-5, 17 C.F.R. § 240.10b-5. Complaints against attorneys were generally premised on the theory that attorneys had aided and abetted the 10-b(5) violation by permitting their clients to make these statements or omissions. However, the Supreme Court's 1994 decision in *Central Bank of Denver* v. *First Interstate Bank of Denver*, 511 U.S. 164 (1994), changed pre-existing understandings of the law by holding that Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C.A. § 78j(b), does not provide a basis for a private suit under an aiding and abetting theory.[1]

The Court determined that "especially in cases interpreting § 10(b) . . . the statutory text controls the definition of conduct." *Central Bank*, 511 U.S. at 175. *Central Bank* did not, however, signal the complete end of actions against attorneys under Section 10(b). Rather, private plaintiffs have responded to *Central Bank* by restructuring their complaints to allege direct liability. *Central Bank* explicitly permitted this by noting that "[a]ny person or entity, including a lawyer, accountant, or bank . . . may be liable as a primary violator under 10b-5 . . . ." *Central Bank*, 511 U.S. at 191.

In *McGann* v. *Ernst & Young*, 95 F.3d 821, *as amended on denial of rehearing*, 102 F.3d 390 (9th Cir. 1996), *cert. denied*, 117 S. Ct. 1460 (1997), the Ninth Circuit found an accounting firm primarily liable under Section 10(b) for misleading statements prepared for a

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[1] *Central Bank* is not applicable to actions brought by the SEC, in either its own administrative tribunal or in Article III courts. Congress made this explicit in the Private Securities Litigation Reform Act of 1995, (Pub. L. 104-67, 109 Stat. 737), enacted in response to the *Central Bank* decision. *See* discussion, pp. 7-8 *infra*.

form 10-K. Although *McGann* is a case of accountant liability, the opinion has implications for attorneys as well. The Court held that Ernst & Young had incurred primary liability by preparing a fraudulent audit report[2] that it knew would be included by its client in a form 10-K. Noting that Section 10(b) extends liability to all those who use a fraudulent device "in connection with" the trading or sale of securities, *McGann*, 95 F.3d at 825, the court reasoned that the fraudulent 10-K report was such a fraudulent device because it would be relied upon by potential investors. Thus, Ernst & Young had incurred primary liability by making "false assertions" in a manner reasonably calculated to influence the investing public." *Id.* at 828 (citations and quotation marks omitted). Ernst & Young knew that this report would be included in the company's 10–K.[3] Therefore, the false report was "in connection with" securities trading.

Since *Central Bank*, the courts have rejected plaintiffs' attempts to impose liability on attorneys through the use of collective theories.[4] The Ninth Circuit, the Second Circuit, the District Court for Maryland, and two Southern District of New York judges have held that *Central Bank* precludes liability for conspiracy to violate 10b-5. *See, e.g.*, *In re GlenFed Inc. Securities Litig.*, 60 F.3d 591, 592 (9th Cir. 1995) (*Central Bank* prohibits actions for conspiracy to violate Section 10(b)); *Dinsmore* v. *Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin*, 135 F.3d 837, 838 (2d Cir. 1998) (same); *Phillips* v. *Kidder Peabody & Co.*, 933 F. Supp. 303, 314 (S.D. N.Y. 1996) (Francis, J.) (same), (*aff'd mem.*, 108 F.3d 1370 (2d Cir. 1997); *Kidder Peabody & Co.* v. *Unigestion Int'l*, 903 F. Supp. 479, 496 (S.D.N.Y. 1995) (Sweet, J.) (same); *In re Medimmune Sec. Litig.*, 873 F. Supp. 953, 964 n.8 (D. Md. 1995) (same).

In *Dinsmore*, the Second Circuit, on interlocutory appeal, reversed a district court decision that had permitted a conspiracy claim to go forward under Section 10(b). Judge Knapp had denied an attorney defendant's motion to dismiss a complaint seeking to hold him liable on the sole ground that his knowing assistance to the other defendants' "Ponzi" scheme kept the conspiracy alive and furthered its objectives. *In re Towers Fin. Litig.*, 936 F. Supp. 126 (S.D. N.Y. 1996). Two years after the Ponzi scheme began, the SEC discovered that the principals had

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2 The audit report failed to disclose accounts receivable problems the company had. No further information is given in the reported case.

3 Ernst & Young's knowledge appears to have been essential to the liability finding. In *Frymire-Brinati* v. *KPMG Peat Marwick*, 2 F.3d 183, 189-90 (7th Cir. 1993), the court refused to find an accounting firm liable for SEC violations when it prepared an allegedly misleading audit report but instructed its client not to release the report to the public.

4 Attempts to characterize such conduct as a RICO violation had been unsuccessful prior to 1995. *See Azrielli* v. *Cohen Law Offices*, 21 F.3d 512, 521-22 (2d Cir. 1994) (acting as an attorney for the assistance of persons who violate the securities laws is insufficient for liability under RICO). Congress subsequently removed securities fraud claims from RICO predicate acts as part of the Private Securities Litigation Reform Act of 1995 (Pub. L. 104-67 109 Stat. 737). As amended, 18 U.S.C. § 1964(c) provides that "no person may rely upon any conduct that would have been actionable as fraud in the purchase or sale of securities to establish a violation of section 1962."

sold unregistered securities. The SEC entered into a consent decree with the participants that directed them to make an offer of rescission. Allegedly, the attorney was then hired to draft an offer of rescission that legally complied with the decree but would effectively discourage investors from accepting it. The plaintiffs alleged that Sorkin, by doing so with full knowledge of the worthlessness of the securities, joined the conspiracy and enabled it to continue. The district court held that the complaint stated a cause of action, even though the attorney had never made a specific false statement. *Id.* at 130.

