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Attorney Liability under the Securities Laws after Ernst & Ernst v. Hochfelder

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ATTORNEY LIABILITY UNDER THE SECURITIES LAWS AFTER ERNST & ERNST v. HOCHFELDER

by David B. Parker*

I. INTRODUCTION

While the role of legal counsel in the operation of federal securities regulations has always been pervasive and indispensable, in the forty years since the passage of the Securities Act of 1933 (the 1933 Act) and the Securities Exchange Act of 1934 (the 1934 Act) there has been a dramatic increase in the attorney’s involvement and influence in this area. It is the responsibility of attorneys to guide the corporate client through the intricate maze of the 1933 Act regulations governing the registration requirements for the issuance of securities, and to facilitate the sale of securities by registration or exemption through opinion letters and drafting of disclosure documents, primarily the

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5. Commissioner Sommer succinctly described the importance of an attorney opinion to the success of a proposed securities transaction: “In a word, . . . the professional judgment of the attorney is often the ‘passkey’ to securities transactions. If he gives an opinion that an exemption is available, securities get sold; if he doesn’t give the opinion, they don’t get sold.” Sommer, The Emerging Responsibilities of the Securities Lawyer, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,631 (Jan. 24, 1974) (speech before Banking, Corporation and Business Law Section of the New York State Bar Association) [hereinafter cited as Sommer]. In terms of the effect of counsel’s opinion on the investing public, the court in United States v. Benjamin, 328 F.2d 854 (2d Cir. 1964) observed: “In our complex society the accountant’s certificate and the lawyer’s opinion can be instruments for inflicting pecuniary loss more potent than
registration statement. No less pivotal is the role of corporate legal counsel in the functioning of the continuous disclosure process established by the 1934 Act, including proxy solicitation statements, disclosure documents pertaining to takeover bids, and annual report filings.

Yet, remarkably, despite these immense responsibilities which have come to rest on the shoulders of the legal profession, the 1933 Act and 1934 Act are virtually silent with respect to the accountability of attorneys to the investing public. By contrast, the Acts do establish a rigorous pattern of regulation for other professions involved in the securities markets, including corporate officers and directors, control persons, broker-dealers, underwriters, investment advisers, ex-

the chisel or the crowbar.” Id. at 863.

6. On the attorney's role in developing the registration statement, it has been said: [T]he registration statement has always been a lawyer's document and with very, very rare exceptions the attorney has been the field marshall who coordinated the activities of others engaged in the registration process, wrote (or at least rewrote) most of the statement, made the judgments with regard to the inclusion or exclusion of information on the grounds of materiality, compliance with registration form requirements, necessities of avoiding omission of disclosure necessary to make those matters stated not misleading. . . . With the exception of the financial statements, virtually everything else in the registration statement bears the imprint of counsel.

Sommer, supra note 5.

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perts such as engineers and appraisers,16 and accountants.17

There have been attorneys whose conduct involving securities has
departed from professional standards of competency and ethics or
whose conduct has involved blatantly unlawful schemes. At times
they have acted strictly as professionals, while more frequently their
status as attorneys has been incidental to their role as principals in
violation of the securities laws. Yet, regardless of the degree of mis-
conduct or the capacity in which attorneys have acted, the injurious con-
sequences have been significant. In few other fields of business or law
are the acts of so few individuals able to cause financial losses for so
many persons. It has required no prophetic insight to foresee that at-
torneys would increasingly be the target of criminal and injunctive
actions by the government and civil damage actions by private investors.
The great difficulty has been to adapt the federal securities laws to
fairly and clearly define the responsibilities of attorneys to the public.
Measures of accountability capable of deterring abuses by attorneys and
capable of providing compensation for damages have also been a diffi-
cult objective.

Traditionally, the courts have passively accepted the omissions in the
1933 Act and 1934 Act relating to the liabilities of attorneys. For-
merly, sanctions were imposed only in those instances where attorneys
acted as principals in fraudulent schemes18 or occupied a non-legal role
such as an officer or director of an issuer.19 Until recently, this view

365-83 infra and accompanying text.
Exchange Act of 1934 §§ 14(a), 17(a), 18, 15 U.S.C. §§ 78n(a), 78q(a), 78r (1970
& Supp. V 1975). For the subject of accountant liability, see references cited in KNEP-
PER, supra note 11, at 283; Ruder, Multiple Defendants in Securities Law Fraud
Cases: Aiding and Abetting, Conspiracy, “In Pari Delicto,” Indemnification and Con-
tribution, 120 U. Pa. L. Rev. 597, 613 n.65 (1972) [hereinafter cited as Ruder].
18. See, e.g., SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972)
(CCH) ¶ 93,594 (S.D.N.Y. 1972)); Katz v. Amos Treat & Co., 411 F.2d 1046 (2d Cir.
1969); United States v. Benjamin, 328 F.2d 854 (2d Cir.), cert. denied, 377 U.S. 953
(CCH) ¶ 93,023 (E.D.N.Y. 1971); Gottlieb v. Sandia Am. Corp., 304 F. Supp. 980
(E.D. Pa. 1969), aff’d, 452 F.2d 510 (3d Cir.), cert. denied, 404 U.S. 938 (1971); SEC
Sarantos, 455 F.2d 877 (2d Cir. 1972) (involving a scheme to defraud the Immigration
and Naturalization Service). See generally Lowenfels, Expanding Public Responsibilities
of Securities Lawyers: An Analysis of the New Trend in Standard of Care and Priori-
ties of Duties, 74 Colum. L. Rev. 412, 413-18 (1974) [hereinafter cited as Lowenfels].
was also reflected in the administrative decisions of the Securities and Exchange Commission (the SEC or the Commission). By contrast, where attorneys functioned solely within the scope of their professional role and did not personally engage in fraudulent activity—regardless of the intimacy of their involvement—sanctions were not imposed.

The modern trend has been to recognize the pivotal role of attorneys in facilitating the fraudulent schemes of the corporate principals and to discard the talismanic immunity of the lawyer qua lawyer. Stressing the remedial purposes of securities legislation, courts have recently broadened the scope of potential attorney liability by expansive interpretation of the 1933 Act, most notably the “seller” requirement of section 12, and by the creative development of the most influential antifraud provision of the securities acts, section 10(b) of the Securities Exchange Act of 1934 (section 10(b)) and rule 10b-5, through the concepts of “duty” and aiding and abetting. The moving force behind this “quiet revolution” in the development of the responsibilities and liabilities of attorneys under the securities laws has been the SEC.

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24. 17 C.F.R. § 240.10b-5 (1976), promulgated under section 10(b), supra note 23 [hereinafter cited as rule 10b-5].

25. The concept of “duty” is examined in notes 119-85 infra and accompanying text.

26. For a discussion of the development of aiding and abetting liability, see notes 94-118 infra and accompanying text.

27. See Lowenfels, supra note 18, at 412.

28. The SEC's role has been much discussed:

During the last few years the traditional view of the securities lawyers' responsibilities and duties... has been eroded by the SEC and, to a lesser degree, by the federal courts. No longer are sanctions and liabilities reserved for securities lawyers who are active participants or prime movers in blatant frauds. No longer is it clear that the securities lawyer owes his first and primary allegiance to his client. Today the SEC is initiating complaints against lawyers qua lawyers, and
This article will examine the more significant trends in the liability of attorneys under the federal securities laws in light of the Supreme Court's recent decision in *Ernst & Ernst v. Hochfelder*, [29] which adopted a scienter standard and precluded negligence as a basis for liability in private damage actions under section 10(b) and rule 10b-5.

II. **Ernst & Ernst v. Hochfelder**

The United States Supreme Court's silence and non-involvement in the critical issues of professional liability under the federal securities laws has been notable. [30] While the history of high court pronounce-
ments on other issues in the area of section 10(b) and rule 10b-5 has indicated a trend toward an expansive and flexible reading of the anti-fraud provision.\textsuperscript{31} In 1975 the Court took the first significant step to limit the scope of rule 10b-5 by recognition of the purchaser-seller requirement for standing in \textit{Blue Chip Stamps v. Manor Drug Stores}.\textsuperscript{32} Thus, there was cause for intense interest and speculation when the Court granted a hearing to review the much publicized Seventh Circuit ruling in \textit{Hochfelder v. Ernst & Ernst}\textsuperscript{33} which held that an accounting firm's negligent failure in the course of its audits to discover a brokerage firm's fraudulent scheme was grounds for aiding and abetting liability in a private action for damages under section 10(b).\textsuperscript{34}

The plaintiffs in \textit{Hochfelder} were victims of a fraudulent securities scheme perpetrated by Leston B. Nay, president of First Securities Company of Chicago, a small brokerage firm. Between 1942 and 1966, with the majority of transactions occurring in the 1950's, Nay induced plaintiffs to invest funds in "escrow" accounts which he personally represented would yield a high rate of return. This scheme required investors to draw personal checks payable to Nay or a designated bank for his account with the monies being immediately converted by Nay. The fraud was eventually uncovered in 1968 when Nay committed suicide, leaving a confessional note.\textsuperscript{35}

Plaintiffs initiated an action for damages against Ernst & Ernst, a national accounting firm retained by First Securities to perform periodic audits and to file the annual reports required of registered brokers under section 17(a) of the 1934 Act.\textsuperscript{36} As described by the Supreme Court,

\begin{enumerate}
\item 32. 421 U.S. 723 (1975).
\item 33. 503 F.2d 1100 (7th Cir. 1974), \textit{rev'd}, 425 U.S. 185 (1976).
\item 34. See notes 39-55 infra and accompanying text.
\item 35. The fraud is described in detail in SEC \textit{v. First Sec. Co.}, 463 F.2d 981 (7th Cir. 1972), \textit{cert. denied}, 409 U.S. 880 (1973), a case involving receivership proceedings commenced by the Commission against the Nay brokerage firm, shortly after Nay's death. Section 10(b) claims for relief against First Securities for having aided and abetted Nay's fraudulent scheme were sustained. The liability of the accounting firm was not considered in that case.
\item 36. The first count of the complaint charged the Midwestern Stock Exchange, of which First Securities was a member firm, with complicity for having breached its duty of supervision over the conduct of its members. Summary judgment in favor of the
[The complaint charged that Nay's escrow scheme violated § 10(b) and Commission Rule 10b-5, and that Ernst & Ernst had "aided and abetted" Nay's violations by its "failure" to conduct proper audits of First Securities. As revealed through discovery, respondents' cause of action rested on a theory of negligent nonfeasance. The premise was that Ernst & Ernst had failed to utilize "appropriate auditing procedures" in its audits of First Securities, thereby failing to discover internal practices of the firm said to prevent an effective audit.37

The district court rejected Ernst & Ernst's contention that a cause of action for aiding and abetting a securities fraud would not lie under section 10(b) and rule 10b-5 for alleged negligent misfeasance. However, the court granted the accounting firm's motion for summary judgment on the grounds that the evidence clearly established that Ernst & Ernst had adhered to generally accepted auditing standards and, accordingly, was blameless for failing to discover the fraud.38

The Court of Appeals for the Seventh Circuit reversed the summary judgment in favor of Ernst & Ernst, finding genuine triable issues of fact with respect to whether the accounting firm complied with its duty to conduct a proper audit in accordance with prevailing professional standards39 and whether such compliance would likely have led to discovery of the fraud.40

Ernst & Ernst's first line of defense, which ultimately prevailed with the Supreme Court, was that it could not be held liable in damages for aiding and abetting a third party's violation of section 10(b) and rule 10b-5, absent an allegation that it knew of the other's improper conduct.41 Relying on its earlier statements in Hochfelder v. Midwest Stock Exchange,42 the court of appeals held that a claim for aiding and abetting solely by inaction can be maintained under rule 10b-5 by showing

that the party charged with aiding and abetting had knowledge of or, but for a breach of duty of inquiry, should have had knowledge of the

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38. The district court also held the action barred by the doctrine of equitable estoppel and the Illinois three-year statute of limitations. These alternative findings were reversed by the court of appeals. 503 F.2d at 1115-19. The issue, of course, is mooted by the Supreme Court's dismissal of the action without remand. See 425 U.S. 185, 193 n.11.
39. 503 F.2d at 1107-11.
40. Id. at 1115.
41. Id. at 1104.
42. 503 F.2d 364. See note 36 supra.
fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure.\footnote{503 F.2d at 1104 (citing Hochfelder v. Midwest Stock Exch., 503 F.2d at 364).}

The court continued:

The foregoing elements comprise a flexible standard of liability which should be amplified according to the peculiarities of each case. Accordingly, where, as here, it is urged that the defendant through action as well as inaction has facilitated the fraud of another, a claim for aiding and abetting is made on demonstrating: (1) that the defendant had a duty of inquiry; (2) the plaintiff was the beneficiary of that duty of inquiry; (3) the defendant breached that duty of inquiry; (4) concomitant with the breach of duty of inquiry the defendant breached a duty of disclosure; and (5) there is a causal connection between the breach of duty of inquiry and disclosure and the facilitation of the underlying fraud; that is, adequate inquiry and subsequent disclosure would have led to the discovery of the underlying fraud or its prevention.\footnote{Id.}

Insofar as the court of appeals' decision recognized liability in damages under rule 10b-5 for negligent breach of a duty of inquiry and disclosure, it is now overruled.\footnote{503 F.2d at 1104.}

Since plaintiffs had disclaimed scienter on the part of Ernst & Ernst, the court of appeals was faced with the issue of whether a duty of inquiry and a concomitant duty of disclosure\footnote{See notes 56-64 infra and accompanying text.} existed and, if so, whether plaintiffs belonged to the class of persons to whom these duties were owed.

Two sources for the accounting firm's duty of inquiry were considered: (1) the common law duty arising from the contractual undertaking to audit,\footnote{17 C.F.R. § 240.17a-5 (1976). See 503 F.2d at 1104-05.} and (2) a statutory duty of inquiry predicated on section 17(a) of the 1934 Act\footnote{17 C.F.R. § 240.17a-5 (1976). See 503 F.2d at 1104-05.} and rule 17a-5, promulgated by the Commission.\footnote{503 F.2d at 1105.} The scope of the common law duty of inquiry was held not to extend to the defrauded investors for two reasons. First, absence of foreseeability precluded an action on the auditing contract itself.\footnote{51. Judge Cardozo's decision in the seminal case of Ultramares Corp. v. Touche,} Second, a tort action, arising out of the contractual arrangement and based on a duty of inquiry extending to those not foreseeable was

\footnote{48. A duty of disclosure was seen as arising inevitably from a breach of the duty to conduct a proper audit pursuant to section 17(a) of the 1934 Act, 15 U.S.C. § 78q(a) (1970). 503 F.2d at 1114.}
precluded because the defrauded investors were not "members of a limited class whose reliance on the financial statements [was] specifically foreseen." 52

The statutory duty of inquiry is mandated by the requirement that a section 17(a) audit be conducted "in accordance with generally accepted auditing standards" 53 which encompass a duty to review "internal accounting control." 54 It is therefore incumbent on the accountant to inquire as to the existence and nature of internal accounting control. With respect to this duty of inquiry, however, the court of appeals held that the plaintiffs were indeed beneficiaries with standing to assert a claim for damages against a negligent accounting firm for conduct inconsistent with requisite standards of section 17(a):

Without reaching the question of whether there is implicit in Section 17(a) a direct duty flowing to the plaintiffs, it is enough for purposes of proving defendant's aid and abetment of a Rule 10b-5 violation that the extant duty of inquiry imposed on Ernst & Ernst is grounded on a concern for the protection of investors such as the plaintiffs. 55

The court of appeals reversed and remanded for trial to determine whether Ernst & Ernst, in fact, breached a duty to plaintiffs by failing to follow section 17(a) standards.

In the view of the Supreme Court, the issue to be decided was much broader than the secondary liability of independent accountants under section 10(b). As framed by Justice Powell, 56 the question was "whether an action for civil damages may lie under § 10(b) of the Securities Exchange Act of 1934 . . . and . . . Rule 10b-5 . . . in the absence of an allegation of intent to deceive, manipulate or defraud on the part of the defendant." 57

174 N.E. 441 (N.Y. 1931), concerning the expansion of liability beyond privity limitations, is extensively discussed in the Seventh Circuit's Hochfelder opinion. 503 F.2d at 1106-07.

52. 503 F.2d at 1107. The court of appeals also noted that plaintiffs' conceded failure to rely on the statements prepared and certified by Ernst & Ernst was an independent basis for finding no duty of disclosure owed to the defrauded investors. Id. See McLean v. Alexander, [Current] Fed. Sec. L. Rep. (CCH) ¶ 95,725 (D. Del. 1976).

