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Preventing Errors in Securities Transactions

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I. INTRODUCTION

While the focus of this symposium is on legal malpractice, the word "errors" has been substituted for that term in this discussion. The potential for attorney liability is much greater in securities transactions than is usually implied in the use of the term "legal malpractice," that is, a breach of duty by an attorney to a client with whom the attorney had an express contract for performing legal services.[1] In addition to parties in privity of contract with an attorney, purchasers of securities, accountants, and others rely on attorneys and may be damaged by an attorney's errors. Furthermore, while other governmental agencies can theoretically take action against attorneys, the Securities and Exchange Commission (SEC) has actively pursued such actions and has also pressured attorneys to aid the SEC in its law enforcement activities. The term "legal malpractice" is sometimes applicable in such actions, but often SEC actions do not raise issues customarily involved in more traditional cases against attorneys.

The focus of this article is on policies and procedures that law firms can utilize to prevent errors that may lead to adversary proceedings against them, whether the claimant be a member of the private sector or the SEC.[2] Although some of these policies and procedures will entail substantive legal considerations, this article is not intended even to attempt to instruct the practitioner on how to properly complete registration forms.

If every policy and procedure mentioned in this article were adopted by a law firm and applied to every securities transaction it handled, the benefits of these policies and procedures would in all likelihood be outweighed by the unnecessary time delay and other problems created by such an across-the-board application. The author's conception of these policies and procedures is that they constitute a checklist with which to measure the degree of protection against errors that a firm is building into a particular transaction. For example, if a firm is aware that it has not rigorously investigated the background of a client, it may be more persistent in requiring information to verify critical facts that are

1. *See* R. MALLEN & V. LEVIT, LEGAL MALPRACTICE 2-3 (1977).

2. While Disciplinary Rule 6-102 of the ABA CODE OF PROFESSIONAL RESPONSIBILITY (1978) prohibits attorneys from limiting their liability to clients for errors, there is no prohibition against preventing errors in the first instance.

presented to the firm by the client. Similarly, if a firm does not implement a stringent policy regarding the transmission of information within the firm concerning mergers, takeovers, proxy fights, and related business and legal disputes, a very restrictive policy would be necessary for members of the firm purchasing and selling securities of clients.

On a related note, the policies and procedures discussed in this article should not be considered a final product. Just as this article was developed in part from earlier treatments of the subject,[3] future developments in this area of law and further analysis by other writers will undoubtedly expand and improve these policies and procedures.

II. Uncontrollable Factors

Over the last fifteen years, general litigation has sharply increased in this country. Between 1967 and 1976, there was an increase of 84% in the number of civil actions filed in the federal district courts.[4] Moreover, it has been estimated that if the growth rate in the number of appeals taken from decisions rendered by the district courts remains constant, the number of judges assigned to the various courts of appeals will have to be increased from approximately 100 to 5,000 by the year 2010.[5]

Actions against attorneys have also increased.[6] The experience of St. Paul Fire and Marine Insurance Company, which historically was a leading insurer of attorneys, is illustrative. Between 1971 and 1975, the number of new insureds increased by 34%, but this was accompanied by a 90% increase in the number of reported liability claims against those new insureds.[7] The general increase in litigation and at least a portion of the increase in litigation involving attorneys, is due to a sharp increase over the last ten years in the supply of two factors—attorneys and causes of action. Approximately 450,000 attorneys are now practicing in the United States, an increase of approximately 50% over the

3. The author wishes to acknowledge the substantial contributions to this article by Frank M. Wozencraft, *Policies and Procedures for Law Firms,* PLI Sixth Annual Institute on Securities Regulation 221 (1975), and by John C. Chappell and James H. Cheek III, *The Development of Law Firm Policies and Procedures Relating to Securities Matters,* PLI Ninth Annual Institute on Securities Regulation 639 (1977).

4. *The Chilling Impact of Litigation,* Bus. Week, June 6, 1977, at 58.

5. *Id.* (Estimate by Professor John Barton of Stanford Law School).

6. *See* R. Mallen & V. Levit, *supra* note 1, at 15-16.

7. Informational Report, ABA Special Committee on Lawyers' Professional Liability 4 (Feb. 1977).

number of practicing attorneys ten years ago. Society has apparently rejected Shakespeare's advice, "The first thing we do, let's kill all the lawyers"[8]—although some physicians have recently advocated its utility. We now have over 17 lawyers for every 10,000 people, which is approximately 2 ½ times the per capita rate in Great Britain, which not so many years ago was the source of a large portion of American legal principles and attitudes.[9]

Although no direct proof exists correlating the increase in the number of attorneys to the increase in litigation against attorneys, it would seem that if the supply of lawyers were restricted (a possibility that would pose an interesting social issue) the incidence of litigation would be reduced. Also, as the supply of lawyers in a given community increases, the percentage of lawyers with which any one attorney is familiar decreases. It is obviously easier to engage in litigation against a mere acquaintance than a friend, and it becomes even easier if one has never met the defendant.

The increase in implied causes of action in the area of securities law[10] is undeniably a contributing factor to the exposure faced by attorneys who practice in this field. While the creativity of attorneys representing private parties in securities litigation has contributed to this increase,[11] the SEC has been the moving force in this expansion. The change in its attitude towards various aspects of law over the last fifteen years is perhaps best illustrated by a comparison of the following two administrative actions. In 1962, in *In re American Finance Co.*[12] the SEC stated:

> 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 [1933] Act of certification by an independent accountant,

8. KING HENRY VI, PART II, Act IV, scene ii, line 86.

9. *See generally* A. KAUFMAN, PROBLEMS IN PROFESSIONAL RESPONSIBILITY 9-112 (1976).

10. *See, e.g.*, J.I. Case Co. v. Borak, 377 U.S. 426 (1964) (proxy rules); Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951); (§ 17 of the Securities Act of 1933); Kardon v. National Gypsum co., 69 F. Supp. 512 (E.D. Pa. 1946) (Rule 10b-5).

11. *See, e.g.*, Black & Co. v. Nova-Tech, Inc., 333 F. Supp. 468 (D. Ore. 1971) (Designation on a client's annual report as corporate counsel was sufficient to defeat the law firm's motion to quash service and dismiss. This designation made the law firm a "participant" under the Oregon blue sky laws for purposes of this motion:).

12. 40 S.E.C. 1043, [1961-64 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 76,832 (1962).

on the other hand, is intended to secure for the benefit of public investors the detached objectivity of a disinterested person.[13]

By 1973 the SEC's approach had changed dramatically, as demonstrated by the following quotation from *In re Emanuel Fields:*[14]

> Members of this Commission have pointed out time and time again that the task of enforcing the securities laws rests in overwhelming measure on the bar's shoulders. These were statements of what all who are versed in the practicalities of securities law know to be a truism, *i.e.*, that this Commission with its small staff, limited resources, and onerous tasks is peculiarly dependent on the probity and the diligence of the professionals who practice before it. . . . This is a field where unscrupulous lawyers can inflict irreparable harm on those who rely on the disclosure document that they produce.[15]

Also in 1973 the SEC instituted its action against National Student Marketing Corporation, its attorneys, and other individuals.[16] This suit was recently settled for some, but not all, of the attorneys in that action.[17]

Demonstrating that litigation with clients is just as dangerous as adversary proceedings with the SEC, a jury in Denver recently returned a verdict of $2.2 million against attorneys in a malpractice case based on errors in a securities transaction.[18] It was subsequently settled for $1.2 million.[19]

Finally, the basic attitude of people in the United States towards the legal profession cannot be ignored as a contributing factor to the problem of increased litigation against attorneys. In a recent Gallup Poll,[20] only 25% of those responding rated the ethical standards and honesty of attorneys as high or very high. If that poll is representative of the population as a whole, the increase in litigation against attorneys is not very surprising.

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13. 40 S.E.C. at 1049.

14. SEC Securities Act Release No. 5404 (June 18, 1973), [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,407 at n.20.

15. *Id.*

16. SEC v. National Student Mktg. Corp., 360 F. Supp. 284 (D.D.C. 1973).

17. SEC v. National Student Mktg. Corp., [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,027 (D.D.C. May 2, 1977). Terms of the settlement are discussed in text, p. 249 *infra*.

18. Huskin v. Hindry & Meyer, The American Lawyer, Aug. 11, 1978, at 7, col. 1 (Dist. Ct. Denver, Colorado).

19. *Lawyers Liability*, The American Lawyer, Aug. 11, 1978, at 6.

