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ATTORNEY'S LIABILITY: THE SECURITIES BAR AND THE IMPACT OF *NATIONAL STUDENT MARKETING*

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On April 19, 1965, the Securities and Exchange Commission filed a complaint against Texas Gulf Sulphur and certain of its officers and employees alleging violations of the antifraud provisions of the Securities Exchange Act in connection with activities surrounding the Timmons, Ontario, ore strike.¹ Subsequently, the court in *SEC v. Texas Gulf Sulphur Co.*² held that anyone in possession of material inside information—regardless of whether he is a director or management officer—must disclose such information or refrain from trading during the period of non-disclosure. The court also held that the now-classic press release indicating caution about the magnitude of the strike would subject the corporation itself to liability if it were found on remand to be misleading.³ Litigation of private damage suits arising from *Texas Gulf* has terminated in settlement only within the last year.⁴

Although *Texas Gulf* prompted commentary from the outset,⁵ the securities bar discovered on March 29, 1968, that they had overlooked a less obvious but equally treacherous problem, and the position of the securities lawyer suddenly became more complicated. On that date, Judge Edward C. McLean of the Southern District of New York denied a motion for summary judgment by the defendants in *Escott v.*

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1. *SEC v. Texas Gulf Sulphur Co.*, Civil No. 65-1182 (S.D.N.Y., filed April 19, 1965). The complaint is summarized at [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,284, and analyzed at greater depth in Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceedings*, 51 VA. L. REV. 1271, 1272-74 (1965).

2. 401 F.2d 833 (2d Cir. 1968), cert. denied sub nom. *Coats v. SEC*, 394 U.S. 976 (1969), affg in part and rev'g in part 258 F. Supp. 262 (S.D.N.Y. 1969).

3. Citations to the widespread commentary this case received are collected by Kennedy & Wander, *Texas Gulf Sulphur, A Most Unusual Case*, 20 BUS. LAW. 1057 (1965). See also Fleischer, *supra* note 1, at 1272 n.2.

4. *Cannon v. Texas Gulf Sulphur Co.*, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,432 (S.D.N.Y. April 11, 1972). Of interest to all practitioners is the fact that attorneys fees expressly were reserved for consideration at future hearings. *Id.* ¶ 93,432, at 92,153.

5. See notes 1 & 3 *supra*.

*BarChris Construction Corp.*⁶ Finding widespread material misstatements in connection with a registration of BarChris debentures, the court held that the directors, underwriters, and auditors had failed to sustain the defense of due diligence outlined in section 11 of the Securities Act of 1933.⁷ Decided in the midst of a robust bull market when scores of untested companies were seeking to go public, *BarChris* produced even greater repercussions than *Texas Gulf*.⁸

BarChris received more attention because the court found an absence of "due diligence" in practices which deviated in small degree, if at all, from traditions prevalent within the industry. The word "lawyer" appeared frequently enough in the court's catalog of misdeeds to cause apprehension among members of the securities bar.⁹ Although the opinion stated that "[n]either the lawyer for the company nor the lawyer for the underwriters is an expert within the meaning of section 11,"¹⁰ *BarChris* has been cited for the proposition that a lawyer who accepts a directorship may be required to meet a higher burden of inquiry than a lay director.¹¹

6. 283 F. Supp. 643 (S.D.N.Y. 1968).

7. 15 U.S.C. § 77(k) (1964). No appeal from Judge McLean's decision was taken. It is quite possible that the defendants elected not to appeal for fear that the plaintiffs would win the right to notify other debenture holders who were not parties to the district court proceeding. Although Judge McLean denied the motion, he did so without compelling precedent in the Second Circuit and in spite of decisions such as *Union Carbide & Carbon Corp. v. Nisley*, 300 F.2d 561 (10th Cir. 1961), which would have allowed the notice to be sent. The financial risk inherent in having all claims or debenture holders before the court could have prompted the settlement.

8. An example of the reaction to *BarChris* was the A.B.A. National Institute, *The BarChris Case: Prospectus Liability*, 24 Bus. Law. 523 (1969). At the Institute, 29 distinguished panelists considered the case and its ramifications before an overflow crowd of approximately 1,000. The proceedings were video-taped; these tapes were later made available for group showings by the A.B.A. Division of Legal Practice and Education.