53. 503 F.2d at 1108.

54. Id.

55. Id. at 1105. Plaintiffs also sought to raise a new and distinct claim based on the "direct duty" under section 17(a) and rule 17a-5 for the first time before the Supreme Court. This was done in anticipation of possible imposition of the scienter requirement on secondary liability. The Supreme Court refused to consider the question in view of plaintiffs' failure to timely amend their complaint to state such a claim. 425 U.S. 185, 194 n.13.

56. Justice Powell wrote for a majority of six justices. 425 U.S. at 187. Justices Blackmun and Brennan dissented. Id. at 215. Justice Stevens did not participate. Id.

57. Id. at 187-88 (citations omitted).
The Court's decision in Hochfelder resolved the long-standing debate among courts and commentators as to whether a cause of action under Rule 10b-5 requires an allegation of "scienter" or whether, in some circumstances, mere negligence will suffice as a basis for liability. The Court held that section 10(b), and, by extension, rule 10b-5 require proof of "scienter," i.e., "knowing and intentional" conduct or, at the very least, something more than mere negligence.

The body of the Court's opinion was devoted to a point-by-point rebuttal to the arguments of the SEC in its amicus brief. The Court found support for the requirement of scienter in the language and legislative history of section 10(b), as well as in its relationship with the other substantive provisions of the securities acts.


60. The Court interpreted the language and administrative history of rule 10b-5 as consistent with the scienter requirement of its statutory source, section 10(b) of the Securities Exchange Act of 1934. A contrary interpretation would involve an overextension of the Commission's delegated authority. 425 U.S. at 213-14.

61. Id. at 201.

62. Placing great emphasis on the key terms, "manipulative," "device," "contrivance," which the Court found to evince an "unmistakable . . . congressional intent to proscribe a type of conduct quite different from negligence," id. at 199, and contrasting this with the language of sections 11 and 12 of the 1933 Act, which evidence an unmistakable intent to expressly proscribe conduct not involving scienter, the Court rejected the SEC's "effect-oriented" approach which would extend inevitably to strict liability. Id. at 198.

63. While acknowledging the scant legislative history from which section 10(b) emerged, the Court did not find in the statements of the drafters or the published legislative reports any evidence which would contradict the clear import of the statutory language. Id. at 201-11.

64. The Court stated:

We also consider it significant that each of the express civil remedies in the 1933 Act allowing recovery for negligent conduct, see §§ 11, 12(2), 15, . . . is subject to significant procedural restrictions not applicable under § 10(b). . . . We think these procedural limitations indicate that the judicially created private damage remedy under § 10(b)—which has no comparable restrictions—cannot be ex-
III. IMPLICATIONS OF Hochfelder

A. Generally

The Supreme Court’s decision in Hochfelder, the most significant interpretation thus far of rule 10b-5, which itself has exerted the greatest influence on the course of securities law since 1933, is certain to have a profound effect on the liabilities of attorneys and other professionals. It is clear that an attorney will not be liable in damages to a purchaser or seller of securities under section 10(b) for mere negligence. Beyond this, many significant questions remain to be answered: What is the scope and meaning of “scienter?” Under what circumstances, if any, will recklessness suffice for liability in damages for a violation of rule 10b-5? Is good faith a defense under all circumstances? What will be the implications of the increasing resort to aiding and abetting liability? What impact will Hochfelder have on the concepts of duty and scope of duty, as distinguished from culpability or standard of conduct? Does the scienter requirement for civil damage actions apply to equitable relief in private actions and in SEC enforcement proceedings? Finally, what is the scope of potential attorney liability under other statutory provisions which do not require proof of scienter?

B. Meaning of “Scienter”

Although the Supreme Court unequivocally rejected the “flexible duty standard” of White v. Abrams65 and the Seventh Circuit’s opinion in Hochfelder v. Ernst & Ernst,66 insofar as the court of appeals recognized negligence as a possible basis for rule 10b-5 liability in private damage actions and established a “scienter” requirement, the question remains: What is meant by the term “scienter?”67 While the continuum of culpable conduct between negligence and specific intent to deceive is complex,68 the primary inquiry as to “scienter” must be directed to the concept of recklessness.

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65. 495 F.2d 724, 734 (9th Cir. 1974). This rule is discussed in note 84 infra.
66. 503 F.2d at 1104.
67. Some have urged that the term be discarded. See, e.g., White v. Abrams, 495 F.2d 724, 728 n.3 (1974).
68. See Mann, supra note 59.
The Court carefully limited the scope of its ruling in defining the degree of culpability which is included, if not required, to establish scienter under section 10(b):

In this opinion the term "scienter" refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability under § 10(b) and rule 10b-5.69

At the same time, the Court recognized that "[o]ther Courts of Appeals have held that some type of scienter—i.e., intent to defraud, reckless disregard for the truth, or knowing use of some practice to defraud—is necessary in . . . [a rule 10b-5] action."70 The question is whether the Court will adopt the broader interpretation of "scienter" which has been recognized with near unanimity among lower federal courts and, if so, whether it will be limited in its application to certain circumstances. This adoption should be distinguished from approval of recklessness as evidence of intent to deceive which may be assumed to be proper.71

A review of the courts which, prior to Hochfelder, had rejected a negligent standard indicates a refusal by the courts to engraft a strict intent to deceive standard on the remedial securities regulations adopted since 1933. In Lanza v. Drexel & Co.,72 the leading case on scienter under section 10(b) prior to Hochfelder, the Second Circuit held that rule 10b-5 requires "proof of a willful or reckless disregard for the truth . . . ."73 Explaining further, the court said:

In determining what constitutes "willful or reckless disregard for the truth" the inquiry normally will be to determine whether the defendants knew the material facts misstated or omitted, or failed or refused, after being put on notice of a possible material failure of disclosure, to apprise themselves of the facts where they could have done so without any extraordinary effort, . . . The answer to the inquiry will of course depend upon the circumstances of the particular case, including the nature and duties of the corporate positions held by the defendants. 74

69. 425 U.S. at 193-94 n.12.
70. Id. (emphasis added).
72. 479 F.2d 1277 (2d Cir. 1973) (en banc).
73. Id. at 1306.
74. Id. at 1306 n.98 (citation omitted).
This standard of recklessness "tantamount to wilful fraud" was applied by the Second Circuit in SEC v. Frank against an attorney guilty of drafting a false and misleading disclosure document. In reversing the injunction on other grounds, the court indicated that an attorney will be liable for assisting in circulating a statement "he knows to be false," and that he cannot "escape liability for fraud by closing his eyes to what he saw and could readily understand."

Judge Adams' dissenting opinion in Kohn v. American Metal Climax, Inc. reviewed the principal pre-Lanza cases and concluded that scienter has not been confined to strict notions of fraudulent intent; rather, it has been applied flexibly according to such variables as the nature of the plaintiff, the relief requested, and the relationship between the parties.


76. 388 F.2d 486 (2d Cir. 1968).

77. Id. at 489.

78. 458 F.2d at 281-88. Adams' opinion dissented in part and concurred in part.

79. Judge Adams stated:

One distinction the cases suggest depends on the nature of the plaintiff. . . . It is fitting that in the face-to-face confrontations, courts should impose a higher standard of disclosure by lessening the degree of culpability upon which liability can be imposed. From a practical standpoint, in such situations, the amount of damages is relatively finite, whereas in a suit on behalf of a class composed of thousands of shareholders, damages might well extend into millions of dollars. When faced with such huge potential payments, the brunt of which will be borne by innocent shareholders of the defendant corporation, the courts seem to have proceeded more slowly, by requiring that the plaintiff class prove conduct closer to the traditional concepts of actionable fraud.

Id. at 286.

80. As to the nature of the relief requested, Judge Adams wrote:

Where the Government or a private party is seeking prospective injunctive relief only, it is appropriate that courts be able to protect the investors and shareholders from future harm even though the conduct involved does not amount to common law fraud. On the other hand, when the plaintiff class is seeking retrospective relief, such as substantial money damages or dissolution of a merger, more serious problems arise and a different balance must be struck. . . . Where the relief discourages conduct through punishment, whether by damages or by divestiture, . . . courts [should] cleave close to the Congressional purpose by construing the statute strictly, and to affix liability only where culpable conduct is made out.

Id. at 286-87 (citation omitted).

81. The parties' relationship should be a factor because

[j]n the normal course of events, the ordinary shareholder has the right to rely on the fiduciary relationship between himself and his company to the extent of justifiably believing that recommendations with regard to shareholder action are in the best interest of the company. . . . Hence, in self-dealing transactions, it does not seem unreasonable for courts, in an effort to achieve the required disclosure, to
It appears that the weight of authority recognized the flexible nature of the scienter concept.\textsuperscript{82} \textit{White v. Abrams},\textsuperscript{83} expressing the Ninth Circuit's "flexible duty standard," should therefore retain considerable authority subject to the exclusion of mere negligence as a potential basis for liability.\textsuperscript{84}

Certainly, the language of section 10(b), which, according to the Court in \textit{Hochfelder}, is determinative with respect to precluding liability based upon negligence, does not per se command adherence to a strict intent to deceive standard.\textsuperscript{85} Since all commentators concede the paucity of legislative history, resort must be had to the underlying policy react by apparently lowering the standard of actionable conduct.

\textit{id.} at 287.


83. 495 F.2d 724 (9th Cir. 1974).

84. In evaluating the secondary liability of a corporate defendant with respect to a misleading proxy statement of an issuer, the district court in H. L. Federman & Co. v. Greenberg, 405 F. Supp. 1332 (S.D.N.Y. 1975) observed:

The Ninth Circuit has proposed a flexible duty standard to judge a defendant's responsibilities under aiding and abetting standards. See \textit{White v. Abrams}, 495 F.2d 724, 734 (9th Cir. 1974). While this approach may be in consonance with the Second Circuit's emphasis on \textit{scienter}, this Court may properly assess the relationship of the defendant to the issuer in evaluating the knowledge element.

\textit{id.} at 1338 n.2 (citation omitted).

In a decision rendered shortly before \textit{Hochfelder}, the Ninth Circuit Court of Appeals reaffirmed the role of the flexible duty formula in evaluating the accuracy and adequacy of a broker's representation to a client-investor. Hughes v. Dempsey-Tegeler & Co., 534 F.2d 156, 176 (9th Cir.), \textit{cert. denied}, 429 U.S. 896 (1976).


As the courts have begun to evaluate the implications of the Supreme Court's decision, the initial returns evidence the continued vitality of the flexible duty concept. \textit{See}, e.g., Gould v. American-Hawaiian S.S. Co., 535 F.2d 761, 780 (3d Cir. 1976); Carr v. NYSE, 414 F. Supp. 1292, 1300 (N.D. Cal. 1976); United States Steel v. Orenstein, \textit{[Current]} FED. SEC. L. REP. (CCH) ¶ 95,680 (S.D.N.Y. 1976).

85. \textit{White v. Abrams}, 495 F.2d 724, 729 (9th Cir. 1974).
of the 1934 Act. The “broad remedial purposes” consistently emphasized by the Supreme Court would be frustrated by imposition of a standard of conduct otherwise subject to traditional state law liability. In this connection, it should be noted that even common law fraud actions under state law may rest on representations made in reckless disregard of truth or falsity. Also significant is the willingness of the federal courts to move away from common law fraud with respect to other section 10(b) elements, such as reliance. In SEC v. Capital Gains Research Bureau, Inc., the Supreme Court observed:

There has ... been a growing recognition by common-law courts that the doctrines of fraud and deceit which developed around transactions involving land and other tangible items of wealth are ill-suited to the sale of such intangibles as advice and securities, and that, accordingly, the doctrines must be adapted to the merchandise in issue.

It therefore appears that the broader view of scienter in Lanza v. Drexel & Co., should ultimately prevail, subject to the defense of good faith.

86. By contrast, the Supreme Court in Hochfelder, refused to consider the issues of public policy in the face of a conclusion that the statutory language was dispositive. 425 U.S. at 214-16 n.33.
87. See cases cited note 31 supra.
88. For an extensive discussion of common law fraud concepts in light of the rule 10b-5 scienter standard, see Haimoff, Holmes Looks at Hochfelder and 10b-5, 32 Bus. Law. 147 (1976). The author’s thesis is that recklessness is a recognized basis for fraud liability under the common law and that scienter under rule 10b-5 represents an equivalent standard.
90. 375 U.S. 180, 194 (1963) (citation omitted).
91. 479 F.2d 1277 (2d Cir. 1973) (en banc). See notes 72-74 supra and accompanying text.
92. While the Supreme Court’s ruling in Hochfelder leaves the scope of scienter in doubt, much of the problem seems resolved by the Court’s strong suggestion that good faith is a defense under all circumstances. After reviewing the legislative history of section 10(b), and focusing on the legislative reports, the Court concluded: “There is no indication that Congress intended anyone to be made liable for such practices unless he acted other than in good faith. The catch-all provision of § 10(b) should be interpreted no more broadly.” 425 U.S. at 206.

The defense of good faith has also been urged by the lower courts. In Kohn v. American Metal Climax, Inc., 458 F.2d 255 (3rd Cir.), cert. denied, 409 U.S. 874 (1972) (Adams, J., dissenting), based on the same legislative reports cited in Hochfelder, Judge Adams observed:

Essential to the elements intended by Congress are the requirements that the defendant has acted in other than “good faith” and that the plaintiff has “relied” on the misleading statement. ... There is no evidence that Congress intended that under Section 10(b) anyone should be an insurer against false or misleading statements made non-negligently or in good faith.

Id. at 280. The Second Circuit has concurred in this view. See Lanza v. Drexel & Co., 479 F.2d 1277, 1299 (2d Cir. 1973).

As a subjective measure of a person’s conduct, good faith expands the buffer zone
This has been the consistent position taken by the courts after *Hochfelder*.93

**C. Aiding and Abetting**

It is generally acknowledged that liability under the securities laws may be *primary*, as where one is a “participant” with others in an unlawful course of conduct or is otherwise individually guilty of a tortious act (or omission), or liability may be *secondary*, as where one conspires with or aids and abets the unlawful conduct of principals.94 Expansion of attorney liability has occurred under both of these theories. On the one hand, there has been a steady erosion of the traditional view that participant liability is necessarily limited to an attorney who has overstepped his professional role.95 On the other hand, attorneys have increasingly come under the scrutiny of the securities laws as aiders and abettors of their clients’ misadventures. This latter approach is most evident in recent SEC enforcement proceedings.96

The *Hochfelder* case, involving accountants rather than attorneys, had been considered a harbinger of anticipated expansion of secondary liability in civil damage actions against attorneys. Unlike previous cases where plaintiffs pleaded primary and secondary liability as alternative theories,97 *Hochfelder* involved a complaint which alleged that

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95. See, e.g., SEC v. Frank, 388 F.2d 486 (2d Cir. 1968). For discussion of participation and “seller” liability under section 12 of the 1933 Act, see notes 289-352 infra and accompanying text.

96. See cases cited note 28 *supra*.

97. See, e.g., SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S.
the accountants were liable only as aiders and abettors in that their improperly conducted audits failed to uncover the fraudulent scheme of the brokerage firm president. The Seventh Circuit's holding, as characterized by Justice Powell, reflects the single issue of aiding and abetting liability:

The Court of Appeals . . . [held] that one who breaches a duty of inquiry and disclosure owed another is liable in damages for aiding and abetting a third party's violation of Rule 10b-5 if the fraud would have been discovered or prevented but for the breach.

In view of the posture of the pleadings, one might reasonably have supposed that any discussion of the degree of misconduct necessary to hold the accounting firm liable in damages for aiding and abetting would include reference to the elements of a claim for aiding and abetting, at least with respect to state of mind. Yet, remarkably, the Supreme Court dismissed the action without even reaching the question of secondary liability. It seems that the Court was implying that, if scienter is required for a primary violation of section 10(b) and rule 10b-5, then at least as much should be required to find a violation by an aider and abettor. Since the Court insists on playing with cards close to the chest, courts and commentators must continue to speculate on the ultimate resolution of these issues.