20. G. GALLUP POLLS, August 22, 1976.

III. Overview of the Defensive Practices of Law as Outlined by Settlements in SEC Actions

To gain a perspective on law firm policies and procedures that may prevent errors in securities transactions, it is useful to review a few of the recent SEC administrative and injunctive actions against both attorneys and accountants.[21] The actions discussed below entail settlements with the SEC based upon the implementation of a series of new or improved firm policies and procedures. Two recent administrative actions against accountants are included because administrative and enforcement actions against attorneys are now viewed in a similar manner by the SEC.[22] While differences in the tasks undertaken by attorneys and accountants in securities transactions result in rather different settlement terms, attorneys can benefit from an evaluation of settlements with accountants, especially in the broad area of quality control.

The first significant administrative action by the SEC against a law firm involving a settlement based upon the implementation of corrective and remedial policies and procedures was in *In re Jo M. Ferguson.*[23] This was a Rule 28e[24] proceeding based upon a failure by bond counsel to include certain material facts in the prospectus. The remedial policies and procedures adopted by the attorney and his firm were extensive. The settlement included the following terms:

> (1) Every two weeks, members of the firm must meet and discuss all of their active cases. Affirmative approval of *each* partner is required before the issuance of any legal opinion.

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21. See cases cited note 31 *infra.*

22. *See* Hager, *SEC Chief to Lawyers: You May Be Next,* Legal Times of Washington, Aug. 14, 1978, 1, col. 2. In a speech to the ABA convention in New York in August 1978, SEC Chairman Harold Williams made a direct reference to the treatment of accountants and attorneys by the SEC:

> I would commend to your careful study the drama which is continuing to unfold concerning whether regulation of the independent accounting profession should be made a subject of federal legislation . . . it provides a clear and very relevant illustration of how the public and the legislative branch may seek to remedy perceived ills in the corporate sector with nostrums directed to those who render professional service to the business community. I suggest that, for these purposes, the similarities between the legal and accounting professions far outweigh their differences.

Id.

23. SEC Securities Act Release No. 5523 (Aug. 21, 1974), 5 SEC Docket 37.

24. 17 C.F.R.§ 201.2(e) (1978). This is the basic authority for SEC actions to bar attorneys and accountants from practicing before the SEC.

(2) The firm must undertake an appropriate investigation in connection with acting as bond counsel including, among other things, obtaining independently audited financial statements and inquiring into the background of the various parties connected with the offering. Written evidence of those investigations and the results thereof must be reviewed by the partners of the firm.
(3) An appropriate "engagement letter" must be sent to all interested parties, emphasizing that the firm's duty is to the issuer and the bondholders. It must define the scope of the firm's work as bond counsel and require submission to it of certain pertinent information.
(4) The firm must require that it receive independently audited financial statements, representations from appropriately interested persons concerning the accuracy and completeness of the statements about them in any offering circulars, and a statement from counsel for any lessee or guarantor that that counsel has reviewed the offering circular and is aware of no inaccuracies therein.
(5) Partners and associates of the firm must attend, at least annually, municipal bond workshops and seminars.[25]

One of the more striking aspects of this settlement is the requirement that each partner in the firm approve every opinion. It is important, however, to note that the firm in the *Ferguson* case was small. This settlement term would not be appropriate for all firms because of the varying number of partners and associates, the scope of their securities practice, the experience and abilities of clients and attorneys, the degree of supervision customarily provided to less experienced attorneys, and numerous other factors. There is also no evidence that the SEC considers any particular provision of any settlement to be a general guideline.[26]

A more recent case that resulted in a settlement with attorneys based on the implementation of new policies and procedures was *SEC v. National Student Marketing Corp.*[27] This case is significant primarily because it was the first SEC enforcement action against nationally prominent law firms. The settlement was based on a letter from White & Case to the SEC confirming the

25. SEC Release No. 5523, *supra* note 23, at n.3.

26. *Contra*, F. WOZENCRAFT, *supra* note 3, at 223 (citing remarks of SEC Commissioner Pollock).

27. [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,027 (D.D.C. May 2, 1977).

procedures then in force in securities transactions. It set forth nine major categories of policies and procedures, which are summarized below:

(1) A committee of partners is responsible for approving any new representation when the firm acts as principal outside counsel in a securities transaction involving registration under the federal securities laws. If the committee ascertains that prior outside counsel resigned, an inquiry will be made as to the basis of the resignation. The firm will request the prospective client to release the prior counsel from any obligation of confidentiality in order to discuss the proposed representation. A written record is to be maintained of this type of investigation.[28]
(2) Prior to undertaking the representation as principal outside counsel of a prospective client having securities registered under the federal securities laws, the responsible partner will determine whether a report on form 8-K[29] has been filed within the previous two years reflecting a change in independent public accountants. A committee of partners will review any such change and determine whether an inquiry of the prior independent public accountant is required. If it is determined that one is required, the prospective client will be asked to direct the prior accountant to respond to inquiries by the firm, and the entire analysis will be documented and maintained by the firm.
(3) When the firm represents the issuer of securities, it will not deliver an opinion in connection with the issue if it has knowledge that (i) any material representation or warranty made by or on behalf of the client is not true and correct in light of the circumstances under which it was made, or (ii) there has been any material adverse change that would render any such representation or warranty false or misleading after the date the transaction is closed.
(4) If the firm becomes aware during the course of a transaction involving the issuance of securities to the public of any false or misleading representation or warranty by or on behalf of the client, the firm will advise the client of its disclosure obligations under the federal securities laws. If a client does not take appropriate action, the partner in charge of the trans-

28. Of some interest is the lack of any requirement that the committee investigate situations in which the client has dismissed prior outside counsel.

29. Companies whose securities are listed on an exchange and those registered under § 12(g) of the 1934 Securities Exchange Act must file a form 8-K Report. It must be filed within 15 days of certain occurrences, which include changes in independent public accountants. For other required information, see 42 Fed. Reg. 4429 (1977) and 42 Fed. Reg. 12,422 (1977).

action will consider with at least two other partners whether the firm must withdraw or take other action.

(5) When the firm represents an issuer participating in a transaction in which securities are issued to the public, and if the terms of the transaction call for the delivery of documents dealing with the issuer's financial conditon, if any party to the transaction elects to waive delivery of such documentation or to accept it in a form that does not comply with the terms of the transaction, the firm will not render any opinion in connection with the transaction until the partner responsible for the transaction has consulted with and obtained the concurrence of at least two other partners.

(6) When the firm represents an issuer or underwriter of securities in a transaction involving the issuance of securities to the public, registration statements prepared by the firm will be reviewed by a second partner who is not directly involved in the transaction. In addition, any opinion delivered by the firm will reasonably identify the matter upon which the opinion is being rendered and describe the nature of the review upon which the opinion is based.

(7) "In connection with any transaction involving the issuance of securities to the public, if the Firm is requested to deliver an opinion with respect to the effective date of such transaction and the responsible partner becomes aware that the date or dates of any events comprising or affecting in any significant way such transaction are other than as reflected in the documents relating to such transaction, such partner will (i) ascertain the reason and purpose for any such variance in dates, (ii) review the matter with another partner of the Firm, and (iii) state in any opinion delivered the extent to which such variance in dates may affect the legal conclusions set forth in such opinion".

(8) In communicating with independent public accountants, the firm will comply with the guidelines established by the *ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information*[30] and the accompanying commentary.

(9) The firm will continue to encourage partners and associates to participate in legal education programs dealing with corporate and securities law develoments. In addition, the firm will make available to the attorneys dealing with corporate and securities law the current materials on those matters.

The additional scope and detail of the *National Student Marketing* settlement, compared to the *Ferguson* settlement, re-

30. 31 BUS. LAW. 1709-45 (1976).

flect many of the factors set forth above that distinguish law firms from each other, but also reflect the developing intention of the SEC to hold law firms representing issuers of securities to the same type of quality control procedures it has required accountants to follow. A review of two recent settlements in Rule 2(e) cases with accountants will demonstrate the similarity between the SEC's approach to attorneys[31] and its approach to accountants.