9. One of the defendant directors was a young lawyer who had served as house counsel to *BarChris*. Judge McLean offered him the wisdom of hindsight in a still-cryptic sentence: "As a lawyer, he should have known his obligations under the statute." 283 F. Supp. at 687. Another defendant was a partner in the law firm which advised *BarChris* on securities matters. Again Judge McLean commented: "It is claimed that a lawyer is entitled to rely on the statements of his clients and that to require him to verify their accuracy would set an unreasonably high standard. This is too broad a generalization. It is all a matter of degree." *Id.* at 690. The underwriters were subjected to liability because their attorney failed to make an adequate in-depth review of the company's operations and finances. *Id.* at 692-97.

10. 283 F. Supp. at 683.

11. See, e.g., Loss, *The Opinion*, 24 Bus. Law. 527, 528 (1969): "I find it hard to quarrel with the holding that, so far as the non-expertised portion of the registration

It is clear that *BarChris* itself disclaimed any intention to impose specific section 11 liability on lawyers *qua* lawyers; accordingly, two commentators¹² discussing the possible ramifications of *BarChris* on the securities bar premised their remarks on the proposition that lawyers, as lawyers, were immune from section 11 liability. The authors indicated that lawyers' liability in the securities area would arise in malpractice actions, if at all. One stated flatly: "The law, so far, is very clear. The lawyers' responsibility is exclusively to their own client."¹³ The same author concluded that *BarChris* was an unusual case demanding special care because the issuing corporation was involved in a "fad industry."¹⁴ The other commentator suggested the need for malpractice insurance coverage and a more thorough acquaintance with securities law standards.¹⁵ If these conclusions seem somewhat less than helpful, it may be that the prospect of broad liability for attorneys involved in allegedly fraudulent securities transactions was totally foreign to the commentators.

The Securities and Exchange Commission has now demonstrated that it operates under no such disability. The Commission has taken the position that the attorney practicing in the securities field owes responsibility not only to his client, but to the investing public as well.¹⁶ In its first major attempt¹⁷ to implement this position, the Commission has targeted two prominent law firms: The complaint in *SEC v. National Student Marketing Corp.*¹⁸ charges the New York law firm of White and Case and the Chicago firm of Lord, Bissell and Brook, and partners

statement is concerned, the director who is a lawyer and who did most of the work on the registration statement has a somewhat greater burden by way of establishing his defense than the other directors."

12. Freeman, *Liability of Counsel for Issuer*, 24 BUS. LAW. 635 (1969); Henkel, *Liability of Counsel for Underwriter*, 24 BUS. LAW. 641 (1969).

13. Freeman, *supra* note 12, at 639.

14. *Id.* at 640.

15. Henkel, *supra* note 12, at 655.

16. This doctrine can be traced back at least to May, 1967, when an attorney was named in injunctive proceedings alleging violations of the antifraud provisions. *SEC v. Frank*, 388 F.2d 486 (2d Cir. 1968).

17. An earlier action charging an attorney with violations of the antifraud provisions is *SEC v. Frank*, 388 F.2d 486 (2d Cir. 1968). See also *SEC v. Fields*, Civil No. 71-5416 (S.D.N.Y., filed Dec. 13, 1971), charging an attorney who issued 65 opinion letters purporting to free hundreds of thousands of shares of unregistered stock of four corporations, with violations of the registration and antifraud provisions. The *Fields* case is noted in 132 BNA SEC. REG. & L. REP. A-8 (Dec. 22, 1971).

18. Civil No. 72-225 (D.D.C., filed Feb. 2, 1972) [hereinafter cited as *Complaint*].

of each, among others, with violations of the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934.¹⁹

In general terms, the complaint alleges an ongoing scheme of fraudulent conduct by the corporation and its officers, directors, and auditors dating from August, 1968.²⁰ It specifically alleges that misleading statements appeared in the 1968 annual report,²¹ 1968 10-K report,²² 1969 interim financial reports,²³ 1969 annual report,²⁴ 1969 10-K report,²⁵ and 1970 10-K report.²⁶ The alleged misconduct of the law firms derives from their participation in the merger of Interstate National Corporation into National Student Marketing.²⁷

The *National Student Marketing* complaint forces a court for the first time to balance the attorney-client relationship, its privileges and fiduciary obligations on the one hand, with the pervasive regulatory scheme adopted "for the protection of investors"²⁸ on the other. The Commission argues that by extending the principles of *BarChris* and *Texas Gulf*, the balance must be struck in favor of the investing public.