The question of whether aiding and abetting is an appropriate basis for liability under section 10(b) seems indisputably answered in the affirmative. Having been sanctioned as early as 1939 in a 1933 Act enforcement action, even before an implied private right of action

98. The Supreme Court declined to consider the issue of primary liability for violations of a "direct duty" owed by the accountants under section 17(a) and rule 17a-5. 425 U.S. at 194 n.13.
99. Id. at 191.
100. The Court evaded the issue by saying:
In view of our holding that an intent to deceive, manipulate, or defraud is required for civil liability under § 10(b) and Rule 10b-5, we need not consider whether civil liability for aiding and abetting is appropriate . . . nor the elements necessary to establish such a cause of action.
Id. at 191-92 n.7.
It is this author's view that for the Supreme Court to persist in its sphinx-like silence on an issue so critical to the effective operation of the federal securities laws and the liability of professionals as aiding and abetting is to abdicate the Court's responsibility. To have done so in this case would not have required far-ranging dicta. If anything, the ruling on the issue of scienter with respect to primary liability, not even presented in Hochfelder, was itself inconsistent with the tenet that only issues requiring the high court's resolution will be considered.
under rule 10b-5 was first recognized,\textsuperscript{102} and applied since that time in an unbroken line of civil damage actions beginning with \textit{Brennan v. Midwestern United Life Insurance Co.},\textsuperscript{103} the propriety of aiding and abetting liability under section 10(b) has never been subject to serious challenge.\textsuperscript{104}

The focus of debate has been on the elements rather than the propriety, of an aiding and abetting claim.\textsuperscript{105} One uncontroverted element is the existence of an independent wrong by a principal.\textsuperscript{106} The second element is that the secondary defendant must give "substantial assistance" to the principal wrongdoer. This is not disputed in theory but is disputed in its application, particularly in cases of inaction by one owing a duty to perform acts which would prevent or disclose the fraud of another.\textsuperscript{107} Lying at the center of controversy is the third element, the requisite extent of the secondary defendant's knowledge of the nature and illegality of the principal's conduct.\textsuperscript{108} The knowledge requirement

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\footnotesize
F.2d 214 (9th Cir. 1942), \textit{rev'd}, 142 F.2d 744, 746 (1944) (insufficient evidence of aiding and abetting).
\end{flushright}


\textsuperscript{103.} 259 F. Supp. 673 (N.D. Ind. 1966), \textit{aff'd}, 417 F.2d 147 (7th Cir. 1969), \textit{cert. denied}, 397 U.S. 989 (1970). For a listing of the significant secondary liability cases prior to 1972, see Ruder, \textit{supra} note 17, at 625-26 n.124. For recent cases, see note 84 \textit{supra}.

\textsuperscript{104.} The arguments against implied aiding and abetting liability are exhaustively considered and rejected by the \textit{Brennan} court. 259 F. Supp. at 677-81.

\textsuperscript{105.} The most influential statement of the elements of aiding and abetting liability is found in \textit{RESTATEMENT OF TORTS} \S 876(b) (1934), which imposes liability for harm to a third party if the person "knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself, . . ." \textit{Id}. This formulation has been adopted in the Second, Third, Fifth, Sixth and Seventh Circuits. \textit{See} \textit{Rochez Bros., Inc. v. Rhoades}, 527 F.2d 880, 886 (3rd Cir. 1975); \textit{Woodward v. Metro Bank of Dallas}, 522 F.2d 84, 94-97 (5th Cir. 1975); \textit{SEC v. Coffey}, 493 F.2d 1304, 1315-18 (6th Cir. 1974), \textit{cert. denied}, 420 U.S. 908 (1975); \textit{Brennan v. Midwestern United Life Ins. Co.}, 417 F.2d 147, 154 (7th Cir. 1969), \textit{cert. denied}, 397 U.S. 989 (1970); \textit{H. L. Federman & Co. v. Greenberg}, 405 F. Supp. 1332, 1336 (S.D.N.Y. 1975).

\textsuperscript{106.} As Professor Ruder indicates:

\begin{quote}
Whether the liability of the secondary defendant is based upon conspiracy or aiding and abetting, an independent illegal act or venture must exist to which he can attach himself either by agreement or by action. If his own act is unlawful, he becomes the primary violator of the securities law. Courts that have imposed liability, administrative sanctions, or criminal penalties upon secondary defendants in securities law cases often do not emphasize the independent wrong requirement, because in most such cases the wrong is easily established.
\end{quote}

\textit{Ruder, supra} note 17, at 628.

\textsuperscript{107.} These cases will be considered in the discussion of duty. \textit{See} notes 141-47 \textit{infra} and accompanying text.

\textsuperscript{108.} \textit{See} discussion in \textit{Ruder, supra} note 17, at 630-38.
in aiding and abetting cases has long been a sub-theme in the general
debate concerning scienter under section 10(b). The issue has been
whether the state of mind requirement ultimately adopted for purposes
of primary liability should apply equally to secondary liability. It has
been argued that the knowledge requirement should be more rigidly
applied as the defendant's position becomes further removed from the
primary wrong. Much of the debate came in response to the incipient
trend, prior to Hochfelder, of approving negligence as a standard of
fraud under some circumstances. As Professor Ruder argued:

Although elimination of a scienter requirement in order to establish vio-
lation by the primary participant may be urged upon the grounds that
maximum protection of investors will be provided by requiring exercise
of care when engaging in activities that might injure others, different
considerations enter into eliminating scienter as an element of aiding and
abetting or conspiracy and substituting a duty of inquiry or a "should
have known" standard. In most cases, the alleged aider and abettor (or
conspirator) will merely be engaging in customary business activities.
. . . If each of these parties will be required to investigate the ultimate
activities of the party whom he is assisting, a burden may be imposed
upon business activities that is too great.

Given the Supreme Court's resolution of the scienter debate in favor
of a standard of culpability greater than simple negligence, it is clear
that secondary liability can require no less in an action for damages
against those whose conduct, taken alone, is neither tortious nor unlaw-
ful. This conclusion is buttressed by the fact that Hochfelder in-
volved solely aiding and abetting liability. One may also resort to proxy
solicitation liability cases decided under section 14(a) of the 1934 Act
for which a negligence standard has been applied for primary liability
with a more rigorous scienter standard invoked as to secondary defend-
ants.

109. See, e.g., White v. Abrams, 495 F.2d 724 (9th Cir. 1974); Myzel v. Fields, 386
110. Ruder, supra note 17, at 632-33.
a case involving accountants, observed:

 Actual knowledge, or a reckless disregard for the truth which is equivalent to actual
 knowledge, is a prerequisite to . . . civil liability . . . [under] Rule 10b-5 in this
 Circuit. Actual knowledge is also a prerequisite to liability for damages for aiding
 and abetting a violation of the securities laws; a negligent failure to inquire and
disclose is an insufficient basis on which to impose liability of aiding and abetting
the alleged misconduct. Any other rule would give rise to the anomaly of assessing
liability on peripheral defendants on a lesser standard of culpability than that re-
quired for the direct liability of a principal.
Id. at 805 (citations omitted).
The remaining question is whether, and under what circumstances, aiding and abetting will require a more demanding degree of culpability, such as knowledge that a third person's conduct is in fact illegal. The "flexible duty" analysis urged by the Seventh Circuit in *Hochfelder v. Ernst & Ernst*,118 the Ninth Circuit in *White v. Abrams*,114 and, arguably, the Second Circuit in *Lanza v. Drexel & Co.*,115 may as yet have a role to play in the resolution of the issue.116 As in the case of scienter generally, there may also be room for a differential standard for aiding and abetting liability in enforcement actions brought by the Commission.117 Finally, courts will increasingly be called upon to formulate standards of culpability for purposes of aiding and abetting liability under other sections of the securities laws such as section 12 of the 1933 Act.118

D. Concept of Duty

1. Advent of Duty Analysis

The modern trend toward liability of attorneys under the securities laws has called into question the traditional view of the dual responsibility of attorneys: the duties of competence and fidelity to the client and the duty to refrain from violations of law. Aiding and abetting liability has had the single greatest influence on the current debate because, as is the nature of secondary liability, the attorney's liability is assertedly derived from the conduct of others, usually the corporate client, its officers and directors, and does not, taken alone, violate the obligation to act within the bounds of the law. Where aiding and abetting liability is based on the failure to investigate and/or disclose the wrongful acts of the client, as was true in *Hochfelder*, it inevitably poses the most difficult of dilemmas: the duty to zealously protect the client's interests, as reinforced by the attorney-client privilege, versus the potential for personal liability to the investing public for guarding the client's secrets. Where aiding and abetting liability is imposed on an attorney for negligence, it poses a poorly disguised challenge to the traditional tenet of foreseeability: an attorney is liable for malpractice only to the client or to those third persons expressly intended to benefit from

114. 495 F.2d 724, 730 (9th Cir. 1974).
115. 479 F.2d 1277, 1306 (2d Cir. 1973), discussed in *White v. Abrams*, 495 F.2d 724, 732-33 (9th Cir. 1974).
116. See note 84 supra and accompanying text.
117. See notes 188-257 infra and accompanying text.
118. See notes 353-64 infra and accompanying text.
the attorney’s services. The resolution of competing duties to the client and to the public underlies the entire body of securities laws with respect to attorney liability, whether the attorney’s role is one of drafter of disclosure documents and opinion letters, or is one of adviser.

In departing from traditional views of liability of attorneys in the special field of securities laws, courts have found little guidance from the securities regulations which deal with the responsibilities of every profession involved in the registration and sale of securities except attorneys. Once again, Hochfelder is illustrative. The question before the court of appeals was whether the scope of the independent accountant’s duty of care in conducting a certified audit included the defrauded clients of First Securities as beneficiaries. The common law duty of care, most clearly analogous to the duty of care of an attorney, was held not to extend to the plaintiffs. In the view of the court of appeals, however, a statutory duty to plaintiffs did arise from section 17(a) of the 1934 Act and Commission rule 17a-5. No such expressed statutory basis of duty exists for attorneys.

2. Distinguishing Duty, Scope of Duty and Standard of Conduct

It is becoming increasingly evident that the trend toward individual liability of professionals as aiders and abettors is a judicial device for raising the level of accountability of such professionals to the investing public where their conduct facilitates the wrongful acts of others but


120. See, e.g., SEC v. Frank, 388 F.2d 486 (2d Cir. 1968). See text accompanying notes 150-51 infra.


123. See notes 11-17 supra and accompanying text.

124. See note 10 supra and accompanying text.

125. See notes 50-52 supra and accompanying text.

126. 503 F.2d at 1105.
is not otherwise proscribed by statute or common law. It appears, moreover, that duty analysis will become the primary vehicle for the development of secondary liability. If this is true, it will first be necessary for greater consideration to be given to the distinction and interrelationship of three aspects: duty, scope of duty and standard of conduct. Greater consideration must also be given to the application of these areas in the context of affirmative and passive conduct.\(^{127}\)

In the broadest sense of the term, duty involves a relationship between individuals which imposes upon one a legal obligation for the benefit of the other.\(^{128}\) When duty is applied to affirmative conduct, it arises from the creation of risk of injury or harm to others. It is the essence of the law of torts that one is bound to refrain from conduct which by its nature or the manner of its performance creates an unreasonable risk of harm to another person. In the famous words of Cardozo: "The risk reasonably to be perceived defines the duty to be obeyed, . . . ."\(^{129}\)

Inseparable from the consideration of liability for tortious breach of this duty is the scope of that liability. For negligent torts, scope of liability is usually evaluated as a question of proximate cause.\(^{130}\) Continuing the Cardozo analysis: "[R]isk imports relation; it is risk to another or to others within the range of apprehension."\(^{131}\) When negligence is alleged, the foreseeability of injury to the plaintiff defines the perimeters of liability for the defendant. When the alleged tort goes beyond negligence and involves the state of mind of the defendant, foreseeability is no longer a factor and the scope of liability increases.\(^{132}\) The state of mind of the defendant also relates to the third aspect of a duty analysis, namely, standard of conduct.

With this prelude, we may now consider attorney liability for negligence in the performance of professional duties. The traditional approach has been that the scope of liability for professional malpractice negligence is confined to the client and intended third party beneficiaries.\(^{133}\) In California, however, there has been some support


\(^{128}\) Id. at 324.


\(^{130}\) See generally Prosser, supra note 127, at 244-45.

\(^{131}\) 162 N.E. at 100.

\(^{132}\) See Ultramares Corp. v. Touche, 174 N.E. 441 (N.Y. 1931).

for expanded attorney liability to third persons. Developments under the antifraud provisions of the federal securities laws prior to Hochfelder suggested an imminent break in that foreseeability barrier.

As always, attorneys were watchful of the fate of accountants as prophetic of their own liability. The Cardozo dictum in Ultramares Corp. v. Touche, limiting an accountant's liability for negligence to intended third party beneficiaries, had come under growing criticism. Then, the Seventh Circuit's decision in Hochfelder, recognizing a statutory duty of care unencumbered by foreseeability limitations, presented a significant development in professional liability to the investing public as third party beneficiaries.

134. In Biakanja v. Irving, 49 Cal. 2d 647, 320 P.2d 16 (1958), the California Supreme Court delineated the policy considerations relevant to determining the existence of an attorney's duty to third persons: (1) the extent to which the transaction was intended to affect the plaintiff; (2) the foreseeability of harm to him; (3) the degree of certainty that the plaintiff suffered injury; (4) the closeness of the connection between the defendant's conduct and the injury suffered; (5) the moral blame attached to the defendant's conduct; and (6) the policy of preventing future harm. Id. at 650, 320 P.2d at 19.

Developments since Biakanja, however, have not conformed to the expectations of some observers that the case would open the way for greatly expanded negligence liability. Subsequent cases seem to hold that, in the absence of culpability greater than negligence, third party liability has been confined to a narrow class of clearly foreseeable and intended beneficiaries. Compare Heyer v. Flaig, 70 Cal. 2d 223, 449 P.2d 161, 74 Cal. Rptr. 225 (1969) (beneficiary of a will); Bucquet v. Livingston, 57 Cal. App. 3d 914, 129 Cal. Rptr. 514 (1976) (beneficiary of testamentary trust); Roberts v. Ball, Hunt, Hart, Brown & Baerwitz, 57 Cal. App. 3d 104, 128 Cal. Rptr. 901 (1976) (issuance of opinion letter to induce investment by third parties to invest in clients' enterprise); and Donald v. Garry, 19 Cal. App. 3d 769, 97 Cal. Rptr. 191 (1971) (attorney for collections agency owes duty to creditor), with Goodman v. Kennedy, 18 Cal. 3d 335, 556 P.2d 737, 134 Cal. Rptr. 375 (1976) (no duty of care to third party investor when advising client on consequences of proposed securities transaction); National Auto & Cas. Ins. Co. v. Atkins, 45 Cal. App. 3d 562, 119 Cal. Rptr. 618 (1975) (no duty to inform creditors of pending probate proceedings in deceased client's estate); Ventura Cty. Humane Soc'y, Inc. v. Holloway, 40 Cal. App. 3d 897, 115 Cal. Rptr. 464 (1974) (no duty to potential beneficiaries under ambiguous will when testator suggests ambiguity); Brian v. Christensen, 35 Cal. App. 3d 377, 110 Cal. Rptr. 688 (1973) (no duty to inform state agency of client's successful lawsuit where client fails to reimburse agency for Medi-Cal benefits).

Outside the field of securities laws, no case of reckless or wilful misconduct by attorneys, comparable to that suggested in Ultramares, has yet arisen. See note 132 supra and accompanying text.

135. 174 N.E. 441, 444 (N.Y. 1931).
137. 503 F.2d at 1105.
138. The SEC's position in the amicus curiae brief filed in the Hochfelder case was that liability for negligence could be predicated upon detrimental reliance of investors where such reliance was contemplated or reasonably foreseeable. 425 U.S. 185, 198 n.18.
The Supreme Court’s decision to circumscribe the availability of rule 10b-5 in third party actions against professionals for negligence could have rested on either of two grounds. Without addressing the scienter debate, the Court could have focused on the scope of liability of accountants, or professionals generally. It could have settled the question of whether the securities laws extended a duty of care in favor of relying investors. Or the Court’s ruling could have been confined solely to the scope of secondary liability of the professional. Instead, the Court chose to resolve the question of liability to third parties by requiring some sort of scienter, thereby excluding negligence as a basis for liability under rule 10b-5. In effect, this mooted the Ultramares debate for purposes of rule 10b-5 because all courts agree that affirmative tortious conduct actuated by recklessness or deceitful intent would be a basis for expanded professional liability.

In sum, the decision in Hochfelder precludes the development of the nascent flexible duty standard under rule 10b-5 by which the foreseeability barrier in negligence actions might have given way to a broadened duty of accountants and attorneys to the investing public.