In re Seidman & Seidman[32] concerned a merger of Seidman & Seidman with the Los Angeles accounting firm of Wolfson, Weiner, Ratoff & Lapin, as well as the audits of certain clients of the latter firm, including Equity Funding Corporation of America. The opinion and order in this action is extremely detailed and lengthy; however the offer of settlement by Seidman & Seidman that was accepted by the Commission can be reviewed, and utilized, without a detailed understanding of the entire opinion. Seidman & Seidman agreed to conduct an in depth examination and evaluation of its audit policies, procedures, and practices and report its determinations to the Commission. The areas to be analyzed included the following:

(1) Hiring practices for all professionals;
(2) training and education for all professionals;
(3) promotion and compensation of all professionals;
(4) acceptance and retention of clients;
(5) setting and recovery of audit engagement fees;
(6) allocation of professional responsibilities within the firm;
(7) professional staffing of files;
(8) maintenance of professional independence;
(9) conduct of audit practice engagements, including staffing, allocation of responsibilities, work paper preparation and review, interoffice communications, identification and resolution of problems, independence review procedures, and outside expertise;

31. Several other recent SEC actions involving settlements with attorneys are useful to review. *See* SEC v. Petrofunds, Inc., SEC Litigation Release No. 8001 (S.D.N.Y. June 28, 1977), 12 SEC Docket 1093 (for a summary of this litigation, see [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,098); *In re* Plotkin, Yolles, Siegel & Turner, SEC Securities Act Release No. 5841 (July 5, 1977), [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,236; SEC v. Geo Dynamics Oil & Gas, Inc., [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,565 (D.D.C. June 1, 1976); *In re* McLaughlin, Stern, Ballen & Miller, SEC Securities Exchange Act Release No. 11,553 (1975).

32. SEC Securities Exchange Act Release No. 12,752 (Sept. 1, 1976), 5 FED. SEC. L. REP. (CCH) ¶ 72,218.

(10) formulation and communication of firm practices, procedures, and policies to professionals in the firm;
(11) creation and implementation of quality controls;
(12) firmwide correction or improvement measures;
(13) criteria and procedures to analyze potential merger or combinations of practice candidates; and
(14) allocation and exercise of responsibilities by various committees of the firm.[33]

Another recent rule 2(e) proceeding involving accountants that reflects the same type of detailed settlement was *In re Laventhol & Horwath.*[34] The facts in the opinion and order itself are not as detailed or lengthy as those in *Seidman & Seidman;* but again, the facts are not necessary to a useful review of the settlement. In essence, this settlement contained the same analysis of the audit practice as was set forth in the *Seidman & Seidman* settlement. The only significant difference is that no provision was made for a combination or merger with other firms.

The settlement provisions set forth in *Ferguson, National Student Marketing, Seidman & Seidman,* and *Laventhol & Horwath* provide a broad outline of the areas the SEC considers important in preventing errors in securities transactions. To the extent that firms adopt policies and procedures that deal with these areas, the chances that an error will be made will certainly be reduced. Each firm must, however, determine the extent to which the investment of time and money in implementing these programs will result in benefit to the firm and the firm's clients.

As to the firm, the chances of an error occurring will likely be reduced; furthermore, the SEC might not take action against a firm that has developed these policies and procedures, even if an error is made. When the Commission believes that action is needed, it may decide against an injunction proceeding in federal court and limit its activities to the implementation of additional guidelines concerning the firm's policies and procedures.

To the extent that adopting policies and procedures in these areas entails the expenditure of both time and money by attorneys, clients are certain to bear some portion of the cost. If partners devote more time to review committees, the total number of hours directly and indirectly attributable to securities transactions will increase. To maintain the same level of income, the firm

33. *Id.* ¶ 72,218, at p. 62,546.
34. SEC Accounting Release No. 227 (Sept. 21, 1977), 5 FED. SEC. L. REP. (CCH) ¶ 72,249.

will have to change its hourly rates or other bases for fee agreements. This does not necessarily mean, however, that the total economic impact on clients will be greater after the adoption of such policies and procedures. Issuers and underwriters are generally as anxious as attorneys are to avoid litigation over the issuance of securities. To the extent that the firm's policies and procedures reduce the likelihood of error, the reduction in exposure to claims and liability will benefit clients such as issuers and underwriters.

IV. THE CLIENT: IDENTIFICATION AND EVALUATION

A. *Identification*

In the area of securities transactions, firms should consider some form of process for identifying and evaluating clients, especially when dealing with new clients. Although it sounds simplistic, evaluation cannot be done until the identification is completed. The process of identification includes the recognition of those parties with whom the firm has an express agreement and generally from whom fees will be received, but also includes the recognition of other persons who may assert and successfully maintain that they stand in the position of clients. This group includes third party beneficiaries in addition to the more general class of persons entitled to redress under the federal securities laws.

The identification of individuals and entities that the firm has expressly agreed to represent is generally not difficult. There exist, however, situations in which a firm knows that it is doing legal work that directly concerns a particular individual or entity but mistakenly decides that there is no attorney-client relationship, solely because it does not receive payment for fees and expenses from that particular individual or entity. While many of these situations fall into the area of third party beneficiaries,[35] in other situations an actual attorney-client relationship is held to exist based on principles of implied contract.

Perhaps the best example of this situation occurred in a non-securities case, *Fort Myers Seafood Packers, Inc. v. Steptoe &*

35. *E.g.* Goodman v. Kennedy, 18 Cal. 3d 335, 556 P.2d 737, 134 Cal. Rptr. 375 (1976); *cf.* White v. Guarente, 43 N.Y.2d 356, 372 N.E.2d 315, 401 N.Y.S.2d 474 (1977) (concerning reliance by limited partners of a firm upon an audit by an accountant employed by the firm).

Johnson.[36] The attorneys in that case regularly represented a seafood packer and did so in a transaction involving an agreement with a commercial fishing company. The latter did not make any agreement to pay fees and expenses, but was participating in contract negotiations to provide fish to the seafood packer. The law firm did prepare documents connected with registration of the commercial fishing company's vessels. Based on a lack of proper registration certain fishing vessels were seized by a foreign country, causing direct damages to the commercial fishing company as well as indirect damages because of its inability to fulfill the terms of the contract. The court held that the commercial fishing company was a client and had standing, essentially based on an implied contract, to institute an action for negligence against the defendant law firm.

Similar situations arise in securities transactions, especially in certain types of investment contract transactions. Real estate syndications involving general partners, limited partners, and real estate brokers (and perhaps promoters who are not within the previous categories) present ample opportunity for an attorney-client relationship to be established even though the firm and the "client" never expressly agreed to enter into such a relationship and even if the "client" does not pay any fees or expenses.[37]

A law firm may find itself assuming the role of counsel to the general partnership or to the general partner, but also preparing legal documents that cover the involvement of additional parties like the limited partners, real estate broker, or promoter. In these situations, the firm should identify all persons who have an interest in the securities transaction and then determine whether these parties are represented by independent counsel. Any party not represented by independent counsel should be sent a "nonengagement" letter by the firm specifically defining its role, including but not limited to a delineation of those individuals or entities it represents *and* those it does not represent. The letter should also suggest that unrepresented parties seek their own counsel. The identification of potential third party beneficiaries and other claimants is important because it will enable the firm to make a more realistic evaluation of the risk in undertaking the representation.

In most securities transactions, potential claimants will file

36. 381 F.2d 261 (D.C. Cir. 1967), *cert. denied,* 390 U.S. 946 (1968); *see* Annot., 18 A.L.R.3d 978 (1968).

37. *E.g.,* Roberts v. Ball, Hunt, Hart, Brown & Baerwitz, 57 Cal. App. 3d 104, 128 Cal. Rptr. 901 (1976).

suit under specific statutes that provide standing. Only if these statutes are not available will litigants resort to third party beneficiary theories. Two recent California cases are instructive concerning when courts may permit third parties to have standing. Because California has consistently been the most flexible jurisdiction in conferring standing on third party beneficiaries in actions against attorneys, the comparison of the following cases should provide a good perspective on the potential exposure to those claims.

In *Roberts v. Ball, Hunt, Brown & Baerwitz,*[38] a law firm was held liable to a third party for negligent misrepresentation based on a statement in an opinion letter that its client was a general partnership. The evidence reflected that certain members of the alleged partnership disputed its status and the law firm did not disclose this in the opinion. The law firm knew that the client would not only attempt to obtain a loan using the opinion letter, but would request the loan from the plaintiff. The client defaulted on the loan, and the resulting damages included the expenses incurred in instituting actions against the alleged partners, since those actions would not have been instituted but for the negligent representation of the defendant.

A few months later, in *Goodman v. Kennedy,*[39] the California Supreme Court held that purchasers of securities had no cause of action against an attorney based upon negligent advice that he gave to his clients, the sellers. The advice consisted of representations that the securities could be sold without interfering with an exemption from registration under Regulation A of the Securities Act of 1933.[40] Specifically, the plaintiffs (purchasers) asserted that the defendant law firm negligently advised its clients (sellers) that the securities could be issued to them as stock dividends and sold to third persons without jeopardizing the exemption.