19. A consent decree to an injunction against National Student Marketing, its officers, agents, employees, and subsidiaries from future violations of the antifraud, proxy, and reporting requirements of securities law has been approved by the United States District Court, District of Columbia. SEC v. National Student Mktng. Corp., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,581 (D.D.C. July 26, 1972). In April, 1972, White and Case moved for a change of venue to New York. In May the attorneys moved for summary judgment. In March, 1973, the district court upheld venue against White and Case in the District of Columbia and denied the motion for summary judgment. SEC v. National Student Mktng. Corp., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,820 (D.D.C. March 21, 1973). For a chronicle of the rise and fall of National Student Marketing by one of its former vice-presidents see A. TOBIAS, *THE FUNNY MONEY GAME* (1971).

20. Complaint, *supra* note 18, ¶ 27.

21. *Id.* ¶ 28.

22. *Id.* ¶ 29.

23. *Id.* ¶¶ 30-32.

24. *Id.* ¶ 39.

25. *Id.* ¶¶ 42-43.

26. *Id.* ¶ 45.

27. *Id.* ¶¶ 47-52. Further fraudulent conduct is alleged on the part of White & Case and Robert A. Katz, an attorney for Compujob, Inc. The Compujob claim is directed at certain opinion letters issued by Katz and White & Case wherein the Commission alleges that they were false in that a merger not yet consummated was represented as closed and that the defendant attorneys knew or should have known of the inaccuracies. *Id.* ¶¶ 53-60. The complaint is closely analogous to SEC v. Fields, Civil No. 71-5416 (S.D.N.Y., filed Dec. 13, 1971) in that it alleges *active* fraudulent misconduct. The *passive* misconduct alleged in connection with the interstate merger has been the subject of the most controversy and will be the primary focus of this Article.

28. Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78(j) (b) (1964).

A decision in favor of the Commission could result in substantial loss to the law firms involved.²⁹

The debacle of *National Student Marketing* has proved disastrous to innocent investors already.³⁰ It is the thesis of this Article that the SEC attempt to hold the attorneys liable, if the factual allegations are proven, is justified. The standard of care proposed by the Commission is no higher than the standard of community responsibility already imposed by the Canons of Ethics. Furthermore, the fact that the complaint has been brought, and that it has aroused such an uproar, suggests that the ramifications of cases like *Texas Gulf* and *BarChris* have yet to be understood fully by the securities bar.

SEC ALLEGATIONS OF WRONGDOING—THE APPLICABILITY OF THE ANTIFRAUD PROVISIONS

As previously indicated, the Commission has alleged fraudulent conduct by the attorneys in connection with the merger of Interstate National Corporation into National Student Marketing. The Commission contends that the proxy statement solicited to acquire shareholder approval for the proposed merger was materially false and misleading in that, among other errors, it claimed \$1,900,000 in earnings for "contracts in progress" when many of these contracts were not in fact client commitments.³¹ As a condition to consummation of the merger, the parties were to receive a comfort letter from the independent auditors, assuring them that the auditors had no reason to believe that the unaudited financial statement which accompanied the proxy materials failed in any material way to reflect accurately National Student Marketing's operations.³²

The Commission charges, however, that the comfort letter did not satisfy this condition. According to the complaint, the letter indicated various adjustments which should have been made and which, if made, would have reflected a net loss rather than net earnings of \$700,000 for the period in question.³³ The complaint further alleges that the at-

29. See notes 69-82 *infra* & accompanying text.

30. Initially offered at \$6.00 per share in April 1968, National Student Marketing rose to a high of \$144.00 per share on December 15, 1969. Recently, the stock was quoted at 2¼ bid, 2½ asked.

31. Complaint, *supra* note 18, ¶ 33. This conduct, if proven, contravenes the Securities Exchange Act of 1934, § 14a, 15 U.S.C. § 78(n) (1964) and Rule 14a-9, 17 C.F.R. § 240.14a-9 (1972).

32. Complaint, *supra* note 18, ¶ 48.

33. *Id.*

torneys knew the contents of the comfort letter prior to the merger, and nevertheless permitted consummation without disclosing the contents of the letter to public investors *and* shareholders of National Student Marketing and Interstate.³⁴ Contemporaneous with the receipt of the comfort letter, it is alleged that White and Case, representing National Student Marketing, and Lord, Bissell and Brook, representing Interstate, issued opinion letters stating that all steps required to consummate the merger had been taken and that their respective clients had violated no law to the knowledge of counsel.³⁵

Before a further examination of attorneys' liability can be conducted, it is appropriate to discuss recent cases concerning questions of whether a merger constitutes a sale of securities and whether privity is a required basis to find the attorneys liable. Where it is alleged that directors of both companies and the auditors were equally culpable in failing to disclose the contents of the letter,³⁶ it seems clear under prior case law that the antifraud provisions will apply to the *transaction* involved. A "sale" of securities is a necessary jurisdictional element to any suit for violations of the antifraud provisions of the securities acts.³⁷ Whether the merger situation constitutes a purchase or sale has been debated

34. *Id.* ¶ 48(a).

