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Peter Chepucavage

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The SEC and the Securities Bar: Adversaries or Allies?

Nothing is so easy as to be wise after the event.¹

The wisdom of two distinguished law firms before the event is presently being questioned by the Securities and Exchange Commission (SEC) in its complaint against National Student Marketing Corporation (NSMC),² which *The Wall Street Journal*³ has recently categorized as "the best-read document since 'Gone With the Wind'." The issue which has created this great agitation is the SEC's contention that:

When an attorney permits his name to be used either in a registration statement or in any other document associated with a securities transaction, and such attorney's opinion or other participation will have the effect of inducing third parties to rely upon that attorney's participation as to the validity of a transaction or the occurrence of an event, the attorney's responsibilities cease to be solely to his client and run to these third parties, of which the SEC may be one, if the attorney's representations are contained in a document filed with such agency.⁴

The SEC has named twenty individual, corporate and partnership defendants in its complaint alleging the perpetration of fraud in the securities market. The complaint charges violations of § 17(a) of the Securities Act of 1933⁵ and § 10(b) of the Securities Exchange Act of 1934,⁶

1. Quoted by Bramwell, B. in *Cornman v. The Eastern Counties Ry. Co.*, 5 Jur. (N.S.) 657, 658 (1859).

2. Civil Action No. 225-72 (D.D.C., filed Feb. 3, 1972) [hereinafter cited as Complaint]. The text of the Complaint may also be found in (1971-1972 Transfer Binder) CCH FED. SEC. L. REP. ¶ 93,360 (1972).

3. Green, *A Bid to Hold Lawyers Accountable To Public Stuns, Angers Firms*, Feb. 15, 1972, at 1, col. 1.

4. N.Y.L.J., Mar. 10, 1972, at 3, col. 5.

5. 15 U.S.C. § 77q(a) (1970).

6. 15 U.S.C. § 78j(b) (1970) and Rule 10b-5 thereunder, 17 CFR § 240.10b-5 (1973). Rule 10b-5 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,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (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 or sale of any security.

The SEC is restricted to seeking injunctive relief as to those acts or practices alleged

both of which prohibit the use of false or misleading statements in the sales or purchase of securities. The complaint also alleges violations of §§ 13(a) and 14(a) of the Securities Exchange Act of 1934⁷ which prohibit the use of false or misleading statements in the solicitation of proxies and require the filing of accurate reports with the SEC when required.

The corporate defendants have accepted a consent decree which enjoins NSMC, its officers, and agents from committing any of the acts enumerated in the SEC complaint and orders them to file amended reports as required by § 13(a) for the period in question.⁸ However, the other defendants including White & Case, a prominent New York law firm; Lord, Bissel & Brook, a well known Chicago law firm; Robert A. Katz,⁹ a sole practitioner in New York City at the time of the alleged violations; Peat, Marwick, Mitchell & Co., a prestigious national accounting firm; and certain individual members of these partnerships have decided to contest the SEC's action. As of August 9, 1973, all defendants have answered the complaint and are awaiting a decision by the U.S. District Court for the District of Columbia on a mutual schedule of discovery.¹⁰

I. *The SEC Complaint*

The SEC is seeking to enjoin the defendant attorneys and accountants from any further violations of the anti-fraud provisions of the Securities Act and

to violate the law or commission rules. However, a private right of action has been found to exist under § 10(b). In fact, White & Case and Lord, Bissell & Brook, among others, have already been named in a civil action on the SEC's complaint in the NSMC case. *Natale v. National Student Marketing Corporation*, Civil Action No. 721-72 (S.D.N.Y., filed Feb. 18, 1972).

If fraud or other willful law violation is indicated, the SEC may refer the facts to the Department of Justice with a recommendation for criminal prosecution of the offending persons. That Department, through its local United States Attorneys, may present the evidence to a federal grand jury and seek an indictment.

7. 15 U.S.C. §§ 78m(a) and 78n(a) (1970) and rules and regulations thereunder.

8. Judgment of Permanent Injunction, *SEC v. National Student Marketing Corporation*, Civil Action No. 225-72 (D.D.C., July 26, 1972).

9. Defendant Katz is named in the fourth claim of the complaint. Mr. Katz represented the purchasers of Compujob, Inc., and prepared and/or drafted the documents in connection with the acquisition of Compujob by his clients from NSMC. The SEC charges that Katz issued a legal opinion to the effect that the Compujob sale was completed and the income from the sale could be properly included in NSMC's financial statements for its fiscal year ending August 31, 1969. The SEC alleges that the sale was not completed, and therefore the income could not properly be included. Thus, Katz contributed to the false and misleading statements which are at issue in this case. However, since Katz was not directly involved in the merger, his role will not be discussed in this article.