The court held that an attorney's duty in this type of transaction does not extend to persons with whom the client dealt, at least when the client acted at arms length and the legal advice rendered to the client was not foreseeably relied upon by the plaintiffs. Of particular importance in *Goodman* was the evidence of prior discussions between the defendant law firm and counsel representing the plaintiffs. The plaintiffs' independent representation was important in determining the likelihood of reliance

38. *Id.*
39. 18 Cal. 3d 335, 556 P.2d 737, 134 Cal. Rptr. 375 (1976).
40. 17 C.F.R. §§ 230.251-.263 (1978).

and in evaluating whether third party beneficiary principles should be applied to provide standing.[41]

B. *Evaluation*

In addition to the disclosure requirements regarding risk factors in business ventures that underlie the issuance of securities, an analysis should be made of the client in order to determine the degree of risk that the law firm faces. A firm should analyze at least four areas in determining whether to accept the client and the particular transaction in question.

First, the firm should make an analysis of the client's background, including relationships with prior attorneys and accountants, and any involvement in litigation. A client who has changed attorneys frequently is just as dangerous as the patient who goes from one doctor to another. Regardless of who is at fault, the fact remains that clients who frequently change attorneys are difficult to satisfy. There is no reason to believe that your firm will be any more successful than previous firms in satisfying such a client.

The reason for changing attorneys nonetheless deserves consideration. To the extent that the reason relates to disclosure items in securities transactions, if the firm accepts the client, special emphasis should be placed on provisions in the engagement letter concerning fees and withdrawal. Payment in advance, or as the work progresses, with clear provisions for withdrawal if disputes arise over disclosure items will at least reduce the economic impact on the firm should a dispute arise.

Prior disagreements with accountants, especially those that resulted in a change in accountants, are also important to consider. The role of accountants in most securities transactions is sufficiently related to the role played by the attorneys that disputes over preparation of financial statements or other documents are probably as good an indicator of potential problems as disputes with prior attorneys are. At a minimum, the firm should determine if the prospective client has filed a form 8-K Report regarding a change in independent public accountants.[42]

Second, it is important to assess the experience of the individuals who will be managing the business venture. Related to

41. California law in this area has generated a line of cases that involved disputes over wills and trusts, beginning with Biakanja v. Erving, 49 Cal. 2d 647, 320 P.2d 16 (1958) and Lucas v. Hamm, 56 Cal. 2d 583, 364 P.2d 685, 15 Cal. Rptr. 821 (1961), *cert. denied,* 368 U.S. 987 (1962), but more recently has focused on securities cases such as *Roberts* and *Goodman.*

42. *See* note 29 *supra*.

this is the ability of those individuals to identify and recruit other experienced and qualified managers. The former inquiry will yield information that will assist attorneys in determining the reliability of business judgments made by or on behalf of the client who may be involved in the disclosure process. The latter inquiry will probably not have any impact on the disclosure process, but will give attorneys some feel for the likelihood that, if the company experiences fast growth, additional managers can be hired without lowering the overall quality of management. If the venture is a new one, this is especially important when the original promoters have their own dream and vision and subsequent management is hired without the same vision or incentive. A young company may therefore find that it is easier to generate initial sales growth than it is to sustain that growth because of the difficulty in hiring and training additional managers.

Third, an analysis should be made of the success of similar business ventures. A pattern of success of similar ventures should not be allowed to obscure any recent lack of success that the industry may have experienced. Also, differences and similarities between the business in question and other similar ventures should be examined to determine if the industry pattern is useful as a predictor of the success of the venture at hand. This information may make a difference on certain disclosure items, and it will also give the firm information from which to determine the likelihood of financial success of the venture. Although there are exceptions, most securities transactions end up in litigation only if investors have lost money or believe they are about to lose money.

Finally, an analysis should be made, especially with new clients, of potential conflicts of interest. While this topic is dealt with below in more detail,[43] it deserves brief mention here. These conflicts can take many forms, including existing representation of competitors or litigation pending against entities with which the prospective client wishes to do business. A more subtle conflict concerns the basis of the proffered representation. It may be that the prospective client first learned about the firm in a transaction with a current client of the firm, in which other counsel represented the prospective client. It should be ascertained whether that transaction has any possibility of producing litigation since the firm's client in the original transaction will probably have an expectation that the firm will handle that litigation. If the prospective client is a defendant in such an action, the

43. *See* section VI, *infra*.

original client could be severely disappointed to find that the law firm, which had received substantial fees and expenses in the process of learning every detail of the transaction, was no longer available for litigation connected with that same matter. It is possible that the fees and expenses that another law firm would charge to obtain the same depth of knowledge could be a liability to your firm.[44]

C. *The Process of Evaluating Clients*

Firms should establish a committee to review prospective clients, at least in securities transactions. This review should include the development of the information discussed in the preceding paragraphs. The process of evaluation should be reduced to writing and organized as though it may become evidence in a trial. On the issue of willfulness or recklessness, the care that a law firm takes in analyzing whether to take on representation will be admissible and possibly very helpful in persuading the trier of fact that the attorneys did not act recklessly or willfully in the actual representation. If this process is ignored or performed carelessly, it may become evidence of willfulness or recklessness.

Consideration should also be given to having the same committee review clients on an ongoing basis. Information should be solicited from partners and associates in the firm to determine if the firm itself possesses any adverse information. If one partner in the firm refuses to undertake work for a client, there may be nothing wrong with another partner doing so, but that partner should at least be fully aware of the reasons for the other partner's refusal. Even if the reasons are purely personal, it is important to identify them. To the extent that the reason for the other partner's refusal is based on a professional judgment, especially if it is related to a cause of action involving that client, evidence of willfulness or recklessness may be uncomfortably close at hand.

D. *Conclusion*

The cessation of past conduct is not a complete defense to an action for equitable relief, even if the cessation occurred prior to the institution of the action.[45] Rather, from a preventative viewpoint, the focus must be on evidence that future violations will not occur even if a court does not issue an injunction or other

44. There may also be ethical problems with representations like the one described above. *See* ABA CODE OF PROFESSIONAL RESPONSIBILITY, CANONS 4 and 5 (1978).

45. Hecht Co. v. Bowles, 321 U.S. 321, 327 (1943).

relief.[46] The policies and procedures discussed in this section as well as in other sections of this article will constitute evidence that future violations will not occur. Good faith implementation of these policies and procedures will demonstrate that a law firm is policing itself, even if an inadvertent error does occur.

V. IDENTIFICATION OF SECURITIES

The failure to recognize that a security was involved in a particular transaction has caused a significant amount of litigation. Most of this litigation has involved notes[47] and investment contracts,[48] but litigation has arisen even over whether stock is a security.[49] In addition, this case law—and the complexity in this area of securities law—has generated a volume of commentary.[50]

An in depth analysis of the law in this area is beyond the scope of this article. Moreover, the sheer volume of case law and commentary focusing on whether a particular transaction involved a security suggests that one more treatment of the subject will not be very productive.

A law firm can adopt only one policy that will effectively reduce the possibility of an error in the determination of whether a particular transaction constitutes a security; one or more partners must be specifically charged with the responsibility of making the final determination of whether a security is involved in a particular transaction, whether it be a litigation or a corporate matter. This assumes, of course, that the firm has one or more partners who have sufficient expertise to properly analyze such

46. *See, e.g.*, SEC v. National Student Mktg. Corp., [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,027 (D.D.C. May 2, 1977), in which the court denied the SEC's request for a preliminary injunction.

47. *See, e.g.*, Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126 (2d Cir. 1976) (focusing on the purposes of the securities acts); Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976) (focusing on the risk capital test); McClure v. First Nat'l Bank, 497 F.2d 490, *rehearing denied*, 502 F.2d 1167 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975) (focusing on the investment-commercial dichotomy).

48. *See, e.g.*, SEC v. W.J. Howey, 328 U.S. 293 (1946); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473 (5th Cir. 1974); SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 82 (1973).

49. *See* United Housing Foundation, Inc. v. Forman, 421 U.S. 837 (1975).

50. *E.g.*, Epstein, *Bank Participation Agreements as Securities*, 87 BANKING L.J. 99 (1970); Lipton and Katz, *"Notes" Are Not Always Securities*, 30 BUS. LAW. 763 (1975); Pollock, *Notes Issues in Syndicated Loans—A New Test to Define Securities*, 32 BUS. LAW. 537 (1977); Note, *Liabilities of Lead Banks in Syndicated Loans Under the Securities Acts*, 58 B.U.L. REV. 45-60 (1978); Note, *Overview of Promissory Notes under the Federal Securities Laws*, 6 FORDHAM URB. L.J. 529-52 (1978); Note, *When is a Note a Security?*, 18 SANTA CLARA L. REV. 757-78 (1978).

matters and a "Catch-22" situation develops if this is not the case.