35. *Id.* ¶ 48(d)-(e).

36. *Id.* ¶ 48(a),(f),(g),(h),(k).

37. 15 U.S.C. § 77(q) (1964) provides in pertinent part: "(a) It shall be unlawful for any person *in the offer or sale* of any securities . . . to engage in any transaction, practice, or course of business which would operate as a fraud or deceit upon the purchaser." (emphasis supplied). 15 U.S.C. § 78(j) (1964) states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .

(b) To use or employ, *in connection with the purchase or sale* of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(emphasis supplied).

17 C.F.R. § 240.10b-5 (1967) provides:

It shall be unlawful for any person directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange . . .

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

(emphasis supplied).

throughout the history of the Securities Acts.³⁸ Although the legislative history of the 1933 Act indicates that a merger was regarded as a sale which would require a registration statement,³⁹ the Commission's position has shifted over the years.⁴⁰

Authority that a merger does involve a sale for the purposes of the antifraud provisions is found in *Vine v. Beneficial Finance Co.*⁴¹ and *Dasho v. Susquehanna Corp.*⁴² Speaking for the court, Judge Schnackenberg stated in *Dasho*:

The argument that the transformation of rights occurring upon statutory merger is a distinct corporate phenomenon which does not involve purchase and sale of securities has some appeal, but in view of the objectives of the securities and the exchange acts, it seems to me better to recognize, for the purpose of the antifraud provisions, that sales and purchases are involved. This view does no violence to the statutory language, and is the present interpretation of the body which is responsible for the administration of the acts.⁴³

The Supreme Court first addressed the question in *SEC v. National Securities, Inc.*⁴⁴ The complaint in *National Securities* closely parallels that in *National Student Marketing*, in that both allege fraudulent misstatements in proxy materials solicited to acquire shareholder approval for a merger.

38. See generally L. LOSS, SECURITIES REGULATION 518-39 (2d ed. 1961).

39. H.R. REP. NO. 85, 73d Cong., 1st Sess. 16 (1933).

40. Note to Rule 5 of Form E-1, adopted 1935. The Commission in *National Supply Co. v. Stanford Univ.*, 134 F.2d 689 (9th Cir.), cert. denied, 320 U.S. 773 (1943), filed an amicus brief contending that a merger was not a sale for purpose of civil liability. With the adoption of Rule 133 under the 1933 Act the Commission retraced its steps, however, and indicated that the "No-Sale" doctrine applied only in matters pertaining to registration. Rule 133 has since been repealed. Effective January 1, 1973, Rule 145, 17 C.F.R. § 230.145 (1973) states definitely that for purpose of the antifraud provisions, a merger does constitute a "sale."

41. 374 F.2d 627 (2d Cir.), cert. denied sub nom. Beneficial Fin. Co. v. Vine, 389 U.S. 970 (1967).

42. 380 F.2d 262 (7th Cir.), cert. denied sub nom. Bard v. Dasho, 389 U.S. 977 (1967).

43. 380 F.2d at 269. But see 9 B.C. IND. & COM. L. REV. 510 (1968), wherein the student author complained that "[S]uch a method of dealing with this important securities law issue is an unsatisfactory method of developing a stable body of law." *Id.* at 520.

44. 393 U.S. 453 (1969).