10. On March 7, 1973, the court denied a motion of Lord, Bissell & Brook to dismiss the amended complaint or, in the alternative, for summary judgment. It also denied motions of defendants White & Case and partner Marion Jay Epley to dismiss the amended complaint or alternatively to sever and transfer those claims against them to the U.S. District Court for the Southern District of New York.

the Exchange Act in connection with the purchase or sale of NSMC stock, or that of *any other issuer*. It also requests an injunction against White & Case and its partner, Marion Jay Epley, against violation of § 13(a) of the Exchange Act by filing of false and misleading annual reports and other documents. Further, it seeks to enjoin them from issuing and disseminating proxy material for meetings of NSMC or *any other person* which does not comply with § 14(a) of the Exchange Act. An injunction of this type could have dire consequences for these defendant attorneys in the future, since it could transform an erroneous opinion of White & Case given in some future securities transaction into contempt of court.¹¹ Moreover, under Rule 2(e) of the SEC's Rules of Practice,¹² the entry of such an injunction could result, without any hearing, in their being suspended from future appearances or practices before the Commission.

The complaint generally is based upon the alleged issuance of false financial reports by NSMC. The specific allegations against the defendant attorneys and accountants, found in the second claim¹³ of the complaint, may be summarized as follows: (a) that at the closing of the merger between NSMC and Interstate National Corporation (Interstate) in New York City on October 31, 1969, the attorneys (White & Case for NSMC, and Lord, Bissel & Brook for Interstate) failed to refuse to issue a legal opinion that all steps taken by NSMC to consummate the merger of Interstate with NSMC had been validly taken and that, to the knowledge of counsel, NSMC had incurred no violation of federal or state law; (b) that they failed to insist that NSMC's financial statements be revised and shareholders be resolicited with respect to the Interstate-NSMC merger; (c) that, having failed to insist on such revision and resolicitation, they failed to cease representing their clients; (d) they failed to notify the plaintiff Commission concerning the allegedly misleading nature of certain unaudited nine-month financial statements of their client NSMC; and (e) they transmitted a report on behalf of their client to the SEC which concealed certain information which defendant Peat, Marwick, Mitchell & Co., had sent in a "comfort letter."

II. Rule 10b-5 Comes of Age

Since the enactment of the Securities Exchange Act of 1934, a considerable body of federal corporation law has developed.¹⁴ This is especially true of

11. Karmel, *Attorneys' Securities Law Liabilities*, 27 *BUS. LAW.* 1153, 1155 (1972) [hereinafter cited as Karmel].

12. 17 C.F.R. § 201.2(e)(3)(i) (1973).

13. Complaint at para. 48.

14. W. CARY, *CORPORATIONS CASES AND MATERIALS*, 594 (4th ed. abr. 1970).

Rule 10b-5. "The courts have used Rule 10b-5 to expand the range of liability in the realm of securities transactions, thereby creating a Federal common law which is in a state of flux."¹⁵ The question presented by the NSMC case is whether corporate attorneys under these circumstances may be included in this range of liability. Although § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 promulgated thereunder state that they may be invoked against "any person" who indulges in fraudulent practices in connection with the purchase or sale of securities, in actual practice defendants in § 10(b) and Rule 10b-5 cases have tended to fall into four general categories:¹⁶ (a) insiders (those persons who, because of their position have access to the facts not available to the general public and use this information for their personal benefit); (b) broker-dealers; (c) corporations whose stock is purchased or sold by plaintiffs; and (d) those who "aid and abet" or conspire with a party who falls into one of the first three categories. In the instant case, defendant corporate attorneys would have to come under the last classification.¹⁷

Although injunction proceedings against attorneys for Rule 10b-5 violations are a recent phenomenon and there is little precedent to follow, the allegations under the circumstances of this case do not seem unfounded. Numerous courts and the SEC have taken the position that accountants may be held liable to third parties as a result of 10b-5 violations.¹⁸ Further-

15. *Drake v. Thor Power Tool Co.*, 282 F. Supp. 94, 97 (N.D. Ill. 1967).

16. *Fischer v. Kletz*, 266 F. Supp. 180, 190 (S.D.N.Y. 1967). See also *Pettit v. American Stock Exchange*, 217 F. Supp. 21 (S.D.N.Y. 1963), where a charge against the American Stock Exchange of aiding and abetting the illegal distribution of stock by failing to take disciplinary action against "abusive conduct and practices priorities" which the agency knew or should have known was held sufficient to sustain a complaint.