While it is easy to formulate policy, it is exceedingly difficult to develop and implement procedures that will carry it out. An approach that offers the best chance of success with the expenditure of a reasonable amount of effort incorporates the identification of securities into file-opening memoranda.

It is recommended the file-opening memoranda include a section called "identification of securities." This should include the definition of a security as set forth in section 2(1) of the Securities Act of 1933[51] and section 3(a)(10) of the Securities Exchange Act of 1934.[52] In addition, it should include the definition found in the applicable state blue sky law if that definition differs in any respect from those in the above federal securities laws.

Any attorney opening a file should be required to forward a summary of the facts to one of the partners with expertise in securities, if the case or transaction in question could be defined as a security. If stocks or bonds are involved, the matter is relatively straightforward. In fact, the only real problems arise when notes or investment contracts are considered.

Notes may cause a problem because the attorney opening the file will most likely try to determine whether the type of note in question constitutes a security. Section 3(a)(3) of the Securities Act of 1933[53] contains an exemption from the registration requirements for notes and other similar documents that have "a maturity at the time of issuance not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." This same language is set forth in section 3(a)(10) of the Securities Exchange Act of 1934.[54] In order to avoid unnecessary risks, no attorney other than those designated as having the requisite securities knowledge should be allowed to make a determinaton of whether any particular note is exempt from the registration requirements or from any anti-fraud provisions.

If these procedures are followed, only "investment contracts" are left as a danger area because transactions that involve investent contracts may not come to the attention of the designated partners. This area constitutes a problem because there is no

51. 15 U.S.C. § 77b(1) (1976).
52. *Id.* § 78c(a)(10).
53. *Id.* § 77c(a)(3).
54. See Note 52 *supra.*

price method to determine whether a transaction involves an investment contract as opposed to stock or a note. The issue of whether a particular transaction involved an investment contract has been sufficiently litigated, however, to set forth a reasonably concise definition, with a few alternative approaches to analyzing the basic formulation.

In *SEC v. W.J. Howey Co.,*[55] the Supreme Court said "[a]n investment contract for purposes of the Securities Act means a contract, . . . whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party. . . ."[56] This basic formulation has been repeatedly utilized, though with some modification. The Supreme Court has subsequently stated, when analyzing any transaction, "forms should be disregarded for substance and the emphasis should be on economic reality."[57]

The Fifth Circuit Court of Appeals has modified the "solely from the efforts of others" aspect of the *Howey* test and has stated that the focus should be on "whether the efforts made by those other than the investor are the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."[58]

If these basic formulations and interpretations are combined into a concise definition of an investment contract, most attorneys should be able to determine whether there is at least a reasonable question concerning a particular transaction. In addition, although it is perhaps not a requirement, each attorney opening a file should ask, "Is someone investing money in a transaction or business other than the business or profession in which that person earns his main source of income?" If so, there is a reasonable chance that a security is involved.

VI. Conflicts of Interest

A. *Trading and Investing in Clients' Securities*

The purchase and sale of a client's securities, whether for short-term trading or long-term investment, present two distinct problems that can lead to errors of judgment even by attorneys

55. 328 U.S. 293 (1946).
56. *Id.* at 298-99.
57. Tcherepnin v. Knight, 389 U.S. 332, 336 (1967).
58. SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 483 (5th Cir. 1974). *See also* SEC v. Glenn W. Turner Enterprises, Inc., 474 F.2d 476 (9th Cir.), *cert. denied,* 414 U.S. 82 (1973).

with good intentions.

First, having made a decision to purchase a client's securities, a mental process should be made resulting in judgments about the intrinsic value of the client. This can lead to diminished objectivity, which in turn can cause errors in the registration process, primarily related to disclosure.

Second, purchases increase the exposure to both claims and liability in connection with the misuse of confidential or inside information. If an attorney is a beneficial owner of ten percent or more of the securities in question, or is an officer or director, exposure is definitely increased under section 16(b) of the 1934 Act.[59] Even if the number of shares is relatively nominal, disclosure may be required pursuant to SEC Registration Guide 56.[60] Furthermore, disclosure does not prevent allegations of conflicts of interest that can adversely affect litigation in which an attorney is named as an aider and abettor.

The ABA Code of Professional Responsibility, particularly Ethical Consideration 5-3 and Disciplinary Rule 5-101(A),[61] put attorneys on notice that they should take great care in analyzing whether an investment in a client's securities constitutes an impediment to the exercise of professional judgment that may adversely affect the client. The cautionary language in those provisions of the Code should be read with a view towards preventing any loss of objectivity as well as preventing potential claimants from utilizing stock purchases in the client's securities as a method of establishing an illicit reason for nondisclosure—possibly establishing willfulness.

SEC Guide 56 relates to the interests of counsel and experts in the registrant. It refers to counsel for the issuer, underwriters, or various holders of securities in situations in which counsel is named in the prospectus as having passed on the legality of any portion of the materials in the prospectus. Counsel must disclose the nature and amount of any direct or indirect interest that they have received or are to receive in the future. While it does not require disclosure unless the value of the securities exceeds $10,000 for an individual member of the firm of $30,000 for the entire firm, it does caution that consideration should be given to

59. 15 U.S.C. § 78p(b) (1976).

60. SEC Securities Act Release No. 5094 (Oct. 21, 1970), 17 C.F.R. § 231.5094 (1978), [1970-71 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,917.

61. *See also* ABA CODE OF PROFESSIONAL RESPONSIBILITY, Disciplinary Rule 5-104(A) (1978).

whether the ownership of the client's securities might result in counsel being a "promoter, finder or executive officer," as those terms are used in various registration forms.

Firms can adopt two basic policies to avoid the problems associated with trading and investing in a client's securities: one that prohibits all trading and investing in these securities, or one that permits it under certain limited circumstances. As a general rule, the safest course is to prohibit all trading and investing. This is essential if anyone in the law firm possesses undisclosed material information concerning the securities.

To effectuate this policy, a list of clients must be prepared and regularly updated. Even if a firm adopts this type of blanket prohibition, however, it would seem unnecessary to extend it to investments in mutual funds that own stock in one or more of the firm's clients. Unless a law firm has a very narrow practice, and unless a particular mutual fund invested exclusively in an industry comprised mainly of such clients, mutual fund investments are simply too remote to be of real concern.

Blanket prohibition may be appropriate in some law firms, but other law firms would find that it interferes with firm business to an extent not justified by the increase in objectivity or reduction in exposure to claims and ultimate liability. It is not uncommon to find members of a firm that hold stock in closely held corporations owned primarily by friends and relatives. Whether that ownership, combined with the representation of the entity, constitutes a conflict of interest should be determined on a case-by-case basis. In addition, it can certainly be argued that the purchase of 100 shares of a large, publicly traded company is so insignificant that it could not cause any decrease in objectivity and increase in exposure.

Firms that decide not to adopt a prohibition against all trading and investments in clients' securities should designate a committee, or at least a partner, to approve those investments. Investments in existing clients, and the representation of new clients when partners or employees of the firm already hold securities in that potential client, should be examined. A decision to accept a new client might be conditioned upon certain attorneys disposing of their stock.

A related problem is the preservation of the confidentiality of material information. For efficiency, the committee established to pass on the purchase and sale of securities should also oversee firm policy in this area. One step that law firms should definitely take is to restrict the availability of confidential infor-

mation on a need-to-know basis. There is no reason, for example, for all members of a firm to know that merger negotiations are underway concerning a particular client. The attorneys assigned to the transaction must be informed of all details in those transactions, and support personnel like secretaries will also need access to it. All these firm personnel should have a set of guidelines to follow, which should include the following:

(1) The use of a numbering system that at least includes all documents containing confidential or sensitive information;
(2) the assignment of each numbered document to a particular person who is responsible for the document;
(3) the maintenance of a master list of all documents and persons having possession of the original or another numbered copy;
(4) the utilization of code names to prevent inadvertent disclosure of sensitive names, for example a target company;
(5) a prohibition against discussing the transaction in nonprivate locations, including hallways, elevators, and generally any location not directly connected with the transaction;
(6) the utilization of delivery systems for all documents so that the person receiving the documents can be specifically identified.