Although the Court in *National Securities* was concerned primarily with the breadth of the McCarren-Ferguson Act,⁴⁵ in holding that the antifraud provisions of the securities laws did in fact apply to the transaction, the question whether a merger involved a purchase or sale necessarily was answered in the affirmative:

Whatever the terms "purchase" and "sale" may mean in other contexts, here an alleged deception has affected individual shareholders' decisions in ways not at all unlike that involved in a typical cash sale or share exchange. The broad antifraud purposes of the statute and rule would clearly be furthered by their application to this type of situation. Therefore we conclude that Producers Life's shareholders "purchased" shares in the new company by exchanging them for their old stock.⁴⁶

The Court also dismissed the contention that the antifraud provisions were inapplicable to misstatements in proxy solicitations:

Section 10(b) applies to all proscribed conduct in connection with a purchase or sale of any security; § 14 applies to all proxy solicitations, whether or not in connection with a purchase or sale. The fact that there may well be some overlap is neither unusual nor unfortunate. . . . Accordingly, we find no bar to the application of Rule 10b-5 to respondents' misstatements in their proxy materials.⁴⁷

In the light of these decisions, it seems clear that the antifraud provisions are applicable to the alleged misconduct in connection with the National Student Marketing-Interstate merger.⁴⁸

The complaint, it should be noted, does not allege that the attorneys entered the market either to buy or sell shares of either of the two companies.⁴⁹ However, they were privy to "inside information" because of

45. 15 U.S.C. §§ 1011-15 (1964).

46. 393 U.S. at 467.

47. *Id.* at 468-69.

48. Transactions after January 1, 1973, are controlled by Rule 145, 17 C.F.R. § 230.145(a)(2) (1973), which states that for purposes of the 1933 Act any merger in which securities are exchanged shall be deemed to involve a "sale" within the meaning of section 2(3) of the Act.

49. The third claim of the Complaint alleges that, after receipt of the comfort letter, White & Case requested, and Lord, Bissel & Brook issued, an opinion letter stating that former Interstate shareholders were free to sell National Student Marketing shares acquired in the merger. The opinion letter, according to the Commission, failed to

their relation to the merger transaction. The first pronouncement of the SEC concerning insider disclosure is found in *In the Matter of Cady, Roberts & Co.*:⁵⁰ “[I]nsiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment. Failure to make disclosure under these circumstances constitutes a violation of the antifraud provisions.”⁵¹ The Commission defined the term “insider” broadly;⁵² thus, anyone who acquires inside information, even one with no continuing relationship to the company, may be held liable for failure to disclose.⁵³

The language of *Cady, Roberts* suggests the necessity of privity to state a cause of action. Nevertheless, when read with *Texas Gulf*, it appears that a stock market transaction by the defendant is not necessary to satisfy at least section 10(b):

disclose the contents of the comfort letter or the alleged need for readjustment of the interim financials. The Commission alleges that approximately 77,000 shares of National Student Marketing valued at \$1,900,000 were sold on the basis of this opinion. Complaint, *supra* note 18, ¶¶ 49-52. The textual analysis is limited, however, to the attorneys' alleged failure to halt the merger until full disclosure of the comfort letter could be achieved.

50. 40 S.E.C. 907 (1961).

51. *Id.* at 911.

52. [T]he anti-fraud provisions are phrased in terms of “any person” and that a special obligation has been traditionally required of corporate insiders, e.g., officers, directors, and controlling stockholders. These three groups, however do not exhaust the classes of persons upon whom there is such an obligation. Analytically, the obligation rests on two principal elements: first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing. In considering these elements under the broad language of the anti-fraud provisions we are not to be circumscribed by fine distinctions and rigid classifications. Thus our task here is to identify those persons who are in a special relationship with a company and privy to its internal affairs, and thereby suffer correlative duties in trading in its securities. Intimacy demands restraint lest the uninformed be exploited.

Id. at 912.

53. *Accord*, SEC v. Texas Gulf Sulphur, 401 F.2d 833, 848 (2d Cir. 1968). See also *Fischer v. Kletz*, 266 F. Supp. 180 (S.D.N.Y. 1967), where the defendant independent auditor sought to dismiss a private 10b-5 damage action predicated on allegations that required reports prepared by the auditors contained false statements, that the auditors subsequently discovered the errors and failed to disclose the newfound information. The court refused to dismiss the complaint.

[I]t seems clear from the legislative purpose Congress expressed in the Act, and the legislative history of Section 10(b), that Congress when it used the phrase "in connection with the purchase or sale of any security" intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities. There is no indication that Congress intended that the corporations or persons responsible for the issuance of a misleading statement would not violate the section unless they engaged in related securities transactions or otherwise acted with wrongful motives; indeed, the obvious purposes of the Act to protect the investing public and to secure fair dealing in the securities markets would be seriously undermined by applying such a gloss onto the legislative language.⁵⁴

Therefore, it appears that a sale of securities did take place in the merger of Interstate National into National Student Marketing, and that it was not necessary that attorneys actually have engaged in market transactions to be subject to rule 10b-5. In light of the lawyers' alleged failure to disclose material inside information, the SEC seems to be on solid ground in issuing the complaint. Whether the attorneys *should* be liable in this situation is a more difficult question.