Thus far we have spoken only of “duty” in the context of positive, tortious conduct and considered the impact of the Hochfelder requirement of conduct actuated by scienter in relation to the liability of attorneys and other professionals in the securities field to third party investors. It is this author’s view that the application of the duty concept to liability for failure to act requires a wholly discrete analysis in which Hochfelder will have only marginal importance.

Risk creation, the primary basis for duty with respect to affirmative misconduct, is seldom, if ever, regarded as a direct consequence of inaction. This is, in part, an explanation of the traditional view of the common law that one is not liable for failure to act, i.e., prevent harm to another, in the absence of a duty to act. Rights, not risks, are the primary basis for the duty to act for the benefit of others.

139. The Court’s concern over the potential scope of professional liability to thousands of public investors is clearly expressed in the Court’s opinion. Id. at 214 n.33.
140. See note 132 supra and accompanying text.
141. This distinction between misfeasance and nonfeasance has been explained: The reason for the distinction may be said to lie in the fact that by "misfeasance" the defendant has created a new risk of harm to the plaintiff, while by "nonfeasance" he has at least made his situation no worse, and has merely failed to benefit him by interfering in his affairs. PROSSER, supra note 127, at 339.
142. Id. at 338-39.
143. Dean Prosser observed: Liability for "misfeasance," then, may extend to any person to whom harm may reasonably be anticipated as a result of the defendant’s conduct, or perhaps even
is not enough, for instance, that an attorney has learned of past fraudulent conduct. Liability for aiding and abetting will follow only where a duty to disclose exists. It may only be asserted by those to whom the duty is owed. Unlike the duty analysis in the context of positive, tortious conduct, the scope of a duty to act for the benefit of another is defined solely by the nature of the duty itself. Neither objective foreseeability of harm nor state of mind will expand or restrict the perimeters of the duty to act. Instead, the existence of a duty and the class of beneficiaries will be determined by the status of the parties, the relationship between them and attendant circumstances.

That *Hochfelder* contributes little to the analysis of liability for omissions becomes clear if the factual circumstances of that case are changed by hypothesis. Suppose that the accountants had challenged Nay's mail rule, discovered the fraud, but failed to come forward publicly? Two inquiries would first have to be made: (1) Was the accounting firm bound to reveal fraud? (2) Were the defrauded investors beneficiaries of that obligation? Certainly, the answer is yes to both questions.144 Have the plaintiffs established a prima facie violation of rule 10b-5 merely by the failure to disclose or does the *Hochfelder* requirement of scienter, clearly applicable to affirmative misconduct, impose some further requirement of proof regarding the accountants' motive for silence? Stated otherwise, would there be any excuse whatsoever for the failure to disclose Nay's fraudulent scheme? Any defense would seem inapposite. This was the view adopted on similar facts in *Fischer v. Kletz*:145

The imposition of the duty [of disclosure] creates an objective standard against which to measure a defendant's actions and leaves no room for an analysis of the subjective considerations inherent in the area of intent. Thus, to base liability in part upon subjective standards of intent of the nondisclosing defendant would blur and weaken the objective basis of impact of nondisclosure upon the plaintiff. In the alternative, if this rationale be deemed unacceptable, it can be persuasively urged that in a nondisclosure case, intent can be sensibly imputed to a defendant who, knowing that plaintiff will rely upon his original representations, sits by silently when they turn out to be false.146

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146. 266 F. Supp. at 188.
Similarly, it is difficult to conceive of any justification for an attorney's failure to disclose a client's intent to perpetrate a future fraud against another person when the attorney could not dissuade the client. Scienter simply plays no meaningful role in limiting liability for breach of a duty to act. And, since the Supreme Court has not spoken directly on the issue of when attorneys or other professionals are subject to a legal duty to act, the question of liability for inaction under section 10(b) remains open.

3. Duties of Attorneys

It appears that affirmative conduct by an attorney, which is either deceptive or manipulative or which facilitates such conduct by others and which injures persons relying thereon, when actuated by intent or reckless disregard, will be actionable under rule 10b-5. The traditional view of attorney qua attorney immunity is no longer a viable defense. The two most significant functions of an attorney in the securities field, which come under the rule in Hochfelder, are to issue opinion letters and to draft disclosure documents. The standard of liability under rule 10b-5 is illustrated in two cases: SEC v. Frank and SEC v. National Student Marketing Corp.

Frank involved a Commission enforcement action against an attorney responsible for drafting an offering circular in connection with an intra-state offering which contained serious misrepresentations. The Second Circuit rejected as "unimpressive" the defense that the defendant attorney had acted purely in a ministerial capacity, and in no event exceeded his professional role:

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. . . . The SEC's position is that Frank had been furnished with information which even a non-expert would recognize as showing the falsity of many of the representations. . . . If this is so, the Commission would be entitled to prevail; a lawyer, no more than


148. 388 F.2d 486 (2d Cir. 1968).

others, can escape liability for fraud by closing his eyes to what he saw and could readily understand.\textsuperscript{150}

Left open was the question of

[w]hether the fraud sections of the securities laws go beyond this and require a lawyer passing on an offering circular to run down possible infirmities in his client's story of which he has been put on notice, and if so what efforts are required of him, [which] is a closer question on which it is important that the court be seized of the precise facts, including the extent . . . to which [the attorney's] role went beyond a lawyer's normal one . . . .\textsuperscript{151}

This latter question, considered below in the context of passive conduct,\textsuperscript{152} is partially answered by \textit{Hochfelder} for, even assuming the attorney's duty to investigate the accuracy of information to be incorporated in a disclosure document, the breach of that duty must at least involve recklessness in order to constitute a violation of section 10(b). What is clear is that an attorney will be liable for knowingly making false representations in a disclosure document drafted by him as corporate counsel based on information acquired through the client.

The recent decision by Judge Parker in the \textit{National Student Marketing} case considers the liability of counsel who knowingly issues a misleading opinion letter. Attorney Katz was found to have issued an opinion letter regarding the propriety of backdating a transaction in order to remove certain losses from the firm's annual statement and present a brighter financial picture.\textsuperscript{153} The court rejected the defense that the opinion was technically correct as a matter of law because this ignored the plain "commercial substance" of the transaction as a sham bound to mislead investors and shareholders:

[T]his Court rejects the proposition that a member of the bar can seek refuge behind a legal technicality, elevating form over substance, when he is a party to and fully familiar with the circumstances which indicate that an illusory transaction is being undertaken which could be utilized to mislead third parties.

....

[I]t can be inferred from the factual circumstances of this case that Katz either knew that NSMC planned to issue a false financial statement, or he ignored what should have been evident to him as a lawyer with some expertise in corporate mergers and acquisitions.\textsuperscript{154}

\textsuperscript{150} 388 F.2d at 489.

\textsuperscript{151} \textit{Id}.

\textsuperscript{152} See notes 177-85 \textit{infra} and accompanying text.


\textsuperscript{154} \textit{Id} at 648-49.
Thus, it is evident that traditional functions of legal counsel may be well within the scope of either primary or aiding and abetting liability. The scope of liability is no longer limited by the traditional foreseeability defense in a common law malpractice negligence action. On the other hand, use of section 10(b) as a basis for an action by these third parties necessitates proof of scienter and may well limit recovery on that basis.

As suggested above, in evaluating potential attorney liability for passive conduct, the Hochfelder requirement regarding the requisite standard of conduct is of questionable applicability. In that regard, an alternative duty analysis is essential and it is that aspect about which the most significant struggles will take place in the development of the responsibilities and liabilities of attorneys under the securities laws. Possession of material information or knowledge of the existence of a fraudulent scheme by others will not alone create liability for an attorney who fails to disclose the information to the persons affected, regardless of the motive for silence. There must first be a duty of disclosure created by a relationship between the attorney and the person or class of persons adversely affected. And, similarly, where nondisclosure is linked to an attorney's failure to discover the material information, there must be established a duty to investigate and disclose.

a. Duty of Disclosure

Under what circumstances will an attorney be liable for fraud under section 10(b) for failure to disclose material information known to him? In order to state such a claim, there must be a duty of disclosure owed to the injured party. What, then, of the duty element? While many of the questions remain imponderable, it is suggested that a useful point of departure is to focus on the nature of the information, distinguishing between after-acquired information, which renders prior statements for which the attorney is responsible false or misleading, and information concerning the misconduct of the corporate client, its officers and directors.


156. Cf. Wessel v. Buhler, 437 F.2d 279 (9th Cir. 1971) (accountant's duty of disclosure).

157. The scope of the duty of disclosure, assuming one is found to exist, seems clear. In the case of after-acquired information, the duty is owed to all persons to whom the attorney would have been liable had the original representation been known to be false.
Less subject to challenge would be the duty to disclose information which renders earlier statements of the attorney, whether in disclosure documents or an opinion letter, false or misleading. To postulate such a duty is merely to logically extend the rule in *Frank* and *National Student Marketing*.158 This view is suggested by two cases.

SEC v. Manor Nursing Centers, Inc.159 involved a failure to disclose events transpiring subsequent to the effective date of a registration statement which “materially alter[ed] the picture presented in the registration statement.”160 One of the principal defendants was Erzine, an attorney. While his role exceeded the traditional functions of an attorney in several respects,161 his responsibility as drafter of the registration statement appears to have sufficed to hold him liable for wilful nondisclosure.162

*Fischer v. Kletz*163 is a leading case on the liability of accountants for nondisclosure of subsequently discovered information which materially affects certified financial statements for which they were responsible. Plaintiffs alleged that Peat, Marwick, Mitchell & Company had audited and certified the financial statements for the 1963 annual report of Yale Express System, Inc.164 Later, in 1964, in the course of “special studies” being produced at the request of Yale for the benefit of internal accounting controls, Peat, Marwick, Mitchell & Company allegedly discovered important misstatements in the 1963 financials but failed to disclose the misconduct of others, i.e., those persons relying on the statement. With respect to the duty to disclose the misconduct of others, this duty would presumably run to the class of plaintiffs to whom the primary offender would himself be liable, a question of reliance and proximate cause.

158. This is precisely the theory adopted by the RESTATEMENT OF TORTS § 551(b) (1938), discussed in text at note 166 infra. See Small, supra note 10, at 1228.
159. 458 F.2d 1082 (2d Cir. 1972).
160. *Id.* at 1095.
161. Clearly a participant even under the traditional view, Erzine exercised blanket authority in the matter of securities transactions in connection with the Manor offering, *id.* at 1089 n.3, personally solicited offers to buy, *id.* at 1090, and effected the actual transactions, *id.* at 1091.
162. The court stated:

Erzine's claim that he acted in good faith likewise is belied by the evidence adduced at trial. As an experienced securities lawyer, he was well aware that failure to correct a misleading prospectus and retention of the proceeds even though the issue had not been fully subscribed constituted violations of the antifraud provisions of the securities laws. Indeed, Erzine's knowledge that the federal securities laws required public disclosure of developments . . . subsequent to the effective date . . . is indicated by his supplementing the Manor prospectus (with regard to the participation of an underwriter in the offering).

*Id.* at 1096-97 (footnotes omitted).
164. *Id.* at 182.
close these until 1965 when the special studies were released. The duty to disclose after-acquired information was defended on the basis of both the common law and the requirements of section 10(b). Relying on section 551 of the first Restatement of Torts, the district court held that a duty of disclosure exists under the common law tort of deceit. Commenting on the argument that deceitful intent is a requisite to liability for such nondisclosure, the district court found that "intent can be sensibly imputed to a defendant who, knowing that plaintiff will rely upon his original representations, sits by silently when they turn out to be false." Thus, in effect, knowledge that the prior statements were false both creates the duty and, coupled with inaction, defines the necessary culpability. As to liability under section 10(b), while the court professed some doubt on the viability of a claim of primary liability, it felt that a claim for aiding and abetting was stated.

While the attorney's duty to correct past misstatements later discovered to be false seems well founded, the issue of compelled disclosure of the misdeeds of other persons, usually the client, raises vastly more difficult questions which can only be resolved on a case-by-case basis. The traditional view, as expressed in the American Bar Association (ABA) Code of Professional Responsibility (CPR) is that an attorney's general ethical obligation is to preserve the confidences and secrets of his client and specifically to refrain from disclosing adverse information acquired through confidential communications protected by the attorney-client privilege. The ABA has urged that attorneys not be subject to civil liability for conduct consistent with the commands of the CPR. While the attorney-client privilege may no longer be an absolute guarantee of confidentiality, at least in corporate affairs where information is sought by the shareholders, it is quite

165. Id. at 183.
166. Id. at 185.
167. Id. at 188. The fact that Peat, Marwick, Mitchell & Company's nondisclosure was not motivated by personal gain was held immaterial. Id. at 187-88.
168. Id. at 188.
169. Id. at 189-94.
171. ABA CANONS OF PROFESSIONAL ETHICS No. 4.
173. See Garner v. Wolfinbarger, 430 F.2d 1093, 1100-04 (5th Cir. 1970), cert. denied, 401 U.S. 974 (1971) (attorney-client privilege between corporate counsel and offi-
another matter to hold attorneys liable for failing to volunteer such information where the client refuses to do so.\textsuperscript{174} The SEC's position in recent years has been that the unique role of attorneys in the field of securities law renders them accountable to the investing public, in the manner of independent accountants, and demands that counsel come forward with information of fraud.\textsuperscript{175} While the Court has yet to confront the issue, the \textit{National Student Marketing} litigation may offer the first opportunity.\textsuperscript{176}

\begin{itemize}
\item[b. Duty to Investigate]
\end{itemize}

Separate from the question of when knowledge compels disclosure is the issue of when an attorney is obligated to seek information by inquiry. Here it is necessary to distinguish first between the duty not to \textit{ignore} obvious indications that a statement is false or that others associated with the attorney are engaged in or have committed unlawful acts and the independent duty to \textit{investigate}. Second, with respect to the duty to investigate, there is a distinction to be drawn between the attorney's voluntary assumption of the duty and the imposition of the duty by law.

To the extent that disclosure is mandated by the possession of material information, the duty to investigate upon the notice of the

\begin{itemize}
\item[\textit{174}. It is Professor Shipman's view that \textit{Garner} will ultimately be extended to the duty of disclosure and other professional duties. \textit{See} Shipman, \textit{supra} note 10, at 257.
\item[\textit{175}. \textit{See} Lowenfels, \textit{supra} note 18, at 427.
\item[\textit{176}. The \textit{National Student Marketing} litigation as it affects the firm of White and Case has recently been settled by consent decree. Without admitting or denying the Commission's allegations, the law firm will remain under a court order to enforce certain control procedures for securities transactions. Attorney Epley consented to a six month suspension from practice before the SEC. \textit{Fed. Sec. L. Rep.} (CCH) No. 692, at 2 (May 5, 1977).
\end{itemize}

existence of such information is simply a corollary responsibility to the duty to disclose. An attorney cannot close his eyes to the obvious.\textsuperscript{177}

A more difficult task is to determine when an attorney must evaluate the accuracy and completeness of information provided by the client where there are \textit{no} discrepancies or other suspicious indicators or when an attorney must oversee the activities of the corporate client and its agents with respect to matters within his responsibility. Once again, the absence of case law requires an appreciable measure of speculation. Certainly, under the circumstances of a particular case, an attorney's opinion letter or a disclosure document drafted by him will reasonably suggest that the attorney has conducted an investigation or that his representations are otherwise based on personal knowledge. Members of the investing public should be permitted to rely on the attorney's professional judgment or representations. The failure to investigate would, under these circumstances, render false what would be tantamount to a representation of fact. At the same time, of course, a cautious attorney can clearly limit the extent of his undertaking to inquire into factual circumstances.\textsuperscript{178} Such is not the case should the duty to investigate be legally imposed upon the attorney by virtue of his professional role in a particular event.\textsuperscript{179}

The imposition of a duty to investigate in favor of the investing public could be imposed directly by express statutory authority or as a matter of public policy. The Seventh Circuit's opinion in \textit{Hochfelder} illustrates the imposition of an express statutory duty of inquiry upon the independent public accountant.\textsuperscript{180} No such comparable provision exists for attorneys.\textsuperscript{181} A duty to investigate might be implied under section 10(b) by virtue of the critical role of securities lawyers. Yet, a comparison of the Second Circuit's rulings regarding the "duty to convey" of an outside director in \textit{Lanza v. Drexel & Co.}\textsuperscript{182} and the responsibilities of an underwriter during the distribution of securities in \textit{Chris-Craft Industries, Inc. v. Piper Aircraft Corp.}\textsuperscript{183} suggests great difficulty


\textsuperscript{178.} See Small, \textit{supra} note 10, at 1209-13.

\textsuperscript{179.} ABA COMM. ON PROFESSIONAL ETHICS, OPINIONS, No. 335 (1973).