In reversing, the Second Circuit held:

> As the many courts that have addressed the issue have recognized, the reasoning leading to the Supreme Court's rejection of aiding and abetting liability under § 10(b) and Rule 10b-5 also applies to conspiracy. Critically, as in the case of aiding and abetting, there is no mention of conspiracy in the text of § 10(b).

Dinsmore, supra, 135 F.3d at 842. However, the court of appeals also said:

> We emphasize that, while we decline to imply a cause of action for conspiracy to violate § 10(b) and Rule 10b-5, secondary actors who conspire to commit such violations will still be subject to liability so long as they independently satisfy the requirements for primary liability.

Id.

The essential element missing from the plaintiffs' case was an allegation of reliance on the lawyer's allegedly misleading statements. Those statements

> were made to the 1986 Noteholders and the SEC, and plaintiffs — far from relying upon these communications in purchasing their securities — were entirely unaware of them. *See Towers I*, 936 F. Supp. at 127. This fact would be immaterial were we to recognize a conspiracy cause of action, and inasmuch as this `would disregard the careful limits on 10b-5 recovery mandated' by the Supreme Court, *Central Bank*, 511 U.S. at 180, 114 S. Ct. at 1450, we refuse to do so. Indeed, recognition of a cause of action for conspiracy would not only conflict with the reasoning of the Supreme Court in *Central Bank,* but would largely undo the effect of that decision itself, inasmuch as many aiding and abetting claims would simply be repleaded as conspiracy claims.

Id. at 843.

B. Lawyer as Participant in Securities Transactions

An attorney may be held to a higher standard of care if he or she offers, or participates in the sale of, securities to potential investors. An essential element of a 10b-5 violation is a finding that it was reasonable for the plaintiff to rely on the defendant's misrepresentations.

In *Trust Company of Louisiana* v. *N.N.P., Inc.*, 104 F.3d 1478 (5th Cir. 1997), the court held an attorney liable for a Section 10(b) violation based on his participation in a sale of securities, misrepresenting to the purchaser of notes from an investment company that the notes had been collateralized by Government National Mortgage Association (GNMA) Certificates. In fact, security interests in the GNMA certificates were not created; however, the attorney held the GNMA certificates for the Reliance Investment Company, and informed potential investors that they could receive the certificates from him on demand in exchange for their securities. The court relied on the fact that he was an attorney in holding that such misrepresentation was material. It noted that the attorney "was presented [to the plaintiff TCL] as a Harvard-educated attorney and former assistant U.S. Attorney, thus it was reasonable that TCL would be misled by [his] misrepresentations." *Id.* at 1490.

An attorney's duty to investors is dependent on the scope of the attorney's representation. Recent cases indicate that courts will impose liability to investors on an attorney who knew, or had reason to know, that his or her factual statements or work product would be communicated to third persons in connection with a securities transaction. In *Rubin* v. *Schottenstein, Zox & Dunn*, 143 F.3d 263 (6th Cir. 1998), the court *en banc* overturned an earlier panel decision that an attorney was not liable for a violation of Section 10(b) for statements he made to prospective investors and their attorney. The defendant attorney's client had previously financed its venture with a line of credit from Star Bank; because the bank loan was not providing enough money, the client sought an infusion of additional debt and equity capital from plaintiffs. In conversations with three investors and their lawyer, the defendant attorney allegedly discouraged direct contact with Star Bank, represented that "everything with the Star Bank was fine," but did not mention that the contemplated investment would result in a material default of his client's credit agreement with Star Bank. *Id.* at 266.

The panel had held that the attorney was not liable because: (1) he did not make affirmative misrepresentations, and (2) he had no fiduciary duty to the plaintiffs to disclose the omitted information. The panel distinguished cases "where an attorney drafts false prospectuses or other securities documents and therefore makes affirmative misrepresentations in connection with the solicitation of securities." *Rubin*, 110 F.3d 1247, 1255 (6th Cir. 1997), *rev'd*, 143 F.3d 263 (6th Cir. 1998).

The Sixth Circuit *en banc* took a different view. It believed:

> One fundamental question posed by this case is whether enterprising attorneys may gratuitously tout their clients' securities unconstrained by the general duty imposed by the securities laws not to make materially misleading statements in connection with the sale of such securities.

143 F.3d at 266. The 12-judge majority saw nothing in the defendant's "status as an attorney that negates Rule 10b-5 duty to disclose." *Id*. at 267. The essential point was that the attorney had had direct contact with the investors.

> "A person undertaking to furnish information which is misleading because of a failure to disclose a material fact is a primary participant." *SEC* v. *Washington County Util. Dist.*, 676 F.2d 218, 223 (6th Cir. 1982). Under the long-established precedents of this circuit, the conversations between Barnhart and the plaintiffs clearly were instances of "direct contacts" sufficient to give rise to a duty to disclose.