17. The precise definition of an "aider and abettor" is not clear. In *SEC v. National Bankers Life Insurance Co.*, 324 F. Supp. 189 (N.D. Tex., 1971), *aff'd mem.*, 448 F.2d 652 (5th Cir. 1971), the court noted that, with respect to fraudulent conduct in violation of § 17(a) of the Securities Act and Rule 10b-5, "aiding and abetting" is an elusive concept, but that "it is clear that the defendant must have some knowledge of the fraudulent act or scheme he is aiding, though that knowledge may be actual or constructive." 324 F. Supp. at 195.

In *Brennan v. Midwestern United Life Insurance Co.*, 259 F. Supp. 673, 682 (N.D. Ind. 1966), *aff'd* 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970), the court noted that "there are circumstances under which a person or a corporation may give the requisite assistance or encouragement to a wrongdoer so as to constitute an aiding or abetting by merely failing to take action." 259 F. Supp. at 682. *But cf.* *Wessel v. Buhler*, 437 F.2d 279, 283 (9th Cir. 1971), "We find nothing in Rule 10b-5 that purports to impose liability on anyone whose conduct consists solely of inaction." For a more thorough discussion of the aider and abetter theory in relation to the NSMC case, see 48 NOTRE DAME LAWYER 661, 664-666 (1973).

18. See *Fischer v. Kletz*, 266 F. Supp. 180, 190 (S.D.N.Y. 1967), and Brief for SEC as Amicus Curiae, *Fischer v. Kletz*, CCH FED. SEC. L. REP. ¶ 91,844 (S.D.N.Y. 1966); *H.L. Green Co., Inc. v. Childree*, 185 F. Supp. 95 (S.D.N.Y. 1960); *In re Touche, Niven, Bailey and Smart*, 37 S.E.C. 629, 670-671 (1957); Consent Injunction

more, as previously stated, both the 1934 Act and SEC Rule 10b-5 include "any person" who indulges in fraudulent practices "in connection with the purchase or sale of securities."¹⁹

Thus, there does not seem to be much reason why an attorney who has made an untrue statement in connection with the purchase or sale of any security should not be found guilty of a Rule 10b-5 violation. As the court reasoned in *SEC v. Frank*,²⁰ "[A] lawyer, no more than others, can escape liability for fraud by closing his eyes to what he saw and could readily understand." In fact, the recent trend of securities law has been that an attorney should be held to a higher standard of due care in securities transactions. In *Escott v. BarChris Construction Corp.*,²¹ an individual attorney-director, among others, was found liable for violation of § 11 of the 1933 Act. In determining whether the attorney involved had made a reasonable investigation before attaching his name to a registration statement, the court reasoned that since his law firm was Counsel for BarChris in matters pertaining to the registration of securities, and he had personally drafted the registration statement for the debentures, more was required of him in the way of reasonable investigation as a result of his unique position. Moreover, in a situation reasonably similar to that in the NSMC case, the court reasoned that "instead of simply relying on the assurances of his client that there had been no adverse changes in the company's financial position, he should have checked for himself those matters which were easily verifiable."²²

III. Attorneys as Policemen

The most interesting and undoubtedly the most surprising aspect of the SEC's complaint is the allegation that, under the circumstances, the attorneys had the duty to notify the SEC of the irregularities. Although, as previously noted, the attorneys could be guilty of a 10b-5 violation by simply issuing a false statement in connection with the purchase or sale of secur-

in *SEC v. Pig 'N Whistle Corp.*, Civil Action No. 545-71 (N.D. Ill., Feb. 14, 1972); In *Pattie Lea, Inc. v. District Court*, 161 Colo. 493, 423 P.2d 27 (1967), the court held that, in a good faith derivative suit initiated by stockholders, the statutory privilege for communication between a certified public accountant and his corporate client did not protect the corporation from being required to disclose such communications to the stockholders. The Colorado court relied upon the analogy of the joint attorney exception and pointed out that employment of certified public accountants by the corporation was for the benefit of all the stockholders.

19. *Supra* note 6 (emphasis added).

20. 388 F.2d 486, 489 (2d Cir. 1968).

21. 283 F. Supp. 643 (S.D.N.Y. 1968). For a more thorough discussion of the *BarChris* case in relation to the National Student Marketing case, see 46 TEMP. L.Q. 153 (1972).

22. 283 F. Supp. at 692.

ities, the SEC's further allegations seem to be more of a guide for other securities lawyers who may find themselves in similar situations. The complaint seems to suggest the various alternatives the SEC believed the attorneys then had. Presumably these alternatives, if acted upon, could have reduced the seriousness of their participation in the alleged fraudulent scheme in varying degrees. The SEC contends that once the defendants had given their opinion, they could have either convinced the corporation to resolicit the proxies or withdrawn from the case and informed the SEC of their withdrawal.