The importance of adopting guidelines to safeguard confidential information was the subject of a recent SEC release.[62] This cautionary release focuses on information the Commission has received about situations in which law firm personnel may have abused confidential information by trading in securities before the information became public.[63] While the release concedes that establishing procedures does not guarantee that an indivudal employee will not take unfair advantage of confidential information, it clearly encourages law firms to establish policies that will safeguard confidential information.

The benefit of establishing such safeguards is amply demonstrated by *SEC v. Sorg Printing Co., Inc.*[64] The court in that case found that the printing company itself was not liable under either section 10(b) of the 1934 Act[65] or rule 10b-5[66] for the unlawful use

62. SEC Securities Exchange Act Release No. 13,437 (Apr. 8, 1977), [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,116.

63. In addition, Disciplinary Rule 4-101(C) of the ABA CODE OF PROFESSIONAL RESPONSIBILITY (1978) requires that an attorney exercise care to prevent employees from disclosing the confidences of a client.

64. [1974-75 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,034 (S.D.N.Y. 1975).

65. 15 U.S.C. § 78j(b) (1976).

66. 17 C.F.R. § 240.10b-5 (1978).

by its employees of confidential information. Summary judgment was granted for the defendant company because it had taken steps to safeguard such information, had informed the SEC of the policies adopted, and had actually requested additional suggestions. The SEC had not responded to the request for additional guidelines.

In light of *Ernst & Ernst v. Hochfelder*,[67] in which the Supreme Court held that mere negligence is not sufficient to support a cause of action under section 10(b) or rule 10b-5, law firms can acquire substantial protection in this area by adopting policies to safeguard confidential information. The adoption and good faith enforcement of those policies should preclude a finding that the firm was willful or reckless in its handling of confidential information.

B. *Multiple Representation*

This discussion is related to the prior discussion of the identification of clients; in that discussion it was pointed out that the failure to properly identify clients can result in multiple representation, but without the firm realizing it. This section, however, will deal with multiple representation in which a conscious decision has been made to represent more than one party in a securities transaction.

An instructive and certainly one of the more complex cases in this area is *Kohn v. American Metal Climax, Inc.*[68] The facts of this case are extremely complex and involve multiple allegations of material misrepresentations and omissions in a proxy statement concerning a merger between a parent and a subsidiary. One of the alleged material omissions in the proxy statement was the failure to advise shareholders that the same law firm was advising directors of both companies regarding certain aspects of the merger.

One law firm did represent both the parent and the subsidiary company for approximately 35 years. The subsidiary was incorporated in a foreign country, and the law firm in question represented the subsidiary in negotiations with the foreign government to clear the way for the merger. The firm continued to represent the parent during these negotiations. The lower court

67. 425 U.S. 185 (1976).
68. 458 F.2d 255 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972).

found that this created a conflict of interest that required disclosure and that the failure to disclose was a material omission. The Third Circuit reversed this specific finding, concluding it was clearly erroneous since the dual representation had ceased prior to the initiation of direct negotiations on the terms of the merger between the parent and subsidiary.[69]

While the law firm in *Kohn v. American Metal Climax, Inc.* was legally vindicated with respect to any conflict of interest, this was accomplished only after considerable litigation, including the lower court decision that it had engaged in conduct that created a conflict of interest and that failure to disclose it was a material omission. Most law firms cannot endure too many such victories. This is especially true in light of a recent case concerning the sale of a construction company. In *Hill v. Okay Construction Co.*,[70] an attorney represented both the seller and the purchaser of a construction corporation. The seller contended that the transaction involved an outright sale, and the purchaser contended that it was a sale without recourse. The attorney was named as a third-party defendant and was found liable essentially as an indemnitor. While the purchaser was held liable to the seller for the purchase price, the attorney was held liable to both the seller and the purchaser for attorneys' fees and costs and for all damages paid by the purchaser to the seller.

The court in *Hill* did not hold that multiple representation in the sale of the corporation was improper *per se*. It looked independently at the duties that the attorney owed to each client as though the other client did not exist. It found that the attorney was negligent as to each client, and therefore each client was able to obtain a judgment against the attorney. The court paid absolutely no attention to any problems the attorney might have had because of the multiple representation itself.

Especially in securities transactions, it is important to focus on two aspects of the ABA Code of Professional Responsibility (the Code), as adopted by the various states. Disciplinary Rule 5-105(A) states that:

> A lawyer shall decline proffered employment if the exercise of his independent professional judgment in behalf of a client would be or is likely to be adversely affected by the acceptance of the proffered employment, or if it would be likely to involve

69. *Id.* at 458 F.2d 268-69.
70. 252 N.W.2d 107 (Minn. 1977).

> him in representing *differing* interests, except to the extent permitted under DR 5-105(C) (emphasis added).

Disciplinary Rule 5-105(C) states that:

> In the situations covered by DR 5-105(A) and (B), a lawyer may represent multiple clients if it is *obvious* that he can adequately represent the interest of each and if each consents to the representation after full disclosure of the possible affect of such representation on the exercise of his independent professonal judgment on behalf of each (emphasis added).

The term "differing interests" is defined in the definitional section following Canon 9 of the Code as including "every interest that will adversely affect either the judgment or the loyalty of a lawyer to a client, whether it be a conflicting, inconsistent, diverse, or other interest." This definition tends to blur any distinction between the prohibitions in paragraph (A); however, it does clarify the basis for declining multiple representation and leaves no doubt that something short of a conflict of interest will prohibit the acceptance of such representation. The Code also attempts to solve the problem of close questions by using the word "obvious" in paragraph (C); however, that may be the most ignored word in the entire Code.

Because of the potential exposure faced in securities transactions, the firm should adopt a policy precluding multiple representation in securities transactions without the express approval of designated committee and the clients. Exceptions to this policy should be rare and should only be made if full disclosure is made to the clients of the attendant risks.

VII. LEGAL OPINIONS

A. Introduction

Legal opinions can focus on many transactions, but typical of the subject matter in the securities area are the following:

(1) Due and valid issuance of securities in public offerings;
(2) private placements of securities;
(3) acquisitions and dispositions of securities;
(4) acquisitions and dispositions of assets;
(5) audit letters;
(6) debt financing;
(7) bond issues; and
(8) tax matters.

Requests for opinions in these areas and others usually arise out of a specific requirement of the securities laws or a specific requirement of the transaction itself. In either event, it involves perhaps the epitomy of the formalized private legal process, and exposure to liability for errors in this area is substantial. It calls for a structured approach in compliance with firm policies and procedures. This must include such precautionary measures as (1) engagement letters, (2) preparation and preservation of a written record, (3) investigation of the facts, including the reasons why reliance is placed on those facts, (4) a formal review procedure, and (5) a careful recitation in the opinion of all restrictions on its use.

B. The Engagement Letter

The engagement letter may find its most important use in the area of legal opinions. The reason for this is that not only must the subject matter of the opinion be carefully delineated, but the firm must determine who will be permitted to rely upon the opinion. The opinion letter itself should specifically identify those persons entitled to rely upon it, and the client must be made aware early on of the limitations the firm will place on the use of the opinion. If the client is unwilling to agree to the limitations on the use of the opinion, then the representation should not proceed. The failure to specify limitations on parties and time parameters has contributed to litigation against attorneys.[71] If the limitations are not set forth in the opinion letter itself, it is unlikely that limitations privately agreed upon between the attorney and client will insulate the attorney from liability.[72]

As is true in the area of disclosure documents, it is important to specify who is responsible for gathering factual information, as well as the amount of backup material required before the firm will rely upon factual matters presented to it by the client. If the transaction concerns unregistered securities, the engagement letter should also include a copy of ABA Formal Opinion 335.[73] This opinion focuses on the duties of attorneys regarding analysis of factual matters presented by the client. It indicates that attorneys have important duties in this area, but stops short of a

71. *See, e.g.*, Roberts v. Ball, Hunt, Hart, Brown & Baerwitz, 57 Cal. App. 3d 104, 128 Cal. Rptr. 901 (1976).

72. *See* SEC v. Spectrum, Ltd., 489 F.2d 535 (2d Cir. 1973); Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).

73. ABA COMM. ON PROFESSIONAL ETHICS, OPINIONS No. 335 (1974).

general requirement of an audit, or its equivalent, of the client's affairs.