Id. at 267. Although the court seemed to accept the initial panel's view that "silence, absent a duty to disclose" does not establish a claim under Rule 10b-5,[5] the court was satisfied that the lawyer was alleged to have spoken to the investors "concerning material details of the proposed investment, without revealing certain additional known facts necessary to make his statements not misleading." *Id*. Even though a lawyer representing a seller of securities "may not always be under an independent duty to volunteer information about the financial condition of his client, he assumes a duty to provide complete and non-misleading information with respect to subjects on which he undertakes to speak. As the Seventh Circuit so aptly put the point, `under Rule 10b-5 . . . the lack of an independent duty does not excuse a material lie.'" *Id*. at 268 (quoting *Ackerman* v. *Schwartz*, 947 F.2d 841, 848 (7th Cir. 1991)).

The court rejected the defendant's attempted reliance on the proposition that "[a] party represented by counsel cannot establish justifiable reliance when the claim is premised upon the legal opinion of an adversary's counsel." *Id*. at 270. Rather, the Sixth Circuit reasoned:

> The theory is that one's own lawyer ought to be able to detect and cure misleading statements of law from the other side. Extending the principle to factual representations would put an investor in far

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5 *See also Schatz* v. *Rosenberg*, 943 F.2d 485, 490-91 (4th Cir. 1991), *cert. denied*, 503 U.S. 936 (1992) (absent a duty to disclose, attorney's silence is insufficient to give rise to a securities violation).

greater peril in speaking to an issuer's counsel than in speaking with the president of the company. In short, it would allow an attorney to mislead investors with impunity. We cannot endorse this perverse result. Admission to the bar, if anything, imposes a heightened, not a lessened, requirement of probity.[6]

C. Lawyer as Advisor

An attorney may also be vulnerable to private suits by a client for alleged errors in advice given to the client in connection with the client's disclosures to third parties. Thus, in *Federal Deposit Insurance Corp.* v. *O'Melveny & Meyers*, 969 F.2d 744 (9th Cir. 1992), *rev'd on other grounds*, 114 S.Ct. 2048 (1994),[7] the court held that a law firm could be liable for negligent conduct in connection with its due diligence investigation. O'Melveny & Meyers had assisted its client, a savings bank, in the preparation of Private Placement Memoranda (PPMs) that were used to induce investors to become limited partners with the client. Information in the PPMs, which had been provided by the client, was determined to be misleading. When numerous investors began demanding the return of their investments, the FDIC, as successor-in-interest to the client, sued O'Melveny & Meyers for professional negligence and breach of fiduciary duty.

The Ninth Circuit held that the law firm had a duty to its client to make an independent investigation of the facts asserted in the PPMs. "Were a subsequent trier of fact to determine that O'Melveny had indeed been negligent, the Firm's negligence would not be based on its declination to `ferret out fraud,' but rather because it failed to make a reasonable independent investigation." *O'Melveny*, 969 F.2d at 749. Because of this, O'Melveny and Meyers could be held liable if it failed to make an appropriate due diligence investigation.

It is important to note that for O'Melveny to fulfill its duty of due diligence in this case, it would have had to investigate its own client, with the result that the PPMs it prepared for its client would have made the client look less attractive to potential investors. The tension between an attorney's duties of loyalty and confidentiality to its clients on the one hand, and a securities attorney's duty of disclosure to potential investors, has been noted by a number of commentators. In describing an attorney's duties in performing a "legal audit" of his or her own

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6 Comparable questions may arise in *Klein* v. *Boyd*, a case that is to be argued in November 1998 before the Third Circuit sitting *en banc*. There it was alleged that a lawyer had assisted in drafting a disclosure package in connection with the formation of a partnership but had knowingly omitted material information involving prior violations of law by the principals of the venture. The Third Circuit panel that initially heard the case held that a claim for violation of securities law was stated "even when the lawyer did not sign or endorse the document and the investor is therefore unaware of the lawyer's role in the fraud." Fed. Sec. L. Rep. (CCH) ¶ 90,136 at 5 (February 8, 1998) (subsequently withdrawn).

7 Following the Supreme Court's reversal, the Ninth Circuit revived its earlier opinion in *Federal Deposit Insurance Corp.* v. *O'Melveny & Meyers*, 61 F.3d 17, 19 (9th Cir. 1995).

client, one commentator stated: "What is unusual about such employment, of course, is that the client has in effect hired the lawyer for the very purpose of revealing information that would otherwise be confidential." Geoffrey C. Hazard, Jr. & W. William Hodes, 1 *The Law of Lawyering: A Handbook on the Model Rules of Professional Conduct §* 2.3, at 101 (Aspen Law & Business, 2d Ed. 1990), *quoted in SEC* v. *Fehn*, 97 F.3d 1276, 1294 (9th Cir. 1996), *cert. denied*, 118 S. Ct. 59 (1997).[8]

O'Melveny & Meyers conceded that they had a duty to potential investors. However, they asserted, they did not have a duty to their own client to uncover that client's fraud. Thus, the law firm argued, because the FDIC was the successor-in-interest to the client, it did not have a cause of action against the attorney. The *O'Melveny* court disagreed, holding that ferreting out and disclosing fraud in the securities context was part of an attorney's general duty of care. "Part and parcel of effectively protecting a client, and thus discharging the attorney's duty of care, is to protect the client from the liability which may flow from promulgating a false or misleading offering to investors." *O'Melveny*, 969 F.2d at 749. Thus, an attorney who does not perform a proper due diligence investigation and advise the client to disclose relevant facts to potential investors has failed in his or her ethical duty to the client.[9]

II. ACTIONS BY THE SEC

A. Liability for Aiding and Abetting

After the Supreme Court decided in *Central Bank*, *supra*, that aiding and abetting liability was no longer available in private actions, there was some question as to whether that decision would also affect actions brought by the SEC. Congress answered that question by enacting the Private Securities Litigation Reform Act of 1995 (Pub. L. 104-67, 109 Stat. 737). Section 104 of that Act amends 15 U.S.C. § 78t by inserting a new subsection. The subsection reads:

> For purposes of any action brought by the Commission under paragraph (1) or (3) of Section 78u(d) of this title,[10] any person that knowingly provides substantial assistance to another person in violation of a provision of this chapter, or of any rule or regulation

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[8] *See* discussion of *Fehn*, *infra*, pp. 8-9.