Probably the most controversial aspect of this case is the interpretation of the SEC's allegation calling for an attorney to be a "policeman" instead of an advocate, thus jeopardizing the confidential attorney-client relationship.²³ This is undoubtedly an overly-broad interpretation of the SEC's position, for a careful reading of the complaint will show that it is only under the particular circumstances of this case, that the SEC asserts this novel obligation.

IV. Circumstances Under Which the Alleged Violation Occurred

A brief history of the events leading up to the closing of the merger is necessary in order for one to clearly appreciate the basis of the SEC's allegation. Included in the merger agreement, which constituted part of the proxy material sent to shareholders of both corporations in order to gain approval of the merger, was the condition that the three partnership defendants were to scrutinize the agreement and to submit opinions on it. One consequence of this was that the shareholders could rely on these opinions as to the validity of the merger. As the SEC stated,

Presumably, these conditions were for the protection of the shareholders and were intended to assure them that the integrity of the merger would be protected by Peat, Marwick, Mitchell & Co. as accountants, and Lord, Bissell & Brook and White & Case, as counsel—all of whom were cited by name in the Agreement as being responsible for fulfilling these conditions.²⁴

According to the merger agreement, Peat, Marwick, Mitchell & Co. was to submit a "comfort letter" which would assure that on the basis of a limited

23. *Supra* note 2.

24. Memorandum of the Securities and Exchange Commission in Opposition to the Motion of Defendants Lord, Bissell & Brook, Max E. Meyer, Louis F. Schauer and Cameron Brown to Dismiss the Complaint for Failure to State A Claim Upon Which Relief Can Be Granted or, in the Alternative, for Summary Judgment and In Opposition to the Motion of Defendants Paul E. Allison, William J. Bache and Robert P. Tate for Summary Judgment. Civil Action 225-72, p. 6 (D.D.C., filed Feb. 3, 1972) [hereinafter cited as SEC Memo].

review, but not an audit, they had no reason to believe that any material adjustments of the unaudited interim financial statements sent in the proxy material would be required.²⁵ This letter was to include the period from May 31, 1969 to a specified date not more than five business days prior to the effective date of the merger. White & Case was to issue a favorable opinion that, among other things, all actions and proceedings required by law to be taken by NSMC in connection with this agreement had been duly and validly taken.²⁶ Lord, Bissel & Brook was to do the same regarding Interstate.²⁷ The closing of the merger occurred on October 31, 1969, when the legal opinion was issued. However, the SEC alleges that on the same day, but before the legal opinion was issued, Peat, Marwick, Mitchell & Co. dictated their findings over the telephone to the assembled representatives of NSMC and Interstate. Their eagerly awaited comfort letter turned out to be of little comfort in that it stated that the financial statements should be adjusted. As the SEC said,

In sum the "comfort letter" stated that in order to get a fair picture of the results of NSMC's operations for the nine months ended May 31, 1969, income should be reduced by \$884,000. Since the company publicly and in the proxy statement has reported earnings of \$702,000, a reduction of income by \$884,000 meant that NSMC should have reported a loss rather than a profit.²⁸

Thus, in order for the shareholders to have been aware of NSMC's true financial status, all proxies should have been resolicited. Indeed, after the closing, in its formal letter, Peat, Marwick, Mitchell & Co. suggested that the companies should consider submitting corrected interim unaudited financial information to the shareholders prior to proceeding with the closing.²⁹ This would have been a costly and time-consuming process. Moreover, if Peat, Marwick, Mitchell & Co.'s estimate of a net loss was correct, there would always be the possibility that shareholder approval would not be readily forthcoming.³⁰ The SEC alleged that the attorneys should have

25. Agreement and Plan of Merger between National Student Marketing Corporation and Interstate National Corporation dated as of Aug. 13, 1969, and included as Schedule C to the NSMC proxy material filed with the SEC on Oct. 6, 1969, para. 9(e).

26. *Id.* at para. 9(a)(IX).

27. *Id.* at para. 8(a)(X).

28. SEC Memo at 8.

29. Complaint at para. 48(c).

30. According to the Affidavit of Cameron Brown, President of Interstate at the time of closing, consideration was given to resoliciting shareholders with correct financial information, but this idea was rejected (SEC exh. 5 page 41, Brown Aff. par. 25).