PRIVILEGE V. DISCLOSURE: THE ROLE OF THE SEC PRACTITIONER

The complaint in *National Student Marketing* has upset members of the securities bar who view it both as a threat to the confidential nature of attorney-client privilege and an attempt to place the attorney in a quasi-adversary position vis-à-vis his own client. These practitioners argue that any attempt to invade the confidential relationship may result in even less disclosure, as clients might withhold potentially damaging information from their securities counsel.⁵⁵ The Commission finds this reasoning specious. One SEC official commented that: "The securities bar is getting to be like the tax bar; it's specializing in finding loopholes in the law."⁵⁶ Former SEC chairman William L. Cary was unequivocal in his support for the Commission's action in *National Student Market-*

54. SEC v. Texas Gulf Sulphur, 401 F.2d 833, 860 (2d Cir. 1968).

55. Wall Street Journal, Feb. 15, 1972, at 17, col. 3.

56. *Id.* col. 4.

ing. He said, "It will set higher standards for lawyers in handling their clients' financial matters."⁵⁷

If prior case law is an accurate guide to the probable disposition in *National Student Marketing*, it seems likely that the Commission's position, rather than the practitioners', will be upheld. As early as 1964, the Second Circuit, affirming the convictions of an auditor and an attorney for conspiracy and mail fraud in connection with a sale of unregistered securities,⁵⁸ stated: "In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar."⁵⁹ More recently, the SEC obtained an injunction against an attorney who had drafted an allegedly misleading offering circular.⁶⁰ Although the issuance of a temporary injunction by the district court was reversed because of procedural defects, the Second Circuit did explain circumstances which would give rise to injunctive relief:

Although Frank makes much of this being the first instance in which the Commission has obtained an injunction against an attorney for participation in the preparation of an allegedly misleading offering circular or prospectus, we find this unimpressive. . . . A lawyer has no privilege to assist in circulating a statement with regard to securities which he knows to be false simply because his client has furnished it to him. At the other extreme it would be unreasonable to hold a lawyer who was putting his client's description of a chemical process into understandable English to be guilty of fraud simply because of his failure to detect discrepancies between their description and technical reports available to him in a physical sense but beyond his ability to understand. The instant case lies between these extremes. The SEC's position is that Frank had been furnished with information which even a non-expert would recognize as showing the falsity of many of the representations. . . . If this is so, the Commission would be entitled to prevail; a lawyer, no more than others, can escape liability for fraud by closing his eyes to what he saw and could readily understand.⁶¹

57. NEWSWEEK, March 6, 1972, at 61.

58. *United States v. Benjamin*, 328 F.2d 854 (2d Cir. 1964).

59. *Id.* at 863.

60. *SEC v. Frank*, 388 F.2d 486 (2d Cir. 1968).

61. *Id.* at 488-89.

If the Commission in *National Student Marketing* proves the facts alleged, the court may well conclude that the attorneys were aware of the discrepancies in the proxy materials and did in fact "close their eyes." For this type of conduct the injunction must issue. The cornerstone of securities regulation is disclosure, and the securities attorney, as an expert in law, is in the best position to insure that the law commanding disclosure is obeyed.

The Commission appears to be on sound ground, not only in bringing to task the conduct of the National Student Marketing attorneys, but also in seeking to establish procedures to be followed by the attorney who learns that his client's statements may be misleading. The complaint recites that the attorneys should have either insisted that the financial statements be revised and shareholders resolicited, or ceased representing the two companies and notified the Commission of the alleged misleading nature of the statements.⁶² It is this duty of disclosure which has caused the greatest consternation,⁶³ even though the Commission's proposed standard of conduct comports with the American Bar Association's Code of Professional Responsibility.⁶⁴

The ABA Code recites:

A lawyer who receives information clearly establishing that:

- (1) His client has, in the course of the representation, perpetrated a fraud upon a person or tribunal, *shall* promptly call upon his client to rectify the same, and if the client refuses or is unable to do so, he *shall* reveal the fraud to the affected person or tribunal.⁶⁵

62. Complaint, *supra* note 18, ¶ 48(i).

63. See Summary, 138 BNA SEC. REG. & L. REP. 1 (Feb. 9, 1972).

64. A contrary view has been advanced; although the Canons specify the need for candor, they also require confidentiality. Analogous cases usually balance these competing needs in favor of maintaining a client's confidences. Moreover, those cases which find accountants liable can be distinguished from cases such as *National Student Marketing Corp.*, insofar as attorney's liability is concerned, on several grounds. These grounds include the following: First, the securities law does not recognize an accountant-client privilege. Second, an attorney acts as an agent for a client while an accountant acts independently to certify material facts. Third, an attorney is not a section 11(a) "expert," but an accountant is. Karmel, *Attorneys' Securities Laws Liabilities*, 27 BUS. LAW. 1153, 1160-63 (1972).