\textsuperscript{180.} See note 55 \textit{supra} and accompanying text.

\textsuperscript{181.} See discussion of attorney liability as an "expert" under section 11 at notes 365-83 \textit{infra} and accompanying text.

\textsuperscript{182.} 479 F.2d 1277 (2d Cir. 1973) (en banc).

in finding an implied representation of verification by securities counsel.\textsuperscript{184} An alternative means of imposing a duty to investigate indirectly would be to abandon scienter in favor of negligence as the measure of liability to third persons, at least under some circumstances.\textsuperscript{185} This avenue is foreclosed in private damage actions under Hochfelder.\textsuperscript{186} Whether such an avenue is available in SEC enforcement actions and private damage actions under the 1933 Act, however, remains an open question.

IV. SEC Enforcement Proceedings Under Section 10(b)

While the future impact of section 10(b) and rule 10b-5 on attorney liability for damages to purchasers or sellers of securities has measurably diminished with the decision in Hochfelder, the Supreme Court carefully declined to rule on the state of mind element in actions for equitable relief\textsuperscript{187} and, more specifically, SEC injunctive actions.\textsuperscript{188} In view of the rulings in several courts, most notably the Second Circuit, that negligence is a viable basis for granting injunctive relief under section 10(b),\textsuperscript{189} it is important to consider the implications of a lesser standard in actions for injunctive relief. The potential for attorney liability is enormous. While the pre-Hochfelder spectre of liability in damages to third persons for mere negligence was unnerving, it should be recalled that there has never been a reported instance of attorney liability in damages to an investor for negligent conduct in an attorney's purely professional role.\textsuperscript{190} Those cases giving rise to the greatest con-


\textsuperscript{187} In Vacca v. Intra Management Corp., 415 F. Supp. 248 (E.D. Pa. 1976) it was held that scienter is a necessary requirement in an equitable action for rescission under rule 10b-5. \textit{Id.} at 250.

\textsuperscript{188} The Court stated: "Since this case concerns an action for damages we also need not consider the question whether scienter is a necessary element in an action for injunctive relief under \textsection{} 10(b) and Rule 10b-5. \textit{Cf. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 . . . (1963).}" 425 U.S. at 193-94 n.12.

\textsuperscript{189} See SEC v. Spectrum, Ltd., 489 F.2d 535, 541 (2d Cir. 1973); SEC v. Dolnick, 501 F.2d 1279, 1284 (7th Cir. 1974).

\textsuperscript{190} Attorneys have been held liable to investors or shareholders in damages for actual fraud as principals in fraudulent schemes. \textit{See} cases cited note 18 \textit{supra}. Liability
troversy were brought by the Commission, not by private investors.\textsuperscript{191} Potential liabilities arising from an SEC enforcement action include irreparable damage to an attorney's professional reputation, absence of liability insurance coverage,\textsuperscript{192} and consequent financial exposure from the burden of a legal defense and a customary coattail of civil actions.\textsuperscript{193} But most devastating is the power of the Commission to automatically suspend an attorney and his firm from practicing before it.\textsuperscript{194}

\textit{A. SEC v. Spectrum, Ltd.: The View of the Second Circuit}

In the leading case on attorney liability for negligence under section 10(b) in SEC enforcement actions, \textit{SEC v. Spectrum, Ltd.},\textsuperscript{195} the Second Circuit held that an attorney who negligently prepares an erroneous opinion letter asserting the exempt status of a proposed issuance of securities, which letter is used in the effort to effect the transaction, could be held liable in an action for injunctive relief by the SEC where the transaction is ultimately shown to violate the registration requirements of the 1933 Act.\textsuperscript{196}

Analysis of attorney Schiffman's peripheral role in the illegal distribution of securities in \textit{Spectrum} is important to an assessment of the potential exposure of attorneys acting in good faith, strictly in their capacity as counsel. Schiffman was neither a participant in the scheme in the traditional sense nor an officer, director, stockholder or control

\textsuperscript{191} See cases cited note 19 supra. However, liability for negligent conduct in a purely professional role has been confined to SEC enforcement actions. See, e.g., \textit{SEC v. Management Dynamics, Inc.}, 515 F.2d 801 (2d Cir. 1975); \textit{SEC v. Spectrum, Ltd.}, 489 F.2d 535 (2d Cir. 1973).

\textsuperscript{192} See cases cited note 28 supra.

\textsuperscript{193} It is a universal aspect of lawyer professional liability insurance that indemnity coverage and the insurer's duty to defend are limited to claims for damages. See \textit{Knepper, supra} note 11, at 310-13. This would seem to clearly preclude coverage in Commission enforcement actions seeking injunctive relief. While the question has apparently not arisen in this specific context, cases involving other liability insurance policies suggest this conclusion. See \textit{Annot.}, 88 A.L.R.2d 1122 (1963).

\textsuperscript{194} The numerous civil actions which followed in the wake of the SEC's offensive are detailed in \textit{Knepper, supra} note 11, \S\ 11.05, at 66 nn.7-11 (Supp. 1976).

\textsuperscript{195} See discussion in notes 250-57 infra and accompanying text.

person with respect to the issuer. As outside counsel, Schiffman was requested to author an opinion letter stating that the securities were exempt from registration for two reasons: (1) pursuant to former rule 133, the exchange of shares between a surviving corporation to a merger and the shareholder of the disappearing corporation was not a "sale" for purposes of section 5, and (2) the subsequent distribution of Spectrum stock through strawmen representing a former control person would involve application of the section 4(1) exemption for private investors not involved in a public distribution of securities. Schiffman consented to prepare the opinion letter as requested, apparently without appreciable investigation into the background of the transaction. A few days after issuing the first letter, the attorney forwarded a second letter, this time instructing against the use of his first letter in the sale of the unregistered stock. The failure to either recall the first opinion letter or incorporate a restriction against its use in that first letter was itself a potential basis for negligence. Nonetheless, it appears that his letter was integral to the success of the distribution and, on this basis, Schiffman would be liable for having aided and abetted the illegal distribution of unregistered securities.

197. Spectrum's corporate counsel, Morton Berger, whose knowledge and involvement appear to have been greater than defendant Schiffman's, was not named as a defendant by the Commission. Berger issued a similar opinion, which formed the basis for the Schiffman opinion letter, but declined to identify the specific individuals whose stock was purportedly exempt and free trading. 489 F.2d at 538. One commentator has suggested that the district court's reluctance to proceed against Schiffman was in part explained by its evident belief that the SEC was after the wrong lawyer. See Freeman, Opinion Letters and Professionalism, 1973 DUKE L.J. 371, 404-05. Nevertheless, the Second Circuit declined to second-guess the Commission's decision to omit Berger. 489 F.2d at 538 n.7.

198. 489 F.2d at 537-39. SEC rule 133, 17 C.F.R. § 230.133 (1976), was rescinded effective January 1, 1973 and has been replaced by rule 145, 17 C.F.R. § 230.145 (1976), which no longer recognizes a registration exemption for securities issued in the course of a merger.

199. 489 F.2d at 537.

200. Id. at 538-39.

201. The court of appeals suggests that the proper course of action under circumstances which preclude thorough investigation is for "an attorney . . . [to] prevent the illicit use of his opinion letter by prohibiting its utilization in the sale of unregistered securities by a statement to that effect clearly appearing on the face of the letter." Id. at 542. Schiffman failed to take such measures:

Schiffman, himself, realized that his opinion letter of December 4 could be used in due course to sell unregistered securities and sought to prevent that use by his subsequent letter to Doyen of December 8. This belated effort was ineffectual, however, since the limitation expressed in the second letter could hardly affect the potency of the December 4 opinion letter which remained unrestricted on its face.

202. In terms of the procedural posture of the case, the SEC's appeal was from the
The application of a negligence standard in SEC enforcement proceedings against the principal participants in a securities fraud was well established in the Second Circuit prior to 1973. \(^{203}\) *Spectrum* is significant for having broadened the scope of that negligence standard in two respects: First, the decision expressly approved of negligence as a basis for liability under section 5 for violation of the registration requirements. \(^{204}\) Second, *Spectrum* represented the first instance of the rule's application to a secondary participant, one who aided and abetted a violation of the federal securities laws. \(^{205}\) It should be noted, however, that the SEC did allege that Schiffman's conduct rendered him directly liable as a primary participant in the illegal distribution scheme. The theory, which the court of appeals declined to consider, was that Schiffman's participation was sufficient to qualify him as a statutory underwriter. \(^{206}\)

The standard of conduct demanded of attorneys by the *Spectrum* court could be characterized as a duty to conduct a reasonable investigation, prior to the issuance of an opinion letter, which will foreseeably facilitate the public sale of unregistered securities. This is in contrast to a duty to inquire upon notice. \(^{207}\) In this regard, it is necessary to

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\(^{204}\) With regard to section 5 liability, the court said:  
Although we have enunciated the negligence test principally in cases involving the anti-fraud provisions of the securities laws, the registration requirement embodied in Section 5 is designed to perform the identical function of protecting investors "by promoting full disclosure of information thought necessary to informed investment decisions." Accordingly, we believe that, in a proceeding by the SEC seeking prophylactic relief, we would be undermining this salutary mechanism by an overly fine appraisal of conduct which contributes to its circumvention.  
489 F.2d at 542-43 (citations omitted).  

\(^{205}\) See Note, 87 Harv. L. Rev. 1860, 1863-64 (1974).  

\(^{206}\) The court refused to apply this theory of direct liability saying:  
The term "underwriter" has been broadly defined to include anyone who directly or indirectly participates in a distribution of securities from an "issuer" (Marder) to the public. . . . Because the record is unclear, we decline to decide whether the extent of Schiffman's alleged participation in the scheme would be sufficient to qualify him as an "underwriter."  
489 F.2d at 541 n.11 (citations omitted). The liability of an attorney as a "participant" under section 12 is considered at notes 284-364 infra and accompanying text.  

\(^{207}\) See Messer, supra note 185, at 454; Note, 87 Harv. L. Rev. 1860, 1868 (1974).  
See also SEC v. Frank, 388 F.2d 486, 489 (2d Cir. 1968), discussed in notes 150-52
consider the breadth of the *Spectrum* ruling. Is it limited to attorney opinion letters in the context of the public distribution of unregistered securities? Judge Kaufman, writing for the court in *Spectrum* cautions:

We could not conclude without emphasizing that the standard of culpability we find appropriate for the author of an opinion letter in an action for injunctive relief only should not be construed to apply to more peripheral participants in an illicit scheme or, for that matter, to criminal prosecutions or private suits for damages. Those questions are not before us.208

Much of the court's response to the argument that a negligence standard would impose too great a burden on the legal profession is framed in terms of the critical role of attorney opinions in securities transactions due to reliance by the investing public:

We do not believe . . . that imposition of a negligence standard with respect to the conduct of a secondary participant is overly strict, at least in the context of this case. The legal profession plays a unique and pivotal role in the effective implementation of the securities laws. Questions of compliance with the intricate provisions of these statutes are ever present and the smooth functioning of the securities markets will be seriously disturbed if the public cannot rely on the expertise proffered by an attorney when he renders an opinion on such matters.

. . .

In the distribution of unregistered securities, the preparation of an opinion letter is too essential and the reliance of the public too high to permit due diligence to be cast aside in the name of convenience. The public trust demands more of its legal advisers than "customary" activities which prove to be careless.209

In view of the Second Circuit's later decision in *SEC v. Management Dynamics, Inc.*,210 it is likely that the negligence rule will not be confined to formal opinion letters by attorneys.211 However, the Second Circuit has indicated that a predicate to secondary liability under the *Spectrum* rule is that it be foreseeable that an attorney's conduct will further the illicit activities of the principals.212 The events in the *Management Dynamics* case centered around the sale of shares by an inactive corporate issuer, Management Dynamics, Inc. (MD).

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*supra* and accompanying text. One might argue, however, that Schiffman was on notice under the circumstances involved.

208. 489 F.2d at 542.
209. Id. at 541-42.
210. 515 F.2d 801 (2d Cir. 1975).
211. Id. at 809-10.
212. Id. at 811.
MD was being used by a land developer and builder as a "shell." Levy, the defendant attorney, also occupied a position as director of MD. It was Levy's dual position which raises questions about the implications of the decision. As will be seen, the Second Circuit's opinion did not rest on the attorney-director status, but only on Levy's actions, which more closely resembled those of corporate counsel. Levy was alleged to have violated section 10(b) by his authorship or approval of a series of materially misleading letters and press releases describing the agreement between MD and the builder-developer and by successfully soliciting shareholder ratification. The court of appeals affirmed the district court's finding that Levy was "responsible" for the misleading statements based on his actions.213

No mention was made of Levy's status as counsel or director except with regard to culpability where his professional familiarity with securities laws is cited in contradiction to Levy's claim of inadvertent error.214 Levy was also found to have violated the registration provisions of the 1933 Act by facilitating the offer for sale of unregistered MD shares. This was allegedly accomplished by Levy's advising the MD Board of Directors that the unregistered securities could be sold without restrictive legend and by his subsequent delivery of the shares to a broker who unsuccessfully attempted to sell the stock.215 Once again, it was Levy's status as a securities attorney which justified a finding of a "high degree of carelessness,"216 and Spectrum is cited for the court's conclusion that "Levy's action thus enabled Watson [the broker] to offer the MD shares for sale to anyone, despite the fact that they had never been registered. His conduct was sufficient to justify issuance of the injunction against him."217 While at one point the court speaks of Levy's "authorizing" the delivery of the shares without restrictive legend,218 nothing further would justify distinguishing Management Dynamics

213. Id. at 804-05, 809.

214. The court found Levy's defense on this ground to be unfounded:
Levy's responsibility for these statements is clear, for he reviewed them and even suggested changes in language which Barrett adopted. Nor can he cloack himself in a professed ignorance regarding the real estate ventures, which he maintains led him to rely on the information supplied by Barrett. As an experienced securities lawyer, Levy surely should have known that contingencies cloud the horizon of almost every business venture, and he should have asked Barrett to tell him about potential obstacles to the planned developments. Moreover, and particularly because of his expertise, he should have insisted that these possible impediments be identified in any communication which described the projects.

Id. at 809.

215. Id. at 805, 810.

216. Id. at 810.

217. Id.

218. Id. at 805.
from *Spectrum* as a director-attorney case. Levy's activities as drafter and adviser could have been those of any corporate counsel. While the public reliance factor is arguably present in the case, there is a strong indication that the rule in *Spectrum* will not be confined either to opinion letters or to the illegal sale of unregistered securities.

*Management Dynamics* is also instructive on the scope of aiding and abetting liability where one has knowledge that one's conduct provides substantial assistance to the unlawful conduct of others. Nadino, a broker actively making a market in MD stock, without any knowledge of the merits of the company or the value of its stock, was relieved of liability for having provided substantial assistance to the attempted distribution of unregistered MD shares because, unlike the attorney in *Spectrum*, he neither knew nor could have surmised that an illegal distribution effort was underway nor that his trading activity would lend support to the scheme. Of course, this limitation may prove illusory as to attorneys, should they be held to a duty to investigate, as is suggested in *Spectrum* and *Management Dynamics*.

**B. SEC v. Coffey: A Dissenting View by the Sixth Circuit?**

The question of differential review of SEC enforcement actions had not been extensively considered among the circuits prior to *Hochfelder*. The Seventh Circuit sided with the negligence rule in *Spectrum*. What some have characterized as a dissenting view has emerged in the Sixth Circuit's decision in *SEC v. Coffey.*

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220. 515 F.2d at 811.

221. For a discussion of the duty to investigate as considered in *Spectrum*, see note 207 supra and accompanying text. The duty to investigate is also suggested in *Management Dynamics*. *See excerpt cited note 214 supra.*

222. *See SEC v. Dolnik*, 501 F.2d 1279, 1284 (7th Cir. 1974) (rejecting the view in *Coffey*).