[9] The professional responsibility rules of Florida, New Jersey, Wisconsin, and Virginia require disclosure of confidential client information either to prosecutorial authorities or to potential victims if required to prevent a client's criminal fraud. *See* Weinstein, *Client Confidences and the Rules of Professional Responsibility: Too Little Consensus and Too Much Confusion*, 35 S. Tex. L.Rev. 727, 734-737 (1994); *see also* Va. Sup. Ct. R. Pt. 6, § II, DR 4-101(D).

[10] Section 78u(d) empowers the SEC to enjoin securities violations and to seek money penalties in civil actions. 15 U.S.C. § 78u(d).

> issued under this chapter, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.

15 U.S.C. § 78t(f); *see* Senate Banking Committee Report No. 104-98 (1995) (amendment grants "the SEC express authority to bring actions seeking injunctive relief or money damages against persons who knowingly aid and abet primary violators of the securities laws.")

In *SEC* v. *Fehn*, 97 F.3d 1276 (9th Cir. 1995), *cert. denied*, 118 S. Ct. 59 (1997), Fehn, an attorney, was enjoined to refrain from aiding and abetting violations of the securities laws. Fehn had been retained by the CTI company in connection with an ongoing SEC investigation of the company. In the course of his representation, Fehn learned that the client had failed to file quarterly 10-Q reports and that its registration documents did not disclose FDA actions against the company. When Fehn brought the filing requirement to the attention of the company president, the president agreed to file a 10-Q but refused to disclose the FDA action. Fehn responded that the disclosures were, in fact, not necessary.

Fehn himself did not draft the 10-Q forms. The company delegated that task to a nonlawyer employee, but Fehn reviewed and edited the documents before they were filed with the SEC. The 10-Qs that were filed did not disclose the FDA actions against the company. Based on these facts, the SEC brought suit against Fehn for aiding and abetting violations of Sections 10(b) and 15(d), 15 U.S.C.A §§ 78j(b), 78o(d).

The district court entered an injunction against Fehn, which the Ninth Circuit affirmed. It noted that the SEC had established all three elements necessary for aiding and abetting liability under 15 U.S.C. § 78t(f): (1) the existence of an independent primary violation; (2) actual knowledge by Fehn of the primary violation and of his role in furthering it; and (3) Fehn's substantial assistance. *Fehn*, 97 F.3d at 1288. Here, there was an independent primary violation because the omission of the FDA information made the other statements misleading, and thus was a material violation. *Id.* at 1290. Fehn's editing of the documents, combined with his knowledge of the omissions in those documents, constituted the requisite substantial assistance. *Id.* at 1295. Finally, Fehn's own testimony established that he was aware there was material information the company did not wish to disclose. *Id.* at 1295. Thus, he had aided and abetted a securities law violation.

In a more recent case, the SEC was granted judgment against the general counsel of entities that had fraudulently sold prime bank securities. The evidence showed the attorney:

> made absolutely no effort to research whether the fraudulent instruments that were to be the `crown jewel' of the investment program actually existed, what any legal restrictions might be on their availability or use, or whether the enterprise that he was representing could make good on its promises in prospectuses and

> other contacts with Investors. Having failed in the duty to investigate, he recklessly prepared and issued prospectuses promoting the schemes that were in clear violation of the law.

SEC v. *D'Acquisto Fin. Group, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 90,153 at p.7 (S.D. Cal. Nov. 7, 1997).

B. Forums for SEC Actions

The SEC has several different mechanisms by which it may bring actions against attorneys. First, as in *Fehn*, *supra*, the SEC may pursue lawyers for an injunction or other relief in a federal district court. Second, the SEC can bring administrative cease-and-desist proceedings before an administrative law judge in the agency against any person who violates, or would cause a violation of, the securities laws. Securities Enforcement Remedies and Penny Stock Act of 1990, Pub.L. 101-429, 104 Stat. 931. Third, the SEC, under Rule 102(e)[11] of the Commission's Rules of Practice, may deny an attorney, temporarily or permanently, the privilege of appearing or practicing as an attorney before the SEC.[12]

The SEC has wrestled with a way to determine when to bring actions against attorneys. In a speech before the Federal Securities Law Committee of the American Bar Association, Commissioner Norman Johnson stated: "After accepting this invitation [to speak], I attempted to formulate a coherent consistent methodology by which I would approach this subject [Commission actions against attorneys]. In so doing, I was reminded of the complexity and endless contradictions that are part and parcel of this area of the law. I pledged to myself that I would provide concrete guidance on how I believe the SEC should deal with the issue of suing lawyers — principles the practitioner could hang a hat on. This has proven to be elusive and bright guidelines are hard to come by." Speech of Norman S. Johnson, "Suits Against Lawyers," November 8, 1996, to the ABA Federal Securities Law Committee, Washington D.C. (text available on Westlaw, 1996 WL 786178 (S.E.C.)). Commissioner Johnson noted that proceedings under Rule 102(e) have historically been derivative. That is, actions were not brought to bar an attorney from practice unless and until that attorney had been adjudicated liable for a securities law violation in a separate action.