65. ABA CODE OF PROFESSIONAL RESPONSIBILITY, DISCIPLINARY RULE 7-102(B) (1) (1969) (emphasis supplied).

As a Disciplinary Rule, this ABA standard is a mandatory requirement of the minimum acceptable level of conduct and is "uniformly applied to all lawyers, regardless of the nature of their professional activities."⁶⁶

Some might argue that the rule applies only to information from independent sources and not to information obtained within the scope of the attorney-client privilege. However, this position does not comply with the Code, which provides that: "A lawyer may reveal . . . [c]onfidences or secrets⁶⁷ when permitted under Disciplinary Rules or required by law or court order."⁶⁸ Thus, an attorney is permitted by the ABA Code to reveal privileged information indicating misconduct by his client, and when the information "clearly" indicates fraud there is nothing in the standard of conduct proposed by the SEC in *National Student Marketing* which constitutes a departure from the ABA Code.

SOME CONSEQUENTIAL CONSIDERATIONS

In its prayer for relief, the Commission seeks to enjoin permanently the law firms and auditors, the named partners, "their agents, servants, employees, successors, assignees and those persons in active concert or participation with them, from, directly or indirectly" violating any of the provisions of rule 10b-5, from filing false and misleading reports with the SEC, and from disseminating proxy materials in contravention of section 14(a) of the Securities Exchange Act of 1934.⁶⁹ This prayer, practitioners have argued, places the defendant law firms on the horns of a most difficult dilemma. First, they can defend the suit, raising the attendant publicity, in an effort to be vindicated; however, if the factual allegations are proven, judgment for the Commission seems warranted. An alternative approach would be to enter a consent decree to the injunction.⁷⁰ The lawyers in *National Student Marketing*, should they enter a consent decree, would avoid the publicity and expense of a

66. *Id.* at PRELIMINARY STATEMENT.

67. "Confidence" is defined by the Code as including all information protected by the attorney-client privilege. "Secret" is a broader term meaning all information acquired in the professional relationship which the client has requested not be released and which would be embarrassing or detrimental to the client. *Id.* at 4-101(A).

68. *Id.* at 4-101(c)(2).

69. Complaint, *supra* note 18, prayer for relief, at 44-45.

70. See, e.g., SEC v. Pig'n' Whistle Corp., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,384 (N.D. Ill. 1972) (Issuer and Financial Public Relations Firm). The consent decree for National Student Marketing Corp. is reported at [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,581 (D.D.C. July 26, 1972).

lengthy suit, but would be subject to possible sanctions under rule 2(e) of the SEC Rules of Practice.⁷¹ The provisions of this rule, as it would apply in this case, are essentially as follows. The Commission, in consideration of the public interest and without a hearing, may suspend temporarily from SEC practice any attorney or other professional who has been enjoined by name from further violations of the securities laws.⁷² For purposes of the rule, any person who consents to an injunction is presumed to have been enjoined for misconduct and is also subject to suspension.⁷³

The temporary suspension would last 30 days, during which time the suspended party would be entitled to petition the SEC to lift the suspension.⁷⁴ If no petition is filed, the suspension becomes permanent; once petitioned, however, the Commission would be required either to lift the temporary suspension or to set the matter for hearing at which time the petitioner could be censured, suspended for an additional period, or disqualified permanently.⁷⁵ After a showing that the injunction has issued, the petitioner would have the burden to show cause why disciplinary measures should not be taken.⁷⁶

The rule imposes severe sanctions. Nevertheless, three mitigating factors are worthy of note. First, the decision to invoke any sanction is discretionary with the Commission, and, therefore, it is by no means certain that an injunction will trigger a suspension automatically. Second, even if the disciplinary proceeding is carried to its full length, the suspended practitioner at any time may apply for reinstatement and, upon a satisfactory showing, be reinstated.⁷⁷ Finally, the Commission has exhibited a tendency to tread lightly on penalties when it breaks new ground in defining violations.⁷⁸ Since rule 2(e) has been rewritten only recently, the attorneys, if found culpable, may escape the most severe sanctions that the Commission might otherwise impose.