Coffey involved an alleged fraud committed by agents for a company seeking loans from the State of Ohio. According to the Commission, Coffey, company vice president, was responsible both as a principal and as an aider and abettor of the scheme to fraudulently obtain the state financing.\(^\text{225}\) With respect to primary liability, the court recognized that "the standards of culpability may be lower in SEC injunctive suits than in private damage actions,"\(^\text{226}\) but held, nevertheless, that the Commission would have to prove that Coffey failed to disclose material information on the company's financial condition by "willful or reckless disregard for the truth."\(^\text{227}\) Addressing the question of secondary liability, the Sixth Circuit held that it would be necessary to prove that Coffey, and the company president, King, "knowingly" allied themselves and assisted the fraudulent activities of the company's agents:

Without meaning to set forth an inflexible definition of aiding and abetting, we find that a person may be held as an aider-abettor only if some other party has committed a securities law violation, if the accused party had general awareness that his role was part of an overall activity that is improper, and if the accused aider and abettor knowingly and substantially assisted the violation.\(^\text{228}\) This "flexible" standard permitted the court to reconcile its ruling with that of the Second Circuit in Spectrum by emphasizing the factual differences in the two cases.\(^\text{229}\) Of course, the factual distinctions do not adequately reconcile the clearly diverse legal standards applied by the two courts.\(^\text{230}\) Yet, such an attempt to bring the two cases in line with one another does not seem unworkable. Coffey's alleged secondary liability was premised on inaction, i.e., failure to call a halt to the conduct of the company's agents. It might therefore be said, in recogni-

\(^{225}\) Id. at 1308-09.
\(^{226}\) Id. at 1314 (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963), discussed at notes 239-48 infra and accompanying text).
\(^{227}\) 493 F.2d at 1314 (citing Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973)).
\(^{228}\) Id. at 1316.
\(^{229}\) The court distinguished Coffey and Spectrum as follows:

We view the Second Circuit's decision in [Spectrum] as correct on its facts. There a lawyer was aware that his misleading opinion letter could be used to sell unregistered securities and failed to take timely steps to prevent such use. We do not believe that this application of a negligence standard to that situation compels us to apply a negligence standard in the very different case we confront. Here there must be some showing that Appellants were aware of the [agent's] alleged misrepresentations. We note further that the attorney in Spectrum, Ltd. had committed three prior securities law violations, so that his argument of innocent knowledge was subject to doubt.

\(^{230}\) Id. at 1316 n.30.

tion of Coffey's peripheral involvement, that his duty to intervene did not arise absent actual knowledge or inquiry notice (recklessness). The attorney in Spectrum was fully aware of the contemplated distribution of unregistered securities which would follow from his affirmative conduct. Given the reliance factors so important to the rule in Spectrum, failure to exercise due diligence was held to trigger injunctive sanction. Whatever the merits of this suggested analysis, it has not yet been articulated in subsequent cases. The conclusion must be that Coffey offers a dissenting view to that in Spectrum.

C. Viability of the Differential Standard of Liability: A Question of Policy

The determination of whether the Commission's efforts to forestall violations of the federal securities laws by seeking injunctive relief require proof of the scienter standard recognized in civil damage actions by the Supreme Court in Hochfelder is inseparable from a consideration of the purpose and effect of injunctive relief. Of these two factors, effect is at the center of debate. No one disputes the importance of the SEC's enforcement role in the protection of the public. The real controversy concerns the view that injunctive relief is a "mild prophylactic."

While the negligence rule was first applied in SEC enforcement proceedings under rule 10b-5 in SEC v. Texas Gulf Sulphur Co., the theory itself finds deeper roots in the earlier opinion of the Supreme Court in SEC v. Capital Gains Research Bureau. The government

231. See Wessel v. Buhler, 437 F.2d 279 (9th Cir. 1971).
232. See discussion at note 209 supra and accompanying text.
233. Professor Ruder has offered a similar perspective focusing on the nature of the occupations held by the alleged wrongdoers in Coffey and Spectrum. See Ruder, Factors Determining the Degree of Culpability Necessary for Violation of the Federal Securities Law in Information Transmission Cases, 32 Wash. & Lee L. Rev. 571, 590 (1975).
234. See notes 208-12 supra and accompanying text.
235. See Mathews, supra note 28, at 106-10.
237. As the court in SEC v. Coffey observed:
Appellants argue that the District Court opinion tars them with the finding that they committed a fraud, thus jeopardizing their right to earn a livelihood. The SEC asserts . . . that injunctive relief is merely a "mild prophylactic," which requires "only that a defendant obey provisions of the law that he was already obliged to obey."
238. 401 F.2d 833, 854-55 (2d Cir. 1968).
sought an injunction under the Investment Advisers Act of 1940,240 which contains language similar to that found in section 10(b), to compel a registered investment adviser to disclose to its customers its practice of purchasing securities, recommending investments in those securities by its clients, and then selling out its own holdings at a profit on the strength of the market rise engendered by the clients’ purchases. In response to the defendant firm’s contention that an injunction for fraudulent practices would not lie in the absence of proof of fraudulent intent, the Supreme Court ruled:

Congress, in empowering the courts to enjoin any practice which operates “as a fraud or deceit” upon a client, did not intend to require proof of intent to injure and actual injury to the client. Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation “enacted for the purpose of avoiding frauds,” not technically and restrictively, but flexibly to effectuate its remedial purposes.241

It should be noted at the outset that the Capital Gains opinion does not purport to sanction a negligence standard. It only abandons the element of fraudulent intent. The Court’s paramount concern was with a course of conduct inevitably creating a conflict of interest and which, in view of the fiduciary relationship between investment adviser and client, compelled disclosure of the firm’s dubious practice without necessity of proving bad faith or some form of scienter. This can hardly be deemed a departure from even the common law,242 as the Court itself observed.243 For this reason, one observer has argued that the decision in Capital Gains merely recognizes the long-established doctrine of constructive fraud.244 Moreover, the Supreme Court’s oft-cited reference to injunctive relief as a “mild prophylactic” is expressly premised on the nature of the relief sought under the facts of that case.245

On the other hand, it must be said that the Supreme Court’s subsequent treatment of Capital Gains has been more expansive. In a series

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241. 375 U.S. at 195.
242. See generally Prosser, supra note 127, at 687-89.
243. 375 U.S. at 192-95.
245. The Capital Gains Court said of injunctive relief:
This is a suit for a preliminary injunction in which the relief sought is . . . [a] “mild prophylactic.” . . . requiring a fiduciary to disclose to his clients, not all his security holdings, but only his dealings in recommended securities just before and after the issuance of his recommendations.
375 U.S. at 192-93.
of high court decisions expanding the scope of section 10(b), Capital Gains has been continually cited for the broad proposition that the remedial purposes of the securities acts require flexible interpretation of their provisions. Significantly, the Commission’s expanding argument ultimately ran out of gas in Hochfelder where the Supreme Court would not accept Capital Gains as authority for ignoring the terms of section 10(b), although the Court offered an oblique and passing reference to the Commission’s “arsenal of flexible enforcement powers.”

There are persuasive reasons for a general principle that the elements of fraud should vary with the nature of the relief sought and the relationship between the litigants. To the extent that the injunction merely commands cessation of a questionable course of conduct, the consequences are not comparable to an award of damages, or even rescission. This is all the more true where the action is taken against a fiduciary acting in the role of a principal. Yet, even if the Supreme Court should ultimately approve of the general rule as announced in Texas Gulf Sulfur, this would not necessarily require application of the rule to secondary liability of attorneys to the investing public with whom there is no professional relationship. Any decision to limit the scope of the negligence rule in Commission enforcement actions could justifiably turn on the more serious consequences incurred by attorneys and other professionals as a result of being the subject of an injunction.

The right to practice before the Commission is indispensable to a member of the securities bar. Forfeiture of this right may be a collateral sanction in the wake of an unsuccessful defense to an enforcement action. The conditions for practicing before the Commission are embodied in rule 2 of the Commission Rules of Practice which pro-

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247. 425 U.S. at 200-01.
248. Id. at 195.
vides for suspension, disbarment or other sanctions251 when an attorney is found to be unqualified, guilty of unethical conduct, or to have willfully violated or willfully aided and abetted the violation of the securities laws.252 The SEC is further empowered to automatically disqualify an attorney from practice before it as a result of having been subject to a permanent injunction sought by the Commission in an enforcement proceeding for violation of the securities laws.253

Temporary suspension may be entered without a hearing. The attorney is then required to petition for lifting of the suspension. If he fails to do so within the brief period allotted, the suspension becomes permanent.254 This follows regardless of whether the injunction was entered by consent decree (with formal denial of the charges) or by litigation on the merits.255 The effect of the court order is to bar relitigating the adverse findings on the question of the attorney's unlawful conduct. The rule 2(e) hearing will be limited to factors offered in mitigation of the ultimate disciplinary sanctions by the Commission.256

The anomalous result is that a negligent lawyer may well suffer more serious penalties than a client who knowingly violated the securities laws.257 This unfair and unwarranted dilemma for attorneys should be resolved by abandonment of the rule in Spectrum, or, more practically, by amendment to the Commission Rules of Practice.258

251. There is a trend toward lesser sanctions in settlement cases, such as an attorney agreeing to be subject to peer review. See e.g., SEC v. Georgia Dynamics, [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,565 (D.D.C. 1976).
253. Id. § 201.2(e)(3).
254. Id. § 201.2(e)(3)(i).
255. Id. § 201.2(e)(3)(ii).
256. Id.
257. See Lipman, supra note 10, at 447 n.61; Mathews, supra note 28, at 106-10; Small, supra note 10, at 1198 n.35. By contrast, the Rules of Professional Conduct promulgated by the California State Bar Association subject an attorney to sanctions for incompetence only where "willful or habitual." CAL. STATE BAR ASSOC., RULES OF PROFESSIONAL CONDUCT No. 6-101.
258. Recently in SEC v. Geon Indus., Inc., 531 F.2d 39, 55 (2d Cir. 1976), the Second Circuit, in denying injunctive relief, acknowledged the serious collateral consequences which may be suffered by a broker-dealer firm as a result of successful Commission enforcement proceedings and balanced this against the firm's minimal culpability. A notable development has been the action brought by an accounting firm, Touche, Ross & Co., against the SEC challenging the authority of the Commission to discipline securities professionals pursuant to rule 2(e). See Touche, Ross & Co. v. SEC, [Current] Fed. Sec. L. Rep. (CCH) ¶ 95,742 (S.D.N.Y. 1976).
D. Impact of Hochfelder upon Subsequent SEC Enforcement Proceedings

The first reference to the survival of the Spectrum rule came in brief dictum by a district court in SEC v. Galaxy Foods. Less than two months later, in SEC v. Bausch & Lomb, Inc., the first successful challenge was directed to the continued viability of Spectrum after Hochfelder. The district court concluded that the rationale of the Supreme Court's decision, i.e., the language and legislative history of section 10(b), precludes a differential standard in favor of SEC enforcement actions which could be justified only on the very policy grounds which the Supreme Court had refused to consider. There is much force to this argument. Indeed, in its amicus curiae brief in Hochfelder, the SEC itself argued in favor of equivalent standards for private actions and Commission proceedings for injunctive relief, albeit in favor of a negligence standard. And, in a statement which may yet come back to haunt the two dissenting justices in Hochfelder, it was argued that rule 10b-5 standards should not depend upon the plaintiff's identity.

Nevertheless, it appears that the Second Circuit may be prepared to stand by its decision in Spectrum. In its most recent statement in SEC v. Universal Major Industries Corp., a three-judge panel refused to overrule the Spectrum line of cases as a consequence of Hochfelder. The court's statements appear as dictum preceding affirmance of the district court's finding of fraud. While noting the lack of unanimity among the circuits, the court did not offer a reasoned analysis for its position. This certainly will not be the last word in view of the SEC's pending appeal in Bausch & Lomb.

The Third Circuit appears to have sanctioned a negligence standard in enforcement actions for injunctive relief in SEC v. World Radio Mission, Inc. observing that "[i]f proposed conduct is objectively within the Congressional definition of injurious to the public, good faith, however much it may be a defense to a private suit for past actions..."
... should make no difference.”268 Also adopting a negligence standard was the district court for the Northern District of California in SEC v. Geotek.269 The basis for the ruling was that, inasmuch as the Supreme Court left the issue open, the court would follow the pre-
Hochfelder “majority” rule of the Second and Seventh Circuits recognizing negligence as a basis for injunctive relief.270 Finally, there was a similar expression by a New Jersey district court judge in SEC v. Trans Jersey Bancrop,271 which refused to permit certain defendants to assert a cross-claim for damages as to which a different standard, scienter, would apply.

V. ATTORNEY LIABILITY UNDER SECURITIES LAWS
NOT REQUIRING SCIENTER

A major consideration expressed by the Supreme Court in Hochfelder was the need to construe section 10(b) in the context of the entire body of federal securities regulations established in the 1933 and 1934 Acts.272 The court found persuasive support for the scienter requirement under section 10(b) by contrasting the language of that section with the carefully crafted language of the 1933 Act liability provisions, sections 11273 and 12,274 which expressly stipulate as to “whether recovery was to be premised on knowing or intentional conduct, negligence, or entirely innocent mistake.”275 While neither section 11276 nor section 12277 requires proof of scienter, both are subject to significant procedural restrictions278 and to limitations on the scope of their coverage, i.e., as to those classes of persons who may bring actions and

268. Id. at 90,661 (citation omitted).
270. Id. at 90,723-24.
272. 425 U.S. at 206-11.
275. 425 U.S. at 207.
276. Discussed at notes 370-72 infra and accompanying text.
277. Discussed at note 288 infra and accompanying text.
278. The Hochfelder Court outlined those restrictions:

Section 11(e) of the 1933 Act, for example, authorizes the court to require a plaintiff bringing a suit under §11, §12(2), or §15 thereof to post a bond for costs, including attorneys' fees and in specified circumstances to assess costs at the conclusion of the litigation. Section 13 specifies a statute of limitations of one year from the time the violation was or should have been discovered, in no event to exceed three years from the time of offer or sale, applicable to actions brought under §11, §12(2), or §15.
425 U.S. at 209-10.
those persons subject to liability thereunder. Section 10(b), by contrast, is not so circumscribed with respect to procedure or to the scope of its coverage. Therefore, to acquiesce in a negligence standard in section 10(b) actions would effectively nullify the liability provisions under the 1933 Act in cases of concurrent scope. The experience in those circuits which, prior to Hochfelder, opted for a negligence standard under section 10(b) suggests that the Court's apprehension was well founded.

The question which now arises is, under what circumstances will attorneys, particularly those fulfilling a purely professional role, be liable under alternative provisions of the two securities acts which do not currently compel proof of scienter?

A. Section 12 of the Securities Act of 1933

Section 12 of the 1933 Act is the most significant source of potential liability of attorneys in the sale of securities. Divided into two subsections, section 12(1) establishes liability for any person who offers or sells a security in violation of the registration requirements of section 5 of the 1933 Act and section 12(2) provides for liability for those who, in the process of offering or selling a security, make false or misleading statements (or omissions) in a prospectus or by oral communication. Common to both provisions is a privity requirement limiting liability to those who sell or attempt to sell securities. The effect

279. See discussion of the scope of liability under section 11 at note 366 infra and accompanying text and the discussion of liability under section 12 at notes 289-302 infra and accompanying text.

280. The Supreme Court noted, for example, that the appropriate state statute of limitations would control actions under section 10(b) and that these have generally been longer than the one year provision in section 13 of the 1933 Act. 425 U.S. at 210 n.29.

281. Section 10(b) proscribes certain forms of fraudulent misconduct by "any person" and requires only that the misconduct occur "in connection with the purchase or sale of any security." Thus, section 10(b) is not subject to a privity limitation. See Bromberg, supra note 94, § 8.5(511).

282. See Stewart v. Bennett, 359 F. Supp. 878 (D. Mass. 1973), where Judge Tauro discusses this problem which he characterizes as an "end run." The Court held that "a purchaser of securities in an allegedly fraudulent transaction may proceed under 10b-5 even though he might also have a section 11 remedy available to him." Id. at 886.

283. For Ninth Circuit examples, see Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961); Matheson v. Armbrust, 284 F.2d 670 (9th Cir. 1960), cert. denied, 365 U.S. 870 (1961).


285. Id. § 77e.

286. Excluded from this discussion is the section 15 provision governing the liability of control persons for the conduct of subordinates in violation of section 11 or 12. Id. § 77c. While section 15 expands the scope of liability under the 1933 Act generally, it has little importance to the liability of attorneys. See, e.g., SEC v. Fifth Ave. Coach Lines, Inc., 289 F. Supp. 3 (S.D.N.Y. 1968).
of this privity limitation on the liability of attorneys is considered below. What distinguishes these two subsections of section 12 beyond the substantive basis of liability is their standard of liability. The sale or offer to sell non-exempt and unregistered securities by the requisite jurisdictional means in violation of section 5 subjects the seller to strict liability under section 12(1). On the other hand, the antifraud prescription of section 12(2) is effective only as against those sellers who fail to sustain a defense of due diligence, thus establishing a negligence standard.