Because the majority of the district court proceedings against attorneys had been brought as aiding and abetting cases, many people believed that *Central Bank's* holding that private aiding and abetting liability was unavailable might result in more actions being brought against attorneys in the SEC's administrative tribunal. Commissioner Johnson's speech noted that "it appeared to many that this [*Central Bank*] would force the attorney disciplinary program

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[11] Formerly known as Rule 2(e).

[12] Under Rule 102(e), the Commission must provide the attorney with notice and opportunity to be heard, and must find, before imposing relief, that (i) the attorney is not qualified to represent others; (ii) the attorney has engaged in improper or unethical professional conduct, or (iii) the attorney has willfully violated or aided and abetted the violation of federal securities laws.

'in-house,' entailing more cease and desist and Rule 2(e) proceedings." *See also* Simon Lorne and W. Hardy Callcott, *Administrative Actions Against Lawyers Before the SEC*, 50 Business Lawyer 1293, 1304-05 (August 1995) (noting that federal district court had been the primary forum for SEC actions against attorneys, but raising concerns about the change in law brought about by *Central Bank*.)

Fehn, supra, made clear, however, that the SEC could still bring aiding and abetting actions in court. According to Commissioner Johnson, "with *Fehn* we will return to the status quo ante and restore the federal court as the primary forum for litigating against lawyers."

Lorne, former general counsel of the SEC, concluded in his 1995 article that, while Rule 2(e) proceedings should only be brought derivatively, the SEC should have more flexibility in bringing an administrative cease-and-desist proceeding. 50 Business Lawyer 1293 at 1316-17. Lorne urged that the SEC should be able to bring an independent cease-and-desist action when the conduct at issue did not present a close question of securities law. Johnson, in his speech, appeared to agree with Lorne to only a limited degree. "I would hope that the cease and desist remedy would be limited to those situations where the attorney's conduct was so egregious that he could properly be deemed a principal actor . . . . We have not brought an original Rule 2(e) proceeding since *Carter & Johnson*[13] and I see no reason to disturb that trend."

III. ATTORNEY LIABILITY FOR INSIDER TRADING

The securities laws forbid insider trading, *i.e.*, profiting in securities transactions from knowledge gained as an insider to a particular transaction. In June 1997, the Supreme Court ruled in *United States* v. *O'Hagan*, 117 S. Ct. 2199 (1997), that an attorney could be criminally prosecuted under the insider trading laws.

O'Hagan's law firm represented Grand Met. Through his employment, he learned that Grand Met intended to acquire the Pillsbury Corporation. O'Hagan proceeded to purchase call options on Pillsbury stock; after the takeover, when stock prices rose, O'Hagan exercised those options and resold the stock for a $4 million profit. He was criminally prosecuted under charges of securities fraud, mail fraud and money laundering, convicted on all counts, and sentenced to 41 months in prison.

O'Hagan's securities fraud convictions were based on two separate theories. First, the trial court found he had committed fraud on the market by misappropriating confidential information from his client, Grand Met, and using it for his own benefit in the securities market, thereby violating Rule 10b-5.

Second, O'Hagan was convicted under SEC Rule 14e-3, 17 C.F.R. § 240.14e-3. Rule 14e-3 was promulgated under Section 14(e) of the Securities Exchange Act of 1934, 15

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[13] 47 S.E.C. 471 (1981).

U.S.C. § 78n(e), which proscribes material misrepresentations or the performance of fraudulent or deceptive acts in connection with a tender offer.

The Eighth Circuit had reversed O'Hagan's conviction on both counts. First, the court of appeals held that the "misappropriation theory" was not consistent with Section 10(b) and thus was invalid. Second, the court ruled that the SEC had exceeded its rulemaking authority in promulgating Rule 14e-3(a), because the rule omitted material elements of Section 14(e). The Supreme Court reversed on both points.

A. "Misappropriation" Under 10b-5

The misappropriation theory is one of two theories under which liability has been imposed under Section 10(b). The first theory, termed the classical theory, holds that a person commits insider trading when he or she buys or sells securities based on material nonpublic information and is an insider of the corporation whose securities are traded. Such trading is a breach of the fiduciary duty the insider owes to the shareholders of the corporation. O'Hagan could not be convicted under the classical theory because he did not trade in the stock of his client, but in the stock of the company which his firm's client planned to acquire. Accordingly, he was not an insider of the company whose stock he traded.[14] The misappropriation theory was developed by the SEC to reach those who are not an "insider" of the corporation. The theory imposes liability on a person who misappropriates material nonpublic information through a breach of fiduciary duty and uses that information in a securities transaction.

Justice Ginsburg, writing for a majority including Justices Stevens, O'Connor, Kennedy, Souter and Breyer, held that the misappropriation theory was a valid theory of criminal liability under Rule 10b-5. O'Hagan had misappropriated confidential information in breach of a duty owed to the source of the information. O'Hagan was held to have violated the rule because he used information gained through his firm's representation of a client for personal gain. 117 S. Ct. at 2207-08.

Justice Ginsburg noted that § 10(b) did not limit use of deceptive devices to the deception of a buyer or seller of securities. Therefore, she wrote, because a fiduciary's use for his own gain of information received from a principal was a deception of the principal, § 10(b)'s "deceptive device" element had been satisfied. However, the Court warned that § 10(b) does not apply to every breach of fiduciary duty; deception of the principal is a necessary additional element. *Id*. at 2208.