A complete escape, however, is unlikely. If wrongful activities are proven, the attorneys might not be barred from SEC practice, but the

71. 17 C.F.R. § 201.2(e), as amended by Release No. 33-5088 (Sept. 24, 1970) and Release No. 33-5417 (May 10, 1971).

72. 17 C.F.R. § 201.3(i).

73. *Id.* § 201.3(iv).

74. *Id.* § 201.3(ii).

75. *Id.* § 201.3(iii).

76. *Id.* § 201.3(iv).

77. *Id.* § 201.4.

78. A classic example is *In re Ira Haupt & Co.*, 23 S.E.C. 589 (1946).

probability of an action for money damages cannot be discounted. At present, five private damage suits naming the attorneys as defendants have been reported.⁷⁹ In this regard, the possibility of class actions seeking damages for attorneys' misconduct should not be ignored. Considerations of whether any single plaintiff could represent a class of traders, however, is beyond the scope of this Article.

Assuming that a plaintiff does succeed, the law firms would become liable under the judgment. Efforts by individual defendants to rely on indemnification agreements to avoid personal liability for violations of the securities laws have been unsuccessful in at least one instance. In *Globus v. Law Research Service, Inc.*,⁸⁰ an underwriter joined as a defendant in a private fraud action sought indemnity under its agreement with the issuer. The court denied the benefit of the agreement, since enforcement would work in derogation of the public policy imposing disclosure obligations on all parties to securities transactions.⁸¹ The only form of protection, and it is really no protection at all, is the right of the defendant who has suffered judgment to contribution from his joined co-defendants.⁸² From the standpoint of lawyers generally, the contribution right under the securities laws has two principal aspects. First, for lawyers named as defendants, the right runs only against those bound by the judgment. Thus, any parties not named as original defendants who may be liable should be served with third-party complaints to preserve the contribution right. Second, for lawyers not named, in suits past and present, the running of the statute of limitations on the original plaintiff's claim, if any, against the lawyer does not bar the possibility of claims for contribution on the part of the named defendants. The action for contribution has its own limitation period, which does not begin to run until judgment is rendered on the original claim. Admittedly, this is little solace for the attorney found liable in a securities fraud suit, but little solace appears justified.

79. See *In re National Student Mktng. Litigation*, [Current Binder] CCH FED. SEC. L. REP. ¶ 93,743 (Jan. 29, 1973).

80. 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 387 U.S. 813 (1970).

81. See *State Mut. Life Assurance Co. v. Peat, Marwick, Mitchell & Co.*, 49 F.R.D. 202 (S.D.N.Y. 1969), where a similar result was reached in a suit by auditors claiming implied indemnity against corporate officers.

82. The right to contribution for 10b-5 defendants was first recognized in *deHass v. Empire Petroleum Co.*, 286 F. Supp. 809 (D. Colo. 1968). It has been acknowledged in the Southern District of New York in *Globus, Inc. v. Law Research Serv., Inc.*, 318 F. Supp. 955 (S.D.N.Y. 1970).

CONCLUSION

The alleged conduct of the defendant attorneys in *National Student Marketing* appears to be actionable fraud under the securities acts. It further appears that the alleged misconduct was in violation of the ABA Code of Professional Responsibility and that the Code forms the standard of conduct which the complaint seeks to establish. One author has remarked: "The auditors probably figured that if something disreputable was going on, then White and Case would not sit quietly by as counsel. White and Case was probably reassured by the fact that Peat, Marwick, Mitchell apparently had no qualms about the financial statements."⁸³ It is the contention of the SEC, however, that passive as well as active misconduct is actionable under the antifraud provisions.

Any outrage at the institution of this complaint is misplaced. If the facts alleged are proven, imposition of liability on the lawyers *qua* lawyers seems justified. To require the securities bar to protect the investing public by disclosing the conduct of which they have knowledge imposes no greater duty upon the practitioner than the American Bar Association's own standards of community responsibility. To impose such a duty, although contrary to accepted industry practice, is a reasonable means to implement a primary purpose of the securities laws—protection of the individual investor through full disclosure.

83. A. TOBIAS, *supra* note 19, at 85.