One inevitable effect of the Supreme Court's decision to impose a scienter standard in rule 10b-5 actions will be to create pressure to expand the scope of liability under the less onerous liability provisions of section 12. The potential for expansion lies in two areas: the "participants" doctrine and aiding and abetting liability.

1. "Participants" Doctrine

It has always been understood that the scope of section 12 liability ("any person who offers or sells a security") is not limited solely to those parties who are technically the sellers or offerors of the subject securities "in the mystical sense of passing 'title.'" Proceeding from the broad definition of the terms "sale" and "offer for sale" in section 2(3) of the 1933 Act, and the remedial purposes of section 12, it is generally acknowledged that the scope of section 12 liability includes those who "participate" in the solicitation and sale of securities. Those who have been held to be participants for purposes of section 12 liability include brokers, directors and officers of an issuer, pro-

287. See notes 303-52 infra and accompanying text.
290. Section 2(3) provides: "The term 'offer to sell', 'offer for sale', or 'offer' shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." 15 U.S.C. § 77b(3) (1970).
292. See In re Caesars Palace Sec. Litigation, 360 F. Supp. 366 (S.D.N.Y. 1973), in which the court said: "Brokers have repeatedly been included within the coverage of both parts of § 12, whether the broker represents both parties to the transaction or only the seller." Id. at 379. See also authorities cited id.; Loss, supra note 289, at 1713-14. But see Canizaro v. Kohlmeyer & Co., 370 F. Supp. 282, 287 (E.D. La. 1974), aff'd, 512 F.2d 484 (5th Cir. 1975) (buyer's broker held not to be a participant where merely effecting unsolicited transaction).
Two questions must be asked. First, what is the proper test for determining, in general, whether a person's conduct is sufficiently involved in the solicitation or sale of securities to become a participant? The leading case which best articulates the standard which appears to have governed the vast majority of decisions regarding the scope of the participant doctrine is *Hill York Corp. v. American International Franchises, Inc.* The task is to formulate a workable compromise "between the antiquated 'strict privity' concept and the overbroad 'participation' concept which would hold all those liable who participated in events leading up to the transaction." Seeking to quantify that degree of participation which might be characterized as "substantial," the Fifth Circuit, in *Hill York*, adopted the test first enunciated in an earlier case, *Lennerth v. Mendenhall:* "[T]he line of demarcation must be drawn in terms of cause and effect: To borrow a phrase from the law of negligence, did the injury to the plaintiff flow directly and proximately from the actions of this particular defendant?" The use of the phrase "directly and proximately" unfortunately obscures the traditional distinction in tort law between the competing tests of proximate causation: direct causation and foreseeability. Further confusion is engendered by the reference to "injury" instead of the subject transaction. Must the participant be directly connected to the events which rendered the transaction illegal? Interestingly, the Fifth Circuit's citation from the *Lennerth* decision omits an important passage:

> But for the presence of the defendant Roger in the negotiations preceding the sale, could the sale have been consummated? If the answer is in the negative, and we find that the transaction could never have

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295. See cases discussed at notes 303-52 infra and accompanying text.


297. 448 F.2d at 692.

298. This term is employed by the court in *Canizaro v. Kohlmeyer & Co.*, 370 F. Supp. 282, 288 (E.D. La. 1974), aff'd, 512 F.2d 484 (5th Cir. 1975).


300. 448 F.2d at 693.
materialized without the efforts of that defendant, we must find him guilty.\textsuperscript{301} 

It thus appears that the test for participation, at least as formulated in \textit{Lennerth}, may more closely resemble causation in fact than proximate causation with respect to the transaction. This is a broad test which, unless otherwise limited, promises to cast a wide net, inevitably involving attorneys, particularly where it is the advice, or opinion letter, or drafting by counsel that is a necessary link in the transactional chain of events. Whether misled by the omitted language from \textit{Lennerth} or by the judgment that \textit{Hill York} modified the test formulated in \textit{Lennerth}, subsequent courts have characterized the rule in \textit{Hill York} as a proximate cause test.\textsuperscript{302} This appears to be the better view.

The second question which must be addressed is under what circumstances will an attorney’s professional role rise to the level of “participation.” One of the earliest cases to consider attorney liability under section 12 was \textit{Nicewarner v. Bleavins},\textsuperscript{303} where the rule of “but for” causation was apparently accepted as the standard for participation. In that case, it was conceded that counsel’s role was necessary to the consummation of the unlawful sale.\textsuperscript{304} At the same time, however, the attorney’s conduct remained within the bounds of his profession.\textsuperscript{305} The attorney did not, in the judgment of the trial court, participate in the solicitation of plaintiff’s purchase because, contrary to plaintiff’s version of events, “it [was] . . . highly probable that [plaintiff] had agreed to make the investment before he ever reached [the attorney] and that the visit to the latter’s office was merely for the purpose of

\textsuperscript{301} 234 F. Supp. at 65 (emphasis added).


\textsuperscript{303} 244 F. Supp. 261 (D. Colo. 1965).

\textsuperscript{304} Consideration of the facets of the attorney’s role made it clear that Hudson’s involvement with this venture was more than casual. From the beginning, it was contemplated that his part in the development and promotion of the timer would be substantial, and it has been despite the fact that he received no portion of Lingenfelter’s royalty interest. At every turn in the testing of the timer, in the printing of promotional literature, in the negotiation for manufacture or distribution of the timer, in Colorado, in Canada, in Florida, Hudson was present; but always in the capacity of attorney for Lingenfelter. Hudson drafted the assignment from Lingenfelter to Bleavins. The assignment from Bleavins to Nicewarner, also a Hudson product, was adopted as the standard form and printed by Lingenfelter. Moreover, Hudson had discussed with Lingenfelter and Bleavins the tax advantages of assigning fractional interests. \textit{Id.} at 266.

\textsuperscript{305} The court concluded that “while it appears that the sale would not have been consummated without the services of some attorney, the evidence fails to establish that Hudson did more than serve as an attorney.” \textit{Id}. 
formalizing the transaction."\textsuperscript{306} The court thus excluded from consider-
ingation the attorney's pivotal involvement as counsel in the scheme pre-
ceeding the subject transaction and found that the evidence did not sup-
port the asserted involvement in the actual solicitation. The fact that 
counsel might have prevented the sale was held not sufficient for liabil-
ity under section 12.\textsuperscript{307}

There are two limitations on the scope of participation which would 
prove important to potential liability of attorneys. First, the degree of 
participation must be substantial, beyond that described as causation in 
fact.\textsuperscript{308} Second, as Nicewarner suggests, participation may be qualified 
by the nature of one's contributory efforts, \textit{i.e.}, solicitation. Because 
the extent of the first limitation is still in doubt,\textsuperscript{309} this discussion will 
focus on the nature of those activities which qualify as participation.\textsuperscript{310}

The Nicewarner court's bright line test, based on the distinction be-
tween the customary practice of law and solicitation, proves difficult in 
application. Certainly, there are cases where counsel actually sells for 
himself or for the account of others,\textsuperscript{311} or directly solicits the unlawful

\textsuperscript{306} Id.
\textsuperscript{307} Id.
\textsuperscript{308} See discussion in note 337 infra and accompanying text.
\textsuperscript{309} See notes 301-02 supra and accompanying text.
\textsuperscript{310} In considering the lawyer-participant cases, one further factor may be added 
to the equation. While the doctrine of participation is generally applied without distinc-
tion to both sections 12(1) and 12(2), see Hill York Corp. v. American Int'l Franchises, 
Inc., 448 F.2d 680, 692 (5th Cir. 1971), \textit{Hill York} has suggested a possibly narrower 
scope of participation under section 12(1). \textit{Id.} at 692. \textit{See generally Loss, supra} 
Fed. Sec. L. Rep. (CCH) \textsuperscript{[}91,034 (S.D.N.Y. 1961)). \textit{See also} Wilko v. Swan, 127 

This narrower application has support in one sense: Unlike section 12(1), there is 
no privity limitation under section 12(2) where the defendant's misstatement is actuated 
by scienter. \textit{Lanza} v. \textit{Drexel} \& \textit{Co.}, 479 F.2d 1277, 1298 (2d Cir. 1973). The avail-
ability of the section 4(1) exemption from liability for violations of section 5 for those 
not an underwriter or issuer does not, in the broad definition of "underwriter," appear 
to further limit the participation doctrine under section 12(1). "Underwriter" has been 
defined as

any person who has purchased from an issuer with a view to, or offers or sells for 
an issuer in connection with, the distribution of any security, \textit{or participates or has a direct or indirect participation in any such undertaking}, or participates or has 
a participation in the direct or indirect underwriting of any such undertaking.

While it might be said that this difference in the standards of culpability might justify 
a narrow interpretation under section 12(1), the lawyer-participant cases, which com-
monly involve that section, do not, with the possible exception of the \textit{Wonneman} case, 
support such a meaningful distinction. \textit{See} Wilko v. Swan, 127 F. Supp. 55 (S.D.N.Y. 

\textsuperscript{311} See, \textit{e.g.}, SEC v. A.G. Bellin Sec. Corp., 171 F. Supp. 233, 235-37 (S.D.N.Y. 
1959).
Counsel may also become a participant by virtue of occupying an executive position with the issuer. On the other hand, an attorney qua attorney defense succeeded in *Wonneman v. Stratford Securities Co.*, in which counsel performed legal work incident to reviving a dormant corporation with a view to obtaining a pre-1933 exemption, revamping the capital structure, and recommending two directors and a transfer agent. The attorney's closest contact with the actual distribution of unregistered securities was through oral advice concerning the purported exemption given to the controlling shareholder.

At this point, the line drawn in *Nicewarner* and *Wonneman* begins to blur. In *Katz v. Amos Treat & Co.* an attorney for a brokerage house and special counsel to the issuer was charged with violations of section 12. Counsel did not take the initiative in the offering. The shares of stock were neither transferred by or through the attorney nor did he benefit monetarily from the transaction. Nevertheless, the attorney was held to be a party to the solicitation because "the evidence clearly warranted the inference that . . . he had not simply answered [the purchaser's] questions, but had placed [the broker] in a position to tackle [the purchaser] for the money." Certainly, *Katz* maintains the focus on solicitation and, unlike *Nicewarner*, the attorney's assurances regarding the merits of the proposed offering appear to have

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312. See, e.g., SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1089 n.3, 1090-92, 1095-97 (2d Cir. 1972), discussed at notes 159-62 supra and accompanying text.


316. 411 F.2d 1046 (2d Cir. 1969).

317. Violations of both sections 12(1) and 12(2) were alleged in *Katz*. Judge Friendly's opinion gives no indication of a stricter standard for section 12(1) and, indeed, does not consider the section 4(1) exemption, i.e., whether Wofsey was a statutory underwriter.

318. 411 F.2d at 1053. The court cited *Nicewarner* by way of contrast. *Id.* The court also dismissed the action as to a director and officer of the issuer whose knowledge of the sale and signing of the stock certificate was held not to rise to the threshold of participation. *Id.*
been a significant factor. In this sense, Katz adheres to the rule suggested in Nicewarner and Wonneman. At the same time, it must be said that the indirect involvement in solicitation by the attorney in Katz represents a more expansive treatment of the participant theory.

This expanded view is amply supported by the Second Circuit's later decision in SEC v. Management Dynamics, Inc. This enforcement action followed in the wake of an unsuccessful offer to sell unregistered securities in violation of section 5 of the 1933 Act. The court of appeals upheld the district court's finding that Levy, attorney and director for the issuer, proposed the ill-fated offering, advised the board of directors of its legality and delivered the shares to the broker, thus enabling the latter to solicit offers to buy and subjecting the attorney to a preliminary injunction. Levy's conduct was consistent with his role as corporate counsel and seems one more step removed from solicitation. On the other hand, the degree of Levy's influence on the events was so decisive that any other result would have seemed anomalous.

In a similar vein is the Tenth Circuit's decision in Andrews v. Blue. Plaintiff sought rescission of his investment in a joint venture for the development of real estate. Subsequent to a merger with another corporate entity, the venture was incorporated. Contrary to representations by defendants and their attorney, Austin, plaintiff's...

319. Id. at 1052. To compare the circumstances in Nicewarner, see note 306 supra and accompanying text.

[O]ver the years, exceptions to [the section 12] strict privity requirement have developed and, in certain carefully defined instances, liability has been extended to more than the plaintiff's immediate seller [including] . . . those who have actively participated in the sale, either as an aider and abettor or as a co-conspirator. Id. at 287-88.
321. 515 F.2d 801 (2d Cir. 1975).
322. While the Commission's action was not brought under the civil liability provision of section 12, reserved for private litigants, there is no indication that directly proceeding under the requirements of section 5 should yield a different scope of liability, particularly in view of the section 4(1) exemption. See note 310 supra and accompanying text.
323. The fact of Levy's dual position does not seem to have influenced the outcome. See generally notes 213-19 supra and accompanying text.
324. The difficulty in assessing the implications of the Management Dynamics case is that the court does not directly confront the issue of participation.
325. 489 F.2d 367 (10th Cir. 1973).
326. Austin, the defendant attorney in Andrews v. Blue, was originally an investing participant in the joint venture. However, upon incorporation and prior to the merger, Austin was bought out. His activities thereafter were confined to his role as corporate...
investment was effectively diminished and frozen by issuance of restricted stock. In sustaining a section 12(1) claim, the court of appeals held that the issuance of unregistered stock in connection with the merger was not exempt as a private placement.\textsuperscript{327}

Attorney Austin's second line of defense was section 4(1), exempting persons not issuers or underwriters from section 5 registration requirements. This argument was rejected by the Tenth Circuit which upheld the lower court's finding that the attorney had participated in his clients' acquisition of merger shares with a view to redistribution.\textsuperscript{328} The precise nature of Austin's conduct is not spelled out but it is clear that his actions were strictly in the scope of his role as attorney.\textsuperscript{329} It is thus apparent that attorneys can no longer rely on the talismanic immunity of their professional role in the illegal sale of unregistered securities by a client.

The most significant recent decision came in \textit{Wassel v. Eglowsky},\textsuperscript{330} a section 12(1) action for damages arising out of the unregistered redistribution of securities by a control person and his agents.\textsuperscript{331} These defendants, as third party plaintiffs, sought indemnification\textsuperscript{332} and contribution against Goldman, their attorney, who curiously was not named in the main action.\textsuperscript{333} Since the basis for the contribution claims required a finding that the attorney was a joint tortfeasor,\textsuperscript{334} the court's counsel. \textit{Id.} at 371. His earlier involvement as a principal does not appear to have affected the question of law.

\textsuperscript{327} \textit{Id.} at 374.

\textsuperscript{328} \textit{Id.}

\textsuperscript{329} There is evidence that Austin corresponded on behalf of his clients, the other defendants, both with plaintiff and with the second corporation in the merger, each time regarding the extent of plaintiff's rights and interests. \textit{Id.} at 371-72. This is the extent of the court's recital of Austin's conduct.

\textsuperscript{330} 399 F. Supp. 1330 (D. Md. 1975).

\textsuperscript{331} Defendants' sole defense was the section 4(1) exemption which failed because a control person is treated as an issuer under section 2(11) for purposes of determining the availability of the section 4(1) exemption. \textit{Id.} at 1361-62. The other defendants actively participated in the solicitation and sale of the subject securities. \textit{Id.} at 1362.

\textsuperscript{332} The claim for indemnification against Goldman failed because he was no more culpable than defendants themselves. \textit{Id.} at 1366.

\textsuperscript{333} It appears that plaintiff, a non-lawyer, originally brought the action \textit{pro se}. \textit{Id.} at 1356. The complaint suffered from several drafting deficiencies, judging from the amendments filed by plaintiff's first attorney, retained shortly after the commencement of the litigation. The section 12(1) claim did not appear until a subsequent amended complaint was filed by a second attorney hired to replace the first. \textit{Id.} at 1357. Presumably, the one-year statute of limitations under section 13 of the 1933 Act barred any action against Goldman by this time. \textit{Id.} at 1370 n.75. The fact that Wassel was apparently not aware, initially, of Goldman's role suggests the distance between Goldman and the events culminating in the eventual subject transaction.

\textsuperscript{334} \textit{Id.} at 1367.
analysis proceeds as if the attorney were named as a defendant. The evidence was conclusive that Goldman's role in the redistribution scheme ceased entirely prior to the solicitation and negotiation phase preceding the subject transaction with Wassel, the plaintiff. The court's ultimate finding that Goldman was a participant in the sale therefore eschewed, by implication, the solicitation requirement suggested in Nicewarner.