Two factors which the SEC thinks influenced the decision not to resolicit proxies are discussed in the SEC Memo:

1) White, Weld & Co. was retained by Interstate to act as investment advisors and evaluate the merger. They had stated in their report that among the principal causes

insisted upon a resolicitation. For the moment let us assume they did, and the corporation refused. What should the attorneys have done? The SEC would have them withdraw from the case and inform the SEC of the alleged irregularities. They would require the same of Peat, Marwick, Mitchell & Co. Thus, a question of professional responsibility arises: Are the attorneys and accountants responsible to their clients, the corporate entity and its management, or to the shareholders who voted the merger and the rest of the investing public?³¹

Under the circumstances of this case a strong argument can be made that the attorney's responsibility lies with the shareholders of both corporations and the rest of the investing public. First of all, one could argue that the communication involved, the comfort letter, was not a confidential document. Secondly, there is a strong possibility that even if it were confidential, the crime-fraud exception to the attorney-client privilege is applicable.

A. *The Communication is not Confidential*

The SEC did not order the revelation of a privileged lawyer-client communication, but rather suggested that the attorneys should have revealed to the

they could foresee for a possible price drop of 20 percent or greater in NSMC's stock was a significant adverse development such as the cancellation of an announced merger, or some incident impeaching the credibility of management (failing to achieve an earnings forecast). *Id.* at 10; and

2) Immediately following the closing, other officers and directors of Interstate and its subsidiaries sold approximately \$1,900,000 in NSMC stock which they had obtained in the merger. Yet, "no one sought to advise the open market purchasers of NSMC's shares that the most recently published financial statements of NSMC were materially in error and that in fact with the PMM adjustments NSMC had sustained a loss. Such a revelation could have caused a major price drop in the stock, as White, Weld & Co., had advised." *Id.* at 12.

It should be further noted that the price of NSMC stock went from an all time high of \$72.00 a share on December 15, 1967 to \$1.00 a share at the time of the filing of the complaint. *Id.* at 14-15.

SEC Rule 14a-9 deals with False or Misleading Proxy Statements. It states in part:

(a) No solicitation subject to this regulation shall be made by means of any proxy statement . . . which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

31. An interesting example of a similar dilemma is found in the recent case of *Garner v. Wolfenbarger*, 430 F.2d 1093 (5th Cir. 1970), *cert. denied*, 401 U.S. 974 (1971). There the defendant corporation attempted to invoke the attorney-client privilege in a shareholder derivative suit. The court of appeals rejected the district court's reasoning that the privilege was invalid in a shareholder derivative suit and reasoned:

But where the corporation is in a suit against its stockholders on charges of acting inimically to stockholder interests, protection of those interests as well as those of the corporation and of the public require that the availability of the privilege be subject to the right of the stockholders to show cause why it should not be invoked in the particular instance. *Id.* at 1103-1104.

Commission the contents of the "comfort letter" sent by Peat, Marwick, Mitchell & Co. This letter, by its nature, was public information since its purpose was to assure the stockholders that material adjustments of the unaudited interim financial statements were not required. Therefore, having given their approval of a merger relying upon the receipt of a comfort letter, it can be said that the shareholders had a right to know that the merger took place in spite of the fact that the comfort letter did not meet the requirements of the merger.

The defendants in this case view their legal opinion and the comfort letter in an entirely different light. In their answer to the SEC's complaint, White & Case and Mr. Epley alleged that the comfort letter "was a waivable condition precedent to Interstate National Corporation's obligation to consummate the merger, but was not a condition . . . to proceed with the merger."³² They argue that the representatives of Interstate were justified in closing the merger in spite of the letter because "[The] question of whether to proceed with the closing or not was for the representatives of Interstate to make as a matter of business judgment as to the best interests of Interstate and its stockholders."³³ Presumably they decided to go ahead in spite of the alleged mistake in earnings because the adjustments "would only reduce earnings by a few cents per share for the fiscal year ended August 31, 1969."³⁴

The SEC's probable response to this argument can be found in its answer to Lord, Bissell & Brook's Motion to Dismiss, where it addressed the "waivable" aspects of these conditions:

If defendants mean to imply that receipt of the comfort letter was waived by the Interstate Board, then they should show a decision of the Board *qua* Board to make such a waiver. This may prove a difficult task in the light of the position of Bach, Allison and Tate, discussed *supra*. [Bach, Allison, and Tate, directors of Interstate, claimed that they were not even aware of the letter or of its contents on the day of the closing or thereafter, until the following week when they received the final version of the letter from PMM in the mail.] Furthermore, under § 29(a) of the Exchange Act, 15 U.S.C. 78c(a), the requirement that statements made in connection with the purchase or sale of securities not be misleading, cannot be waived.³⁵

It appears that whether the conditions were waivable and by whom is not the important point here for the statute speaks of "misleading information." The issue could be more appropriately framed by asking whether

32. Answer of Defendants White & Case and Marion Jay Epley to the first amended complaint. Civil Action No. 225-72 (D.D.C., filed Mar. 27, 1973).

33. *Id.* at par. 33.