The Court therefore held that "full disclosure forecloses liability under the misappropriation theory." *Id*. at 2209 (distinguishing *Santa Fe Indus.* v. *Green*, 430 U.S. 462 (1977).) Had O'Hagan told his law firm or the firm's client that he planned to trade on the

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14 Outside counsel may be considered insiders. O'Hagan had conceded that he was an insider of Grand Met, but was not an insider of Pillsbury, as his firm was not Pillsbury's counsel. It is generally accepted that an in-house counsel are insiders for purposes of § 10(b) liability. *See, e.g., SEC* v. *Hoover*, 903 F. Supp. 1135 (S.D. Tex. 1995).

material information garnered through the firm's representation, he would not have been liable under § 10(b), although he might have been liable under a state law claim for breach of the duty of loyalty.

The majority further held that the "in connection with" element was satisfied because the fiduciary's fraud was not completed until the misappropriated information was used in trading. Because confidential information ordinarily derives its value from its use in securities transactions, there is a nexus between the misappropriation of the information and its later use in a securities transaction. *Id*. at 2208-09.

B. The Validity of Rule 14e-3

The majority was joined by Justice Scalia in holding that the SEC had acted within the scope of its authority in promulgating Rule 14e-3. The rule defines as a "fraudulent, deceptive of manipulative act" the purchase or sale of any securities by a person in possession of material nonpublic information which that person knows or has reason to know has been acquired from the offeror, issuer, or an insider of either.

Rule 14e-3 directs that a person in possession of material nonpublic information which that person knows or has reason to know has been directly or indirectly acquired from an insider to a tender offer must either disclose that information or abstain from trading. The Eighth Circuit had accepted O'Hagan's argument that this rule exceeded the SEC's authority to implement § 14(e) because it applied regardless of whether the trading person breached a fiduciary duty. Thus, the lower court had held, the Rule went beyond the common-law definition of fraud, and criminalized acts that were not "fraudulent" within the meaning of § 14(e).

In holding that the SEC had the power to promulgate the rule, the Supreme Court majority did not decide the scope of the SEC's authority to define fraud. Rather, it held that § 14(e) empowered the SEC to enact prophylactic measures reasonably designed to prevent fraudulent trading in the context of tender offers. "A prophylactic measure, because its mission is to prevent, typically encompasses more than the core activity prohibited." *O'Hagan*, 117 S. Ct. at 2217. Even though Rule 14e-3 could encompass acts that were not fraudulent, the rule was acceptable because it was reasonably designed to prevent fraudulent acts. *Id.* at 2216-19.

IV. LAWYER AS MEMBER OF CLIENT BOARD OF DIRECTORS

The practice of lawyers serving as directors of client corporations has produced considerable debate within the profession over the last decade because of the special ethical and liability issues that can result from the dual roles. Formal Opinion 98-410 of the American Bar Association's Standing Committee on Ethics and Professional Responsibility, issued on February 27, 1998, addresses three issues in substantial detail: the need to advise management and other directors of the potential implications of the dual role; the potential unavailability of attorney-client privilege to protect communications the lawyer-director may receive; and the conflict of interest and other ethical issues that may arise as a result of the dual relationship. The ethical issues addressed by the Opinion include the problem presented when the lawyer-director or her firm is asked to represent the corporation in advancing a matter that she, as a director, unsuccessfully opposed; the potential conflict a director faces if asked to provide legal advice on actions in which she participated as a director; the conflict of interest that arises when the board considers whether to engage the lawyer-director's firm to perform legal services; and the conflict that may arise in representing the corporation or its directors or officers as defendants in litigation.

Interestingly, the ABA Opinion quotes, but does not fully agree with, the blanket nature of prohibitions found in Formal Opinion 1988-5 of the Professional Ethics Committee of the Association of the Bar of the City of New York:

> "The lawyer may not `tak[e] advantage of his or her position [as director] to procure professional employment for the lawyer or the lawyer's law firm,' N.Y. State 589 (1988), or participate in the board's decision to retain the lawyer, N.Y. City 611 (1942). Indeed, the lawyer-director may not participate `in any decision of the [board] that will or reasonably may affect the lawyer's own personal or financial interests as counsel.' N.Y. State 589 (1988). Finally, the lawyer-director must exercise his or her independent professional judgment `solely for the benefit of [the corporation] and free of compromising influences and loyalties,' EC 5-1, that may arise out of his or her role as director (such as a desire to be re-elected to the board or concern for the lawyer's personal liability as a director)."

ABA Opinion 98-410 concludes by offering a half dozen guidelines to assist a lawyer-director in avoiding a "disciplinary infraction" of the rules of professional responsibility. Thus the Opinion advises that a lawyer-director should:

- "reasonably assure" that corporate management and directors fully understand the implications of the separate responsibilities of legal counsel and director;

- "reasonably assure" that corporate management and directors understand that the presence of a lawyer-director does not extend the attorney-client privilege to discussions nspiracy to violate § 10(b) and Rule 10b-5, secondary actors who conspire to commit such violations will still be subject to liability so long as they

- recuse herself from consideration of issues affecting the relationship between the company and the lawyer or her firm;

- at all times “[m]aintain in practice the independent professional judgment required of a competent lawyer, recommending against a course of action that is illegal or likely to harm the corporation even when favored by management or other directors”;

- be certain to perform counsel’s duties diligently even if the lawyer, in her capacity as a director, disagrees with the company’s business decision, “unless the representation would assist in fraudulent or criminal conduct, self dealing or otherwise would violate the Model Rules;” and

- decline to act as counsel whenever the lawyer’s interests as director conflict with her duties as counsel.