Nonetheless, it was held that Goldman was a "key person" whose extensive involvement in laying the legal groundwork for the redistribution scheme rendered his actions the "proximate cause" of the trans-

335. Id. at 1346. With respect to the rule 10b-5 claim for failure to reveal material information to Wassel during negotiations, defendants Eglowsky and Stillerman conceded that Goldman neither caused nor participated in their fraudulent nondisclosure. Id. at 1365 n.65.

336. See discussion at notes 303-07 supra and accompanying text.

337. 399 F. Supp. at 1369. The court thus adopted the Hill York view requiring more than simple "but for" causation. Id. at 1361. See notes 296-302 supra and accompanying text for a discussion of Hill York.

The district court had earlier concluded that Goldman's role was a necessary or "but for" element in the chain of events. 399 F. Supp. at 1369. This conclusion was held to warrant establishment of personal jurisdiction and the propriety of venue in Maryland under section 22(a) of the 1933 Act, 15 U.S.C. § 77v(a) (1970), despite Goldman's never having entered the state nor even having contacted persons within that jurisdiction. In this connection, it should be pointed out that the numerous cases under section 22(a) purporting to find attorneys to be "participants" in a sale taking place within the forum jurisdiction for purposes of venue and jurisdiction are inapposite authority in the context of section 12 liability. See, e.g., Keene Corp. v. Weber, 394 F. Supp. 787, 790 (S.D.N.Y. 1975); Sohns v. Dahl, 392 F. Supp. 1208, 1213-16 (W.D. Va. 1975); SEC v. National Student Mktg. Corp., 360 F. Supp. 284, 291-94 (D.D.C. 1973); Black & Co. v. Nova-Tech, Inc., 333 F. Supp. 468, 472-73 (D. Ore. 1971); Leasco Data Processing Equip. Corp. v. Maxwell, 319 F. Supp. 1256 (S.D.N.Y. 1970).

The venue cases arise at the threshold of the proceedings and are resolved on the basis of the broad allegations in the complaints. Courts have almost uniformly rejected objections to venue, requiring only an allegation of common scheme, occurrence of a material act in furtherance of the scheme within the forum, and a general allegation of the defendant attorney's "participation". See, e.g., Sohns v. Dahl, 392 F. Supp. 1208, 1214-15 (W.D. Va. 1975). Keene Corp. v. Weber is the only case discovered which did not sustain the venue allegations. Whether attributable to the fact that the case had proceeded through the deposition phase of discovery, the court appears to have decided the question on the basis of the merits of liability. 394 F. Supp. at 790. The court's opinion is of interest for its denunciation of plaintiff's gossamer and contrived allegations of "participation" by [the attorney which the court found] . . . indicative of an unfortunate tendency, which has become all too prevalent, to proceed on speculative assumptions in the absence of a sound factual foundation, against professional men as aiders and abettors, for the supposed in terrorem effect thereof due to the potentially coercive impact of such a suit on their professional status and reputation. Id. at 789. The "knowing participation" venue standard in Keene was recently criticized as aberrant authority in Klepper Krop, Inc. v. Handford, 411 F. Supp. 276, 280 (D. Neb. 1976).
action and therefore exposed him to liability as a participant to the sale. The district court made the following findings with respect to Goldman’s specific involvement: (1) as counsel to the issuer and a protagonist in a series of events involving the issuance of stock in order to secure desperately needed financing followed by a takeover of control by outsiders, Goldman knew of the intention of the main defendants, as controlling persons, to publicly redistribute their restricted holdings; (2) in order to facilitate the envisioned transactions, Goldman agreed to issue an opinion letter to the transfer agent advising that the securities were free-trading and instructing the removal of the restrictive legend then appearing on the stock certificates; and (3) fully aware that those acquiring the shares during the initial transfer of the securities for later redistribution were relying on his professional assurance of the free-trading status of the stock, the attorney rendered the opinion and authorized removal of the restrictive legend. On this basis, the court concluded: “Goldman did much more than simply serve as an attorney for [the issuer] herein. Compare Black & Company v. Nova-Tech, Inc., . . . with Nicewarner v. Bleavins. . . . Goldman was one of the key persons in bringing about and making possible the sale . . . .”

The court in Wassel v. Eglowsky would at first glance appear to have followed the Nicewarner view that an attorney qua attorney will not be liable as a participant in a transaction in violation of section 12. This author suggests, however, that the court’s detailed recital of Goldman’s actions does not comport with the conclusion that Goldman exceeded his professional role. That his involvement in the scheme is pervasive does not bely a contrary view. Goldman was neither an executive of the corporation nor a controlling stockholder. His only apparent financ-

339. 399 F. Supp. at 1336-37.
340. Id. at 1337-39. Goldman acted as authorized representative of two individuals then in control of the corporation in negotiations which led to a transfer of control to an outside group which had acquired a considerable number of shares. Id.
341. Id. at 1369.
342. Id. at 1338, 1346, 1369.
343. Id. at 1344-45, 1369.
344. Id. at 1345-46, 1369.
345. Id. at 1369. The citation to Black & Co. v. Nova-Tech, Inc. appears to be implied recognition of the distinction between participation for venue/jurisdictional purposes and ultimate liability under section 12(1). See note 337 supra.
346. 399 F. Supp. at 1369.
cial interest was in his legal fees. All ministerial acts were at the direction of the main defendants and none would seem to depart from the rubric of legal representation by corporate counsel. The court does suggest that Goldman, together with two control persons, “planned and controlled” the corporation's destiny. Yet, there is no evidence that Goldman’s influence derived from other than his role as legal adviser, whose views were well received. It is difficult to square the court’s conclusion with the fact that shortly after Goldman’s issuance of the opinion letter he was summarily dismissed as corporate counsel without notice. Furthermore, as pointed out above, Goldman was out of the picture before the negotiations which eventually led to the transaction with Wassel.

The case therefore illustrates the trend toward attorney liability as a “seller” under section 12 where he is substantially involved in the events culminating in an illegal transaction and is aware that his activities are integral to the scheme. The fact that counsel acts solely in his professional capacity and is insulated from the solicitation effort will not be determinative because, as the court in Wassel observed, “[one’s] conduct as a member of the bar may in an important sense pose more danger to our societal needs than the conduct of [the principals].”

2. Aiding and Abetting

Along with the trend toward expanding the participant doctrine under section 12 to include attorneys acting within their professional role as “key persons” in a distribution scheme, there appears to be movement along a second front. Recent cases suggest that secondary liability may arise from aiding and abetting participants in an unlawful or fraudulent securities transaction.

The significance of this trend for the potential liability of attorneys

347. Goldman's fee was fixed by agreement not to exceed $15,000. Id. at 1338.
348. To conclude otherwise would be to ignore the broad spectrum of activities which are acknowledged to come within the charge of attorneys who represent public corporations. See generally Knepper, supra note 11, at 285-87.
349. 399 F. Supp. at 1346.
350. Goldman gained his position by virtue of his acquaintance with Steckerl, president of the corporation. Steckerl was ultimately unseated by the rival group. Id. at 1337-39.
351. Id. at 1341.
352. Id. at 1366.
is seen in *SEC v. Spectrum, Ltd.* Schiffman, the attorney in *Spectrum*, authored an opinion letter on the assertedly exempt status of the proposed distribution of securities issued pursuant to a merger. Schiffman’s involvement, when compared to Goldman’s in *Wessel v. Eglowsky*, was minimal, although his opinion letter was equally critical to the scheme and his knowledge of the significant events was considerable. The Commission alleged both theories: participation as a statutory underwriter and aiding and abetting the illegal distribution of Spectrum stock. To have held Schiffman to be a direct participant would have been the farthest reaching decision among the lawyer-as-participant cases discussed above. Not only was Schiffman’s conduct strictly within the bounds of his legal practice, his position as outside legal consultant was quite remote. Unlike Goldman in *Wessel v. Eglowsky*, Schiffman did not participate in the preparation of the overall redistribution plan. Thus, the Second Circuit declined to reach the issue of Schiffman’s primary liability as participant. Instead, it was held that Schiffman’s issuance of an erroneous opinion letter with knowledge that it could be used to facilitate the distribution of the subject securities by providing needed assurance to prospective purchasers that the offering was exempt from registration constituted aiding and abetting in violation of section 5. Arguably, a finding of aiding and abetting liability in enforcement actions directly under section 5 should not necessarily be determinative in a civil liability context. Yet, the growing acceptance of the doctrine of secondary liability in disputes between private litigants suggests a contrary view might prevail.

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Where the standard of culpability is negligence with respect to the attorney's opinion and knowledge of the plan for distribution of unregistered securities and the probability that the opinion will facilitate that effort, the effect of secondary liability may be tantamount to an abandonment of the seller requirement of section 12. While this is not to ignore the shift in the burden of proof to the purchaser who alleges secondary liability in lieu of participation under section 12(2), or the requirement of culpability (negligence) in contrast to liability without fault under section 12(1), it does suggest an expanded scope of liability beyond that intended by the drafters of the 1933 Act. The theory of secondary liability under section 12 is recent in origin and the elements of aiding and abetting have not yet been spelled out, but the decision in Spectrum does not bode well for the position of attorneys as counselors in the sale of securities.

B. Section 11 of the Securities Act of 1933

1. Scope of Liability Under Section 11

Section 11 of the 1933 Act also involves a measure of coordinate...
liability with respect to the broad antifraud proscription in rule 10b-5. Section 11 creates a private right of action for damages for purchasers when a registration statement includes untrue statements of material facts or fails to state material facts necessary to preserve the accuracy of statements which do appear in the document. Within the carefully limited scope of section 11, Congress expressly identified the potential defendant classes and provided for differential standards of culpability as to each class.

With a view to potential liability of attorneys under section 11, two factors are important. First, the scope of potential defendant classes does not expressly include attorneys. Liability is limited to the issuer, signatories to the registration statement, corporate directors (or partners), underwriters and "experts." Most certainly, attorneys will be exposed to liability when they act in a dual capacity, such as corporate director. Moreover, as suggested by the experience of the attorney-directors in the two leading cases, Escott v. BarChris Construction Corp. and Feit v. Leasco Data Processing Equipment Corp., the standard of liability—failure of due diligence—will be flexibly applied according to the defendant's degree of involvement, his expertise, and his access to information and data which, in practical effect, will impose greater demands on the attorney-director by virtue of his special expertise in matters of securities law. The only potential exposure for attorneys' fulfilling their professional role lies in the category of experts named in the registration statement as having prepared or certified portions of the necessary documentation. This will be considered below.

The second factor involves the standard of liability. In contrast to the scienter standard of culpability now held to govern actions under section 10(b) of the 1934 Act, negligence is the measure of liability under section 11. As with section 12(2), the burden lies with

365. See notes 272-83 supra and accompanying text.
368. 332 F. Supp. 544 (E.D.N.Y. 1971)
371. See text accompanying note 288 supra.
the defendant to establish his due diligence. This is a significant concession to those aggrieved purchasers who can state a claim within the limited perimeters of section 11. Therefore, it may be expected that pressure will be exerted upon the meaning of expert liability for misstatements in registration statements.

2. Attorneys as Experts

It should be said at the outset that the significance of the potential liability of an attorney as an expert lies not only in avoidance of the more rigorous burden of proving scienter under section 10(b). That liability may also be an alternative ground where the “seller” requirement proves a fatal obstacle to a successful claim under section 12(2) which is an overlapping liability provision for misstatements in the registration statement.

Section 11(a) (4) provides for liability in negligence for every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him . . . .

It is clear from the statute that liability may only be imposed with respect to those portions attributable to the expert where he fails to demonstrate that he exercised due diligence in the investigation upon which his judgment is based and that he reasonably believed the truthfulness of his statements as of the effective date of the registration statement. It is also a condition to liability as an expert that such person consent to being named in the registration statement as having prepared or certified the pertinent portion.

372. See note 278 supra and accompanying text.

373. Section 12(2) of the 1933 Act, 15 U.S.C. § 77l(2) (1970) is considerably broader in scope than section 11 in that it (1) imposes liability for oral misstatements made in the sale of the subject security, (2) is not limited to defects present on the effective date, see SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972), and (3) is not limited to registered securities.


Most commentators agree that an attorney can acquire the status of an expert provided the statutory conditions are met, although there are no reported instances of such liability. On the other hand, it is clear that an attorney who drafts the registration statement does not thereby render himself accountable as having expertised the entire document, unless, of course, in addition he occupies a dual role as director. Attorney-expert liability would most conceivably lie in the preparation of formal opinion letters appearing as exhibits in the registration statement.

To the extent that formal opinions of counsel come within the scope of section 11, the due diligence standard appears comparable to the


378. See, e.g., Folk, supra note 369, at 58; Lipman, supra note 10, at 463; Shipman, supra note 10, at 236-37, 264; Small, supra note 10, at 1192-94; Wheat, Professional Responsibility—The Corporate Bar, INST. OF SEC. REG. 213, 217 (1973).

379. There is some question whether counsel can provide qualified consent to the incorporation of their legal opinions in the registration statement without becoming experts. It is a common practice for counsel to provide such consent with the additional qualification that in so doing the attorney does not admit to being an expert under section 11. See C. Israels & G. Duff, Jr., When Corporations Go Public 250-51 (1962).

380. The contrary argument was advanced in BarChris. The district court rejected it, saying:

The defendants do not agree among themselves as to who the "experts" were or as to the parts of the registration statement which were expertised. Some defendants say that Peat, Marwick was the expert, others say that BarChris's attorneys . . . and the underwriters' attorneys . . . were also the experts. On the first view, only those portions of the registration statement purporting to be made on Peat, Marwick's authority were expertised portions. On the other view, everything in the registration statement was within this category, because the two law firms were responsible for the entire document.

The first view is the correct one. To say that the entire registration statement is expertised because some lawyer prepared it would be an unreasonable construction of the statute. Neither the lawyer for the company nor the lawyer for the underwriters is an expert within the meaning of Section 11.


381. This would primarily involve an attorney opinion on legality of the proposed issue as required by the Securities Act of 1933 § 7, 15 U.S.C. § 77g (1970) and Schedule A, ¶ 29, 15 U.S.C. § 77aa(29) (1970). For various forms prescribed by the SEC for the registration of securities which require such opinion of counsel, see, e.g., Form S-1, 2 Fed. Sec. L. REP. (CCH) ¶ 7128 (1976); Form S-2, id. ¶ 7147; Form S-3, id. ¶ 7157; Form S-4, id. ¶ 7167; Form S-5, id. ¶ 7177; Form S-6, id. ¶ 7187; Form S-7, id. ¶ 7196; Form S-8, id. ¶ 7202; Form S-10, id. ¶ 7222; Form S-11, id. ¶ 7239; Form S-12, id. ¶ 7256; Form S-13, id. ¶ 7265; Form S-14, id. ¶ 7276; Form S-16, id. ¶ 7295.

It is also common for corporate counsel to be requested, by the underwriter or others, to author a legal opinion on other aspects of the proposed offering, such as tax consequences, the status of the issuer's title to material properties, or certain contingent liabilities including pending litigation. Where properly incorporated in the registration statement, such opinions would probably qualify counsel as an expert under section 11.
duty of care imposed by the common law on attorneys with respect to services performed on behalf of the client. There are, however, two important differences where section 11 imposes a greater burden on corporate counsel. First, due diligence is an affirmative defense to be asserted by the defendant attorney in order to avoid liability for an erroneous expert statement.\textsuperscript{382} The purchaser of the security need only go forward in establishing his standing and the requisite misstatement. Second, the scope of liability is widened to include all persons purchasing securities covered by the defective registration statement despite the absence of a foreseeable relationship.

VI. CONCLUSION

Unquestionably, the impact of section 10(b) and rule 10b-5, the most influential and potentially flexible instruments for the development of standards of liability for attorneys under the securities laws, will be substantially reduced by the Supreme Court's decision in \textit{Hochfelder} barring private damage actions based on negligence.\textsuperscript{383} Nevertheless, vast areas of uncertainty remain, including the role of duty analysis for secondary liability, the requisite standard of liability in SEC enforcement actions, and the scope of attorney liability under the Securities Act of 1933.

While the trend moves steadily toward increased exposure of securities lawyers in their professional role, the greatest cause for concern is the sheer uncertainty. Certainly, the legal profession is capable of adjusting its standard of conduct to clear rules of liability. The immediate need is for concerted involvement of the Court, the Commission and the Congress in resolving these questions.

\textsuperscript{382} See Small, \textit{supra} note 10, at 1194-95.
\textsuperscript{383} \textit{Id.}