Specific mention should be made of certain SEC releases set forth or mentioned in Formal Opinion 335, and consideration should be given to attaching those releases in full. The client's attention should specifically be drawn to Securities Act Release No. 5168.[74] In dealing with certain basic standards of conduct required of broker-dealers in the sale of unregistered securities, reference is made in that release to a prior SEC release[75] that states:

> Indeed, if an attorney furnishes an opinion based solely upon hypothetical facts which he has made no effort to verify, and if he knows that his opinion will be relied upon as a basis for a substantial distribution of unregistered securities, a serious question arises as to the propriety of his professional conduct.[76]

Reference should also be made in the engagement letter to certain portions of the Report of the Special Committee on Lawyers' Role in Securities Transactions.[77] In any event, guideline one of part II of the report, dealing with written legal opinions and securities transactions, should be followed. It states:

> Before rendering an opinion, a lawyer should ascertain the purpose for which the opinion is sought; whether the opinion is to be addressed to the client or another recipient; whether any persons other than the client or other addressee are intended to be entitled to rely on the opinion and, if so, their identity; and whether use by and reliance on the opinion should be expressly limited to a specific person or group of persons or to a particular purpose. When a securities law opinion is to be limited to any particular person or purpose, it will usually be advisable for such limitation to be clearly stated in the opinion.[78]

One frequently overlooked group of persons who should be considered with respect to reliance on the opinion is other lawyers. Clients sometimes find that an attorney will not proceed unless provided with an opinion from specialized or local counsel. In those situations the attorney preparing the opinion must consider the possible lack of specialization and knowledge of the

74. SEC Securities Act Release No. 4445 (Securities Exchange Act Release No. 6721) (Feb. 2, 1962), 17 C.F.R. § 241.6721 (§ 231.445) (1978), 2 FED. SEC. L. REP. (CCH) at ¶¶ 22,753-59.

76. *Id.* 2 FED. SEC. L. REP. (CCH) at ¶ 22,757.

77. Association of the Bar of the City of New York Report, 32 BUS. LAW. 1879 (1977).

78. *Id.* at 1886-87.

attorney handling the transaction. Some consideration should be given to limiting the use of the opinion to attorneys qualified to handle securities transactions, in which case the opinion should state that it is assumed that only such an attorney will be utilizing the opinion. Again, the attorney drafting the opinion has some responsibility to determine who will utilize it and whether that person is qualified.

C. *Factual Investigation*

Following the outline of the engagement letter, the designated persons should undertake the necessary factual investigation. Specific guidelines should be set forth on the records to be reviewed, the persons to be interviewed, and the research to be conducted. A review procedure should be established whereby someone other than the persons primarily doing the factual investigation determines the ultimate reliability of the facts.

It is particularly important to systematically review any facts that are subject to change, such as the financial condition of the client, as well as any facts that are subject to disagreement. The review process should include specific memoranda detailing the positions advanced with identification of their author and should also set forth the reasons underlying the resolution of any differences of opinion on the reliability of various facts or legal conclusions.

Superimposed upon these procedures are certain considerations that may determine the extent to which other procedures must be followed. First, the history of the attorney-client relationship is important, especially any knowledge the firm has of the reliability of communications from the client. A form should be distributed to all attorneys in the firm requesting a written response to several questons, which might include the following:

(1) Have you represented this client or had any other contact with this client?
(2) If so, what was the nature of the representation or contact?
(3) Were there any instances in which the client was not candid or did not accurately set forth factual or other matters?

Utilization of this type of form will not only give the attorneys in charge of issuing the opinion critical information, but the process will aid in establishing the defense of due diligence and a lack of recklessness or willfulness should litigation arise from the issuance of the opinion.

The subject matter or type of opinion being rendered will also distinctly influence the above procedures. A public offering of securities, which may involve thousands of purchasers entitled to rely upon any opinion set forth in the prospectus, has greater exposure in most instances than a private placement involving five or ten investors and substantially less money.

D. Preparation and Preservation of a Written Record

This procedure was touched upon in the above discussion of engagement letters and factual investigations, but deserves specific attention as a category of its own. There is little reason for not reducing to writing the methods and procedures used to investigate the factual and legal matters that are involved in the issuance of the opinion. In addition, facts and legal issues that are ultimately determined not to be applicable should also be reduced to writing and preserved. Finally, in all instances the persons doing the investigation and decision making should be identified.

The written memoranda should be organized according to the initial outline of the representation set forth in the engagement letter. This should also correspond in most instances with a detailed outline initially prepared to structure the work to be performed for issuance of the opinion letter. These memoranda should be prepared with a view towards the possibility of disputes or litigation, bearing in mind that laymen will be listening to testimony based upon these memoranda, or at least based upon the testimony of expert witnesses who have used the memoranda.

E. Firm Review of Opinions

Within the process of issuing an opinion letter, there will be reviews of factual and legal matters by the partner or partners in charge of issuing the opinion; however, it is suggested that at least one other partner not directly connected with the transaction be required to review and approve the opinion before it is issued. This is equivalent to the "cold review" used in the preparation of disclosure documents, to be discussed below; however, it is more beneficial with opinion letters because, as a rule, opinion letters are more narrowly focused and enable the reader to form a judgment without as much detailed background concerning the client. This is in part due to the nature of the opinion letter itself, which should set forth all the fact and law upon which it is based.

F. *Subsequent Review of Opinions*

The engagement letter should inform the client; the opinion itself should set forth whatever limitations are appropriate concerning the scope, purpose, and time within which the opinion may be utilized. A determination should be made of the likelihood that facts may change or that other conditions may change and impair the validity of the opinion. Even if this is done, however, a procedure should be instituted to periodically review opinions to determine whether the law firm has knowledge of any events that would compel it to inform the client or other persons entitled to rely upon the opinion that, notwithstanding any previous analysis, the opinion can no longer be relied upon.

G. *Utilizing Special Counsel*

In certain situations, it is necessary to obtain opinions from local counsel in various states to render the ultimate opinion requested by the client. In selecting local counsel, care must be taken to insure that the local counsel is well qualified in the area. Negligence in the selection of local counsel does provide a basis for a cause of action against the attorney selecting the counsel.[79] In addition, even if an ultimate defense exists based upon the lack of negligence of the firm seeking the opinion of local counsel, there is nothing to be gained from associating local counsel who is not well qualified.

VIII. DISCLOSURE DOCUMENTS

A. *Introduction*

This section will deal with procedures that can be implemented to reduce the likelihood of errors in the preparation of various disclosure documents, including the annual report, report on form 10-K, registration statements, and proxy materials. Some of these procedures are recommended based upon their inclusion in the SEC settlements that were previously discussed.[80] In addition to these specific procedures, consideration should be given to the discussion contained in the section on conflicts of interest.[81] It is assumed that having reached the point of preparing a disclosure document, the considerations set forth in the

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79. *See* Tormo v. Yormark, 398 F. Supp. 1159 (D.N.J. 1975).

80. *See* section III *supra.*

81. *Id.* section VI *supra.*

sections on identifying clients,[82] evaluating clients,[83] and identifying securities[84] have already been followed.

B. *Procedures*

1. Engagement Letters.—Engagement letters should be considered a requirement prior to representing clients who seek the review or preparation of disclosure documents. The payment of fees and expenses should of course be included in this engagement letter, but from the point of view of preventing errors the most important aspect of the letter is the definition of the scope of the representation, including provisions for withdrawal.

The engagement letter should specifically define the scope of the attorney's undertaking and, in addition, define the responsibilities assigned to the client and to other professionals. An outline should be made of each major category of work that must be completed and a specific assignment should be made of that category. A written acknowledgement should be required from the person or entity assigned a specific category so that there is no disagreement later over whether the assignment was accepted. As to assignments made to the firm itself, it is not necessary to specify in the engagement letter which attorneys will undertake specific duties, but such an assignment should be made and acknowledged in writing within the firm.

If the role of the attorney is limited, for instance, to the review of a report on form 10-K, which is prepared and signed by the client, the attorney should seriously consider not being named in the report. There is no requirement of an opinion in form 10-K, and the SEC has not set forth any requirements for opinion of counsel for filings under the 1934 Act.[85] If the law firm is named, care should be taken to specify the nature of the representation and the specific tasks undertaken by the firm. Those tasks not undertaken by the firm should be specifically identified. Consideration should be given to disclosing the person or entity that did undertake these tasks.

Provision should be made for withdrawal, whether the need for it should arise based on a conflict of interest, a disagreement over disclosures, or some other matter. While withdrawal is not a topic that is easily discussed with clients, it is nonetheless rela-

82. *Id.* section IV *supra.*
83. *Id.* section IV *B supra.*
84. *Id.* section V *supra.*
85. 15 U.S.C. § 78*l* (1976).

tively easier to discuss in the abstract prior to embarking on a representation than it is with only a few days left to file a registration statement. The engagement letter should point out that withdrawal near the date a transaction must be completed may well jeopardize the closing of the transaction. The client should acknowledge that the attorney nonetheless has the right to withdraw if the client and the attorney are unable to agree on appropriate disclosures. The same is true for conflicts of interest, although the attorney will bear a much greater burden in this area because conflicts usually can and should be evaluated prior to undertaking the representation.