V. IN-HOUSE COUNSEL COMPLIANCE RESPONSIBILITIES

Special duties may be imposed on an in-house counsel and others in a supervisory position within a corporation with respect to the compliance of other persons in the organization with the securities laws. Any discussion of such responsibilities must be premised on the SEC’s explication of them in *In re Gutfreund*, 51 S.E.C. 93 (Dec. 3, 1992), an SEC administrative proceeding brought in connection with the Salomon Brothers Treasury bond scandals the early 1990s. In that case, lower-level employees within the firm were involved in a scheme where they used names of clients in bidding on U.S. Treasury securities. Federal law placed limits on the amount of bonds any individual or organization could purchase. By using client names, the employees were able to purchase several times the legal limit of these bonds. There was no indication that senior management was involved in either the planning or execution of this scheme. Nonetheless, the SEC asserted that those officers were properly subject to cease-and-desist orders and temporary suspensions for their failure to supervise employees adequately, and thus to prevent the scheme.

The SEC held that, once a person in a supervisory position learns of information suggesting misconduct, at a minimum, the supervisor has a duty to investigate. The investigation, at a minimum, should include questioning of employees in the department where the misconduct originated and review of documentation surrounding the questionable activity.

Whether a person is in a supervisory position, the SEC held, depends on the facts of each case, rather than the individual’s title. The relevant inquiry is whether “that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.” *Id.*

The SEC claimed that Donald Feuerstein, Salomon’s chief legal officer, was a supervisor, both because he had directed the firm’s response in other instances of misconduct, and because senior officers of the firm had informed him of the Treasury bond situation for the purpose of obtaining his advice. Because he was a supervisor, he was obligated to take reasonable and appropriate action.

The SEC noted that "[it] is not sufficient for one to be a mere bystander to the events that occurred." *Id.* Instead, a supervisor must either take appropriate steps, or ensure that others will do so.[15] Examples the SEC gave of appropriate steps included: directing or monitoring an investigation of the conduct; instituting procedures reasonably designed to prevent future misconduct, and ensuring that such procedures are implemented; and, as a last resort (if management fails to act on the supervisor's recommendations) disclosure to the board of directors or a regulatory agency or resignation.[16]

The *Gutfreund* decision has been accepted as an explication of the duties expected of compliance officers in cases where misconduct of other employees comes to light. Recent administrative actions by the SEC against broker-dealers and others in supervisory positions provide examples of specific conduct that the SEC will find to be in violation of the responsibilities articulated in *Gutfreund*.

In *In re Padgett*, 64 S.E.C. 272 (March 20, 1997), the SEC found that principals of a registered broker-dealer were liable for a number of violations that their supervisory practices had in some way encouraged, or at least failed to prevent. Therefore, the SEC Rule 2(e) proceeding barred them from further associations with brokerages or dealerships based on supervisory violations.

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15 In Feuerstein's case, he had advised senior management that the transactions were illegal and recommended that the transactions be reported to the government. However, he allegedly did not direct that an inquiry be done, implement a plan to deter future misconduct, or ensure that a report to the government was made. The SEC implied that his conduct was thus insufficient to discharge compliance responsibilities. It noted that, if a person "takes appropriate steps, but management fails to act and that person knows or has reason to know of such failure, he or she should consider what additional steps are appropriate to address the matter." *Id.*

16 To an extent, the *Gutfreund* decision tracks the American Bar Association's view of an attorney's ethical responsibilities to a client organization, as set forth in ABA Model Rule 1.13. That Rule directs an attorney to proceed "as reasonably necessary" to protect the organization's interests if the attorney knows of an action or pending action by a person associated with the organization that could result in a violation of the law imputed, and that could cause substantial damage, to the organization. Examples of steps that may be reasonably necessary include: asking that the person reconsider, advising the person to get a second legal opinion, referring the matter to higher authority in the organization, or, at the choice of the attorney, resigning from the representation. *See* ABA Model Rule 1.13(b)(1-3); (c). Unlike *Gutfreund*, the Model Rule does not direct an attorney to take control of the situation, monitor it, or institute preventive measures.

In addition, neither *Gutfreund* nor Model Rule 1.13 requires the attorney to make disclosures outside the organization, even if the highest authority in that organization refuses to act. *See* Comment to ABA Model Rule 1.13 (stating that such a disclosure rule was proposed by the original commission of the Model Rules, but rejected by the ABA's house of delegates).

First, the SEC found the Padgett and Graff, the president and chairman, respectively, of Stuart-James Co, Inc., had overseen the creation of a training manual for new employees. Padgett and Graff, in their initial review of the manual as it was being prepared, had requested of the preparer, a consultant, that scripts already in use at the firm be placed in the manual. However, they did not review the scripts before the manual was distributed. As finally distributed, the manual contained a sample script to use in telephone solicitations with potential investors, including scripted answers to frequently encountered objections. The Commission found that this script was misleading because it promised high returns on investments but did not disclose their speculative and risky nature.