34. SEC Memo at 9.

35. *Id.* at 31, n.37.

defendants misled the shareholders by saying in one part of the proxy statement that a reputable law firm would pass upon the validity of the merger, as a condition to the merger, and saying in another portion of the proxy statement that this legal opinion could be waived. Had the shareholders realized that the condition could be waived, there would be no reason why defendants would have had to bring to their attention the fact that the comfort letter, as described, was never really received. On the other hand, if the shareholders believed that the receipt of a comfort letter was in fact a condition to the closing, it would be extremely difficult for defendants to argue that it was in fact confidential information which they could not show to either the shareholders or the SEC. The question for the court to determine will be whether the description of the comfort letter as a waivable condition to the closing of the merger was misleading.

B. *Even if the Communication is Confidential the Crime-Fraud Exception to the Attorney-Client Privilege is Applicable*

If the comfort letter was misleading, there is yet another reason why the attorneys' duty lies with the shareholders and the investing public. There has always been a "crime-fraud" exception to the lawyer-client privilege. "Communications made by a client to his attorney during or before the commission of a crime or fraud and for the purpose of being guided or assisted in such commission are not privileged."³⁶

Recent articles in BUSINESS LAWYER³⁷ and the TEXAS LAW REVIEW³⁸ have examined the NSMC case in light of past actions involving securities violations by attorneys. Both conclude that the "crime-fraud exception" is not applicable under these circumstances because neither of the following requisites for this exception can be found:

36. *Garner v. Wolfenbarger*, 430 F.2d 1093, 1102 (5th Cir. 1970) (dictum). At least one famous case states the exception even more broadly, extending it to communications with a lawyer in furtherance of "the purpose of committing a crime or tort." *United States v. United Shoe Machinery Corp.*, 89 F. Supp. 357, 358 (D. Mass. 1950). See also DR 7-102(B)(1) Code of Professional Responsibility (Adopted by the American Bar Association on Aug. 12, 1969):

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

DR 4-101(C)(2) and (3) state:

A lawyer may reveal confidences or secrets when permitted under Disciplinary Rules or required by law or court order. [He may also] reveal the intention of his client to commit a crime and the information necessary to prevent the crime.

37. *Supra* note 11.

38. 50 TEX. L. REV. 1265 (1972) [hereinafter cited as Texas Note].

Where such documents contain false or misleading information, an attorney's liability for such fraud, where an attorney is acting solely as agent for a client, must necessarily depend upon either actual knowledge of the fraudulent statements, or, absent such knowledge, a duty to discover the fraud.³⁹

Thus, since the crime-fraud exception does not apply, the authors argue that defendant attorneys had a higher duty to their client.

Hopefully, the legitimate public interest in preserving the confidential relationship between attorney and client will be regarded as more important than the SEC's apparent intention of enlisting the aid of private practitioners to implement enforcement of the securities laws.⁴⁰

Using both of these viewpoints to examine the applicability of the crime-fraud exception, it can be shown why their respective authors have not given enough weight to certain facts which make the SEC's complaint much stronger than they presume.

The first question to consider is whether the attorneys had actual knowledge of the fraud. Ms. Karmel seems to argue that the attorneys did not have actual knowledge of the fraud because it took place when the proxies were solicited. She cites ABA opinion 314 for the proposition that "[t]he difficult problem arises when the client has in fact misled but without the lawyer's knowledge or participation. In that situation, upon discovery of the misrepresentation, the lawyer must advise the client to correct the statement; if the client refuses, the lawyer's obligation depends on all the circumstances."⁴¹ She further notes that "[t]he complained-of soliciting material was disseminated prior to the time PMM or the defendant law firms were aware of possible problems in the presentation of the May 31, 1969 financials."⁴² This may be true, but it is irrelevant to the violation alleged. The SEC is not alleging any wrongdoing by the attorneys in the solicitation of proxies, for it is true that at that time they had no knowledge or any way of obtaining knowledge as to the validity of the financials.⁴³ Rather, the SEC alleges that the fraud occurred when the defendant attorneys supplied the "favorable opinion" necessary to close the merger, although they had been

39. Karmel at 1156. Texas Note at 1269-72.

40. Karmel at 1164.

41. *Id.* at 1161.

42. *Id.* at 1162.