In framing the language of the withdrawal provisions in an engagement letter, one should not attempt to insulate the law firm from liability to the client. That is, a distinction must be made between the disclosure of what the firm may do and any promise by the client that no action will be taken by the client for an improper withdrawal. Canon 6 of the ABA Code of Professional Responsibility, adopted in a nearly identical form by all states, prohibits attorneys from insulating themselves against liability to their clients. The disclosure in the engagement letter will, however, indirectly insulate the attorneys from liability in that the client will be unable to state a cause of action for negligence for failure to reveal the possibility of withdrawal or its consequences.

2. *References to Counsel in Disclosure Documents.*—This topic was touched upon in the section above on engagement letters, but in light of one fairly recent case deserves independent attention. In *Black & Co. v. Nova-Tech,*[86] a federal district court held that, under the Oregon Blue Sky Laws, the designation in the annual reports of the law firm as corporate counsel was sufficient, for the purpose of a motion to quash service and dismiss, to make the law firm's partners participants in any unlawful transaction in which the annual reports were used for promotional purposes. Although the court specifically pointed out that the issue of participation in the service of process was distinct from the issue of liability, the expense of further defense in such actions alone suggests the need for caution in this area.

Designation as corporate counsel on annual reports includes elements of prestige and, to use an increasingly controversial word, advertising. In addition, this form of advertising is free and

86. 333 F. Supp. 468 (D. Ore. 1971).

traditionally has not been the subject of any criticism from disciplinary agencies. These benefits are not to be ignored but, as demonstrated by *Black v. Nova-Tech,* they carry with them certain exposure. On balance, it is suggested that the detriments outweigh the benefits unless the recipients of the annual report include specifically identifiable persons or entities who would take notice of the firm only as a result of being designated as corporate counsel in the annual report or other disclosure document.

Item 3 of Schedule A to the Securities Act of 1933[87] requires that a registration statement include a designation of an agent for service. The role of the agent for service is generally a nominal one, but in light of *Black v. Nova-Tech* some consideration should be given to whether the firm should be designated as the agent.

One benefit of being named as agent is that the firm retains a certain degree of control over the flow of information and is in a position to add its own viewpoint to the information it receives prior to presenting it to the client. This can make the flow of information not only generate additional fees, but also give the firm an opportunity to provide more comprehensive service to the client. It does, however, raise the profile of a firm and in certain situations could contribute to difficulty in prevailing on a motion to dismiss since the firm will have designated itself the official recipient of all communications forwarded by the SEC in response to the filing of the registration statement. Nevertheless, careful attorneys will indicate on the registration statement that copies of all correspondence are to be sent to them.

The attorney is not required to be named in the prospectus. If the firm name is mentioned, consideration should be given to limiting the reference to the firm's having passed on the validity of the issuance of the stock with a specific statement that the firm has not passed on the validity or legality of any other aspect of the offering.

3. Blank Signature Pages.—In form S-1[88] or other registration statement, a practice used by some firms that entails a high degree of exposure is the use of blank signature pages. Preparing blank signature pages in advance and having them executed for the filing of amendments obviously provides an expedient method of meeting time deadlines. Those signing the document,

87. 15 U.S.C. § 77aa(3) (1976).
88. *See* 17 C.F.R. § 239.11 (1978).

however, are relying completely upon the attorney and may actually have become clients under an implied contract theory.

If this practice is utilized, the signatory should definitely be informed of the nature of the amendment. In addition, the general nature of the amendment should be set forth in writing in as great a detail as the situation permits. While signatories can still complain that the actual amendment was not precisely the same as the written explanation or prediction of it, that is still a better position to be in than to have a dispute over the entire content of the amendment. Changes that are approved orally should be kept to a minimum but may be required by the nature of particular transactions.

4. *Officers and Directors.*—Firms acting as principal outside counsel to issuers (and probably underwriters) of securities should not permit members of the firms to act as officers or directors of the clients.

Escott v. BarChris Construction Corp.[89] is a good example of the increased obligations placed upon a person who occupies a dual role of an attorney and a director:

> As the director most directly concerned with writing the registration statement [under the Securities Act] and assuring its accuracy, more was expected of [the lawyer who served as a director] in the way of reasonable investigation than could fairly be expected of a director who had no connection with the work.[90]

When a partner in the law firm serves as a director, there must be some concern with the objectivity of the firm in general in the preparation of disclosure documents. This is especially true with registration statements signed by the directors. It is possible that the firm might unconsciously err on the side of excessive caution in the disclosure process, disclosing items that need not be disclosed, in order to insure that the partner-director is protected. On the other hand, the firm might rely to a greater extent on the factual representations of management because of the presence on the board of directors of one of the partners in the law firm. Given the responsibilities that most lawyers have outside of serving on the board of a corporate client, this reliance is certainly questionable.

5. *Backup Reviews.*—In addition to the partner or partners

89. 283 F. Supp. 643 (S.D.N.Y. 1968).
90. *Id.* at 690.

in charge of a particular transaction, the disclosure document should be reviewed by a partner not primarily responsible for the transaction. This is referred to on occasion as a "cold review," but a true "cold review" is subject to some serious limitations. The primary limitation is that the cold review is limited to the disclosure document itself and is unlikely to reveal omissions, because the reader will not have any additional background information. To the extent that additional background information is provided, it is no longer a true cold review. Another limitation is that many transactions are bound by tight time tables, and the insertion of another level of review at the end of the transaction could pose a time problem. If time does not permit this cold review and it was initially determined that such a review should be made, the failure to undertake the cold review may be the basis for a charge of negligence for a breach of internal safeguards should a lawsuit arise.

A variation of the cold review is to set up a procedure for consistently focusing on and resolving disputes over disclosure items. In most instances the disclosure items that could become the focus of a lawsuit receive a higher than normal degree of attention during the preparation of the disclosure document. Either the attorneys handling the transaction or the attorneys and the client together in most instances will have spent considerable time discussing the issue of disclosure and the language to be used for such items. Because there is a nebulous yet real degree of pressure to "get the transaction completed," the use of an attorney not specifically assigned to the transaction to help resolve difficult questions could provide a degree of objectivity that would prevent some errors. This attorney could regularly participate in the process of resolving disagreements among the attorneys assigned to the transaction or between the attorneys and the client, but would not be assigned to an overall review at the end of the process. Having participated in these discussions, that attorney would not be in a position to undertake a cold review, although yet another attorney could be assigned to such a review.

If the choice is between the ongoing resolution of disputes or a "cold review," it is suggested that the ongoing review has greater potential to yield benefits and does not suffer from the time problems created by a mass of work at the very end of the process.

6. *Preparation of a Written Record.*—The engagement letter should define the scope of the representation, but only a con-

tinuous written record and preservation of that record will insure that if a dispute later arises there will be documentation that the roles and functions outlined in the engagement letter were maintained. In addition, the written record can demonstrate the absence of any recklessness or willfulness, and when the specific defense is available it can provide the basis for the "due diligence" defense.

The heart of the written record is the preservation of all drafts of the disclosure document itself. The drafts should identify each attorney who contributed to it and briefly summarize the areas in which each attorney participated. All internal memoranda and correspondence with the client should of course be retained, but specific attention should be paid to the preparation of memoranda concerning disclosure items over which there is any extended discussion whatsoever. The specific viewpoints of different attorneys, the client, or any other person contributing to the discussion should be preserved. In addition, the rationale for the final decision should be set forth in writing.

Careful consideration must be given to forming a policy regarding drafts of correspondence, memoranda, and other documents. If every draft is retained, attorneys may be inhibited by the process and spend unnecessary time making the entire written record read like testimony at a trial. A balance must be struck between the preservation of a written record and the unnecessary expenditure of time and money on redrafting various written communications.

As to the factual investigation, the person or entity responsible for it should be required to provide written backup material for the facts presented and the process used in determining those facts. In each case in which the law firm is not responsible for undertaking the investigation, correspondence should confirm the engagement letter regarding the responsibility for the factual investigation. The law firm should also obtain copies of the backup information and review written summaries of the process used in investigating the facts and in determining the final conclusion.

The accurate recording of time expended in the transaction should also be emphasized. It should be possible to determine from the time records the total amount of time expended by attorneys, paralegals, and others in connection with each specific task the law firm undertakes. This again can be useful in demonstrating that the law firm exercised due diligence and did not act recklessly or willfully.