The Commission further held that Padgett and Graff bore responsibility for the misleading statements, although they had neither written nor reviewed them. "[They] had a duty to determine the contents of the Manual or reasonably to delegate that function . . . . Despite knowing that [the preparing consultant] lacked compliance experience, Padgett and Graff did not review the Manual after directing [him] to add the scripts." *In re Padgett*, at *6. The Commission also cited Padgett and Graff's failure to request that a compliance officer undertake a review of the Manual, and their direction that the Manual be distributed on a very short schedule (leaving no time for review).

In addition, the SEC found that the branch office managers had committed independent supervisory violations in their management of the sales staff. Sales compensation policies made it advantageous to "cross trade," that is, to match a selling customer with a buying customer within the firm, rather than "net sell," which was a sale from a customer to the firm's trading department. It is a violation of SEC rules to prohibit net selling. Although the managers did not sell securities themselves, and did not outright prohibit their sales staff from net selling, the SEC found that they had established an office policy which discouraged the practice. This included: active encouragement of cross selling, telling sales staff that net selling would lead to price declines, and telling agents to attempt to talk customers out of net selling. This was sufficient to find that the branch office managers had violated SEC rules.

Finally, the SEC found that Graff and Padgett were also responsible for a tacit "no net selling" rule. At a regional meeting, the two apparently made statements that several employees construed as forbidding net selling. The SEC noted that, following that meeting "Padgett and Graff could not claim to be unaware of the practice of no net selling at the firm. Padgett and Graff knew, at a minimum, of employee confusion about net selling. Neither, however, took any action to investigate or address a specific problem about which they were aware." *Id.* at 11. Because the two were aware that there was confusion among the employees as to whether net selling was allowed, they had a duty to investigate and address the issue.[17] Their failure to do so permitted the practice to continue and constituted a failure to supervise.[18]

By contrast, in *In re Graham*, 63 S.E.C. 2059 (Feb. 7, 1997), the SEC held that a midlevel manager did not have a duty to supervise his employee in her execution of trades violative of the securities laws, when those trades were directly ordered by the "hands-on" owner of the brokerage firm. Even though the employee was normally subject to the manager's supervision, under the facts of this case, the SEC found that he did not have the "requisite degree of responsibility, ability [and] authority to affect [her] conduct," as required under *Gutfreund*. In addition, the SEC noted that the manager had made available to the owner information that suggested the employee was engaging in illegal conduct. Thus, under the circumstances, he had taken necessary and reasonable steps to discharge his supervisory responsibilities.

The steps necessary to discharge a supervisor's responsibilities are fact-specific, and depend on such factors as the person's role in the organization. A compliance officer is likely to be held to the higher standard set forth in *Gutfreund*, while a lower-level in-house counsel employee may fulfill compliance responsibilities through reporting suspicious information up the chain of command, as in *Graham*.

VI. STATE BAR DISCIPLINARY PROCEEDINGS FOR SECURITIES VIOLATIONS

Attorneys should remember that conduct amounting to a securities law violation may also reflect on an attorney's fitness to practice law. Thus, state bar associations may impose their own disciplinary sanctions on an attorney who has been found (by either the SEC or by an Article III court) to have violated securities laws. In *Florida Bar* v. *Calvo*, 630 So.2d 548 (Fla. 1993), *cert. denied*, 513 U.S. 809 (1994), for example, the Florida Supreme Court upheld the Florida Bar's decision that attorney Calvo be disbarred on the basis of ethical violations. These ethical violations consisted of Calvo's failure to disclose, or ensure that his clients disclosed, material information regarding his client corporation's capitalization to potential investors. The information was also not disclosed to governing authorities.

The SEC brought an action against Calvo in federal court in Connecticut, where he was found liable. The Florida Bar then instituted disciplinary proceedings, taking judicial notice of the findings in the SEC proceedings. Although Calvo argued that such proceedings could not be noted because of their different standard of review, the Florida court held that this went only to weight of the evidence, but not its admissibility.

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17 However, where the SEC rule is unclear, supervisors may not be liable for improper practices. In *Upton* v. *SEC*, 75 F.3d 92 (2d Cir. 1996), the court reversed a sanction on a supervisor on the grounds that he lacked reasonably sufficient notice that the conduct at issue was violative of SEC rules.

18 The duty to supervise has been extended to include independent contractors. *In re Giordano*, 61 S.E.C. 345 (1996) (senior officer of a clearing firm had a duty to reasonably supervise activities of a direct-access broker contracting with the firm).

Florida, like many other states, has a provision in its code of ethics stating that it is unethical for an attorney intentionally to engage in conduct, in violation of his or her professional duties, that causes serious or potentially serious injury to a client, the public or the legal system. The Florida Supreme Court held that securities laws violations amounted to such conduct: "We can conceive of few situations posing more serious harm to a large segment of the public than a fraudulent offering of securities. Such misconduct certainly is comparable to abuse of client trust funds, except that here the number of persons exposed to the risk of harm potentially was in the hundreds of thousands." *Calvo*, 630 So.2d at 551, *see also*, *In re Woodard*, 638 N.Y.S.2d 1 (N.Y.Sup. 1996) (attorney convicted of securities violations brought before the bar, but was entitled to show mitigating factors in bar disciplinary proceedings); *Chadwick* v. *State Bar of California*, 776 P.2d 240 (Cal. 1989) (insider trading by attorney warranted one-year suspension); *Matter of Kersting*, 726 P.2d 587 (Ariz. 1986) (failure of attorney to disclose material nonpublic information to violated disciplinary rules of conduct).

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