43. If in fact the financial statements were untrue then the corporation would have committed a violation of § 14 and Rule 14a-9 when the proxy statements were sent out. On the other hand, since Rule 10b-5 requires that misleading statements be made "in connection with the purchase or sale of any security," the attorney's violation would not occur until Interstate shareholders exchanged their shares of stock for NSMC shares. See *SEC v. National Securities, Inc.*, 393 U.S. 453 (1969).

told in plain language by Peat, Marwick, Mitchell & Co. that the approval of the merger was based on false financial statements.⁴⁴ If this language was not clear enough, Peat, Marwick, Mitchell & Co. allegedly later stated in their "comfort letter" that Interstate and NSMC should consider submitting corrected interim unaudited financials to stockholders prior to proceeding with the closing.⁴⁵ Thus, although the "comfort letter" was supposed to be a requirement for closing,⁴⁶ the attorneys went ahead and issued a "favorable opinion" on the closing when,

in short, the comfort letter told those who saw it that the figures on which the Interstate (and NSMC) shareholders had given their approval for the merger were materially false and misleading. Yet, no disclosure of the adjustments required by the comfort letter was made to the Interstate shareholders (or the NSMC shareholders) specifically or to the investing public generally until the filing of the instant complaint by the Commission.⁴⁷

Assuming that even these actions do not constitute actual knowledge of a fraud, an examination of the second proposed requirement is necessary.

Based upon the information they had available to them, did the attorneys have a duty to discover the alleged fraud before they issued their opinion? The Texas article states, "[I]n the instant case, the accountant's last-minute discovery demanded a rapid judgment on a complex question—the legality of the NSMC merger."⁴⁸ Although the closing had been scheduled for October 31, 1969, the agreement did not require that the merger be consummated for almost one full month, until November 28, 1969.⁴⁹ Therefore the attorneys had almost a month to determine whether the Peat, Marwick, Mitchell & Co. allegations were correct, but they did not do so.⁵⁰ Although there seems to be little precedent concerning the duties of attorneys to verify information given them by their clients, *SEC v. Frank*⁵¹ seems relevant in that it deals with the most extreme position:

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

44. Complaint at para. 39(b).

45. *Id.* at para. 48(c).

46. *Supra* note 25.

47. SEC Memo at 9.

48. Texas Note at 1272.

49. *Supra* note 25, at paras. 9(j) and 8(k).

50. One thing the defendants could have done under these circumstances was to seek advice from the SEC. Although they had four weeks in which to do so, defendants did not approach the Commission for advice. A request for an opinion from the Commission or its staff is a well-recognized mitigating circumstance. *SEC v. Torr*, 87 F.2d 446 (2d Cir. 1937), *SEC v. Harwyn Industries Corp.*, 326 F. Supp. 943 (S.D.N.Y. 1971).

51. 388 F.2d 486 (2d Cir. 1968).

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.⁵²

There seems little doubt that the same could be true of a corporation's financial statements, if the attorney had no reason to suspect them. Yet the court held in *Frank* that although the attorney was not an expert within the meaning of § 11 of the Securities Act, he failed to establish his due diligence defenses because there were too many instances where he failed to make inquiries which he could easily have made and which, if pursued, would have put him on his guard.⁵³ Ms. Karmel would distinguish *Frank* in that "[t]he court in the *Frank* case viewed the defendant as an insider who played more of a role than is customarily played by outside counsel."⁵⁴ While it is true that the attorneys in this instance were purely outside counsel, it could be argued that they went beyond their role of advising clients in that they actually participated in the alleged scheme by allowing their prestigious names to be used to assure the stockholders that this complex merger agreement was lawful. Further, although they were not insiders in the strict sense of the word, given the statements made to them by Peat, Marwick, Mitchell & Co., they had as much reason to be on guard as would an insider.

Ms. Karmel further argues that the SEC is wrong in likening the functions of a securities lawyer to that of an independent certified accountant. She reasons that "[a]n attorney's opinion is not based upon the same type of independent investigation as is an accountant's certificate, and it is therefore a different and more limited imprimatur."⁵⁵ She relies on the following language from an SEC decision in the *American Finance Co.* case:

Though owing a public responsibility, an attorney in acting as the client's advisor, defender, advocate and confidant enters into a personal relationship in which his principal concern is with the interests and rights of his client. The requirement of the Act of certification by an independent accountant, on the other hand, is intended to secure for the benefit of public investors the detached objectivity of a disinterested person.⁵⁶

If this is the case, if the attorney's principal concern is with the interests and rights of his client, one can only wonder why it was necessary to make

52. *Id.* at 489.

53. *Id.* at 489-92.

54. Karmel at 1159.

55. *Id.* at 1163.

56. 40 S.E.C. 1043, 1049 (1962).

the attorney's favorable opinion a part of the merger agreement in the first place. It is not required by the SEC Rules and Regulations and, as the defendants allege in their answer, it could be waived by both corporations if they so desired. Presumably, the SEC believes that the corporation was in fact using the "favorable opinion" as it would an accountant's certification, that is, to secure for the benefit of its shareholders the opinion of a reputable law firm in order to ease the shareholders' minds as to the legal implications of the planned merger. The point being that when law firms begin assuming the role of a certified public accountant, they should be willing to accept the inherent responsibilities.

Finally, it would seem that if the facts are as alleged, an \$884,000 error in the financial statement upon which approval for the merger was secured should have put the attorneys on guard whether they were insiders, experts, purely outside counsel or a law firm assuming the role of a certified public accountant.

In the *BarChris* case the Court stated in dicta:

It is claimed that a lawyer is entitled to rely on the statements of his client 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. To require an audit would obviously be unreasonable. On the other hand, *to require a check of matters easily verifiable is not unreasonable*. Even honest clients can make mistakes. The statute imposes liability for untrue statements regardless of whether they are intentionally untrue.⁵⁷

V. Conclusion

The NSMC case is shaping up as a classic confrontation between the SEC and the securities bar where professional responsibility is to be measured against the well-established attorney-client privilege. The SEC has set forth a heretofore unannounced position on the duties and obligations of securities lawyers, which would appear to significantly expand their liabilities. But they are not making policemen out of lawyers, for the issue is not, as the Texas article states, an attempt to make "lawyers—in the limited role of counsel—. . . accountable with their clients for violations normally attributed to the clients alone."⁵⁸ Nor is it as Ms. Karmel sees it, an action charging illegal conduct by the defendants *qua* attorneys.⁵⁹ Rather it is when an attorney acts as a *participant* as distinguished from his traditional role of *counselor* in a scheme to defraud investors, that he is bound to withdraw from

57. 283 F. Supp. at 690 (emphasis added).

58. Texas Note at 1265.

59. Karmel at 1156.

the case and to inform the investors and the SEC of his withdrawal.⁶⁰ To claim the attorney-client privilege under these circumstances would be to use it as a sword rather than a shield. Moreover, it is difficult for one to disagree with the purpose of the SEC which was stated by former SEC Commissioner Needham: "What we're saying is that in the securities area we have always relied on the Bar and feel they have a special responsibility in the securities area, just as accountants and other professionals do."⁶¹

Yet one cannot help but consider the inherent questions involved in such a reliance on the bar. This particular case is easy to accept, in that the attorneys actually participated in the fraudulent scheme by allowing the investor to rely upon their legal opinions. But, according to the *ABA Code of Professional Responsibility*,⁶² participation is not necessary in the crime-fraud exception to the lawyer-client privilege. All that is required is that the lawyer receive information that his client, in the course of the representation, has perpetrated a fraud upon a person or tribunal. Under this reasoning certain variations of the NSMC case could present difficult questions for the practicing lawyer. Suppose that the attorneys in the NSMC case had learned about the misleading financial statements after the "favorable opinion" had been issued and the merger consummated. Would they then have a duty to inform the SEC or be liable for a 10b-5 violation?⁶³ Suppose that the attorneys had not lent their name to the merger agreement, but rather, in helping the corporation to prepare the monthly reports to the SEC, the attorneys suspected that the corporation had used misleading information in securing approval of an upcoming merger. Would the fact that they continued to advise their clients constitute aiding and abetting a 10b-5 violation? Another interesting aspect of the SEC's theory is its applicability to other regulatory agencies. Suppose that the attorneys sus-

60. *Supra* note 4, at 3, cols. 6, 7.

61. N.Y.L.J., March 6, 1972, at 1, col. 3. In a recent release, the SEC announced that it was considering another method of enforcing the special responsibility which it believes is required of professionals in the securities area. In Release No. 10296, dated July 25, 1973, the Commission said that it is considering requiring the disclosure by public corporations in their filings with the Commission of certain legal proceedings or disciplinary actions involving their independent accountants, outside law firms or other professionals doing work for them. The SEC noted that several judicial proceedings have been instituted recently which include allegations that the failure of issuers to disclose litigation involving accounting firms in proxy statements subject to the Commission's Proxy Rules resulted in omissions of material facts. The Commission invited interested persons to submit information and comments on the proposed rule.

62. *Supra* note 36.

63. In *Fischer v. Kletz*, *supra* note 16, the court determined that accountants may be obligated under Rule 10b-5 to disclose misrepresentations in financial reports which they learned about after they had honestly and carefully audited the financial status of a corporation.

pected that the merger agreement would constitute an antitrust violation, and although they advised their clients of this, the client continues with it anyway. Would they have any obligation to either the Antitrust Division of the Justice Department or the Federal Trade Commission? In each of these situations would the attorneys' obligation be to simply withdraw from representing the corporation, or to inform the SEC (or the FTC) of their withdrawal and the reason for it? It is questions such as these that have made the NSMC complaint the best read document since "Gone With The Wind."

Peter Chepucavage