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Securities -- Attorney's Opinion Letter in an Unregistered Sale -- Standard of Culpability in SEC Injunction Action -- SEC v. Spectrum, Ltd.

Randolph H. Elkins

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In conclusion, it is submitted that the court in *Manor Drug* should have followed its analytically more precise decision in *Mount Clemens* and concluded that the non-purchasing plaintiffs had no standing to sue.

LARRY E. BERGMANN

Securities—Attorney's Opinion Letter in an Unregistered Sale —Standard of Culpability in SEC Injunction Action—*SEC v. Spectrum, Ltd.* [1]—In an action by the Securities and Exchange Commission (SEC) to enjoin twelve defendants from further alleged violations of the federal securities laws in connection with the illegal sale of unregistered securities,[2] the United States Court of Appeals for the Second Circuit reversed the district court's denial of an injunction[3] in the case of defendant-appellee Stuart Schiffman—an attorney who prepared an opinion letter on the basis of which some of the unregistered securities allegedly were sold—and remanded for an evidentiary hearing to determine the extent of his role in the scheme.[4] The Second Circuit further directed that, should Schiffman be found liable as an aider and abettor of the scheme, the standard of culpability to be applied would be that of negligence.[5]

The *Spectrum* case involves a particularly complex fact situation and a large cast of characters; it is therefore necessary to outline in perhaps greater than usual detail the events leading up to the suit. On April 2, 1971 the SEC filed a complaint charging Spectrum, Ltd. (Spectrum), appellee Schiffman, and ten other defendants with participation in a scheme to distribute unregistered shares of Spectrum in violation of the registration provisions of the Securities Act

[1] 489 F.2d 535 (2d Cir. 1973).

[2] The SEC obtained permanent injunctions against at least ten of the defendants, but was unsuccessful in obtaining a preliminary injunction against defendant-appellee Schiffman. Id. at 536. The SEC derives its authority to obtain injunctions from section 20(b) of the Securities Act of 1933, 15 U.S.C. § 77t(b) (1970), and section 21(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u(e) (1970). The purpose of such injunctive relief is to prevent further violations of the securities laws by defendants.

> The typical SEC fraud injunction restrains the defendant from making any untrue statement of a material fact concerning a number of specific matters, or any untrue statement of a material fact similar to those statements specifically set forth or of similar purport or object. And the typical injunction under § 5 of the Securities Act restrains any further offers or sales of any securities in violation of the registration or prospectus requirement, with an explicit exception normally for exempted securities or transactions.

3 L. Loss, Securities Regulation 1978 (2d ed. 1961) (footnote omitted). Such relief does not usually affect defendants' criminal or private civil liability.

[3] [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,631, at 92,868 (S.D.N.Y. 1972).

[4] 489 F.2d at 541, 543.

[5] Id. at 541.

of 1933 (the 1933 Act),[6] antifraud provisions of both the 1933 Act[7] and the Securities Exchange Act of 1934 (the 1934 Act),[8] and SEC Rule 10b-5.[9] The purpose of the scheme was to distribute and sell to the public and others over one million unregistered shares of Spectrum common stock in order to obtain monies to be used to pay off debts incurred by several of the defendants.[10] The scheme comprised several stages, the first of which commenced on November

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[6] Section 5 of the 1933 Act, 15 U.S.C. § 77e (1970), provides in pertinent part:
(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale. . . .

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communications in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security . . . .

[7] Section 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1970), provides:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

[8] Section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b) (1970). 15 U.S.C. § 78j provides in pertinent part:

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

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

[9] 17 C.F.R. § 240.10b-5 (1973) (Employment of manipulative and deceptive devices) provides:

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

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

[10] [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,631, at 92,864.

10, 1969, when Westward Investment Corporation (Westward), controlled by defendant Louis Marder, was merged into Spectrum, which then issued a large block of unregistered common stock in exchange for all issued and outstanding Westward shares. The merger and subsequent stock issuance was intended to avoid the registration requirement of section 5(c) of the 1933 Act[11] by means of an exemption from section 5 under SEC Rule 133,[12] which provided that the exchange of shares between a surviving corporation and the shareholders of a disappearing corporation in the course of a merger would not be considered a "sale" under section 5.

The next step was to comply with section 4(1) of the 1933 Act,[13] which provides that the recipients of unregistered stock, such as that received in the Westward-Spectrum merger, could dispose of it without the filing of a registration statement provided that such recipient-sellers were not issuers, underwriters, or dealers under the Act.[14] Since Marder, as a controlling shareholder of Westward, was classified as an underwriter by Rule 133,[15] he was not qualified for exemption from registration requirements. Therefore, prior to the merger Marder began distributing some of his Westward shares to various friends, who were exempt from registration requirements by section 4(1),[16] and who in many cases were in fact unaware of their status as Westward shareholders.[17] By obtaining stock powers from these persons, Marder came into actual control of over one million Spectrum shares then issued and outstanding. Following the merger, he intended to sell the Spectrum stock these friends would receive, thus appearing to meet the criteria of a section 4(1) registra-

[11] 15 U.S.C. § 77e(c) (1970). For the text of this section, see note 6 supra.

[12] 17 C.F.R. § 230.133 (1973), rescinded (with certain stated exceptions), 37 Fed. Reg. 23,636 (1972) (effective Jan. 1, 1973). Rule 133 has been replaced by Rule 145, 17 C.F.R. § 230.145 (1973), which no longer provides a registration exemption for securities issued in the course of a merger.

[13] 15 U.S.C. § 77d(1) (1970). The section provides in pertinent part that "[t]he provisions of section 77e of this title [section 5 of the 1933 Act] shall not apply to—(1) transactions by any person other than an issuer, underwriter, or dealer. . . ."

[14] The terms issuer, underwriter and dealer are defined in 15 U.S.C. §§ 77b(4), (11) and (12) (1970) respectively.

[15] The Rule provided in pertinent part:

> [A]ny person who is an affiliate of a constituent corporation [Westward] at the time any transaction [otherwise qualifying for an exemption under this Rule] is submitted to a vote of the stockholders of such corporation, who acquires securities of the issuer in connection with such transaction with a view to the distribution thereof shall be deemed to be an underwriter of such securities within the meaning of section 2(11) of the Act.

17 C.F.R. § 230.133(c) (1973). However, even if Marder had not been a controlling shareholder, an exemption under Rule 133 was still not available because such exemption was conditioned on approval of the merger by the disappearing corporation's shareholders and no such vote was taken.

[16] Since neither the district court nor the Second Circuit indicated otherwise, it can be inferred that the friends to whom Marder distributed the stock were not issuers, underwriters or dealers.

[17] 489 F.2d at 538.

tion exemption.[18] At this point, several of the defendants, including Marder, began "dumping" hundreds of thousands of the unregistered Spectrum shares onto the market in the United States and Canada.[19]

On the day of the merger, Spectrum's general counsel, Morton Berger, wrote an opinion letter[20] instructing Spectrum's transfer agent on the proper classification of the securities to be issued. The letter included Berger's opinion that the merger itself complied with the requirements of Rule 133, and that certain recipients of the newly-issued Spectrum stock should receive shares marked "restricted," *i.e.*, not for public sale, because those former Westward shareholders, whom Berger listed by name in the letter, were considered to be "underwriters" under Rule 133.[21] Berger also stated that the remaining former Westward shareholders, including the persons to whom Marder had transferred Westward shares, could be issued unrestricted shares. These persons were not listed by name in the opinion letter; however, two weeks later Berger wrote a letter to the president of Spectrum, in which he specified those persons who had received unrestricted shares of Spectrum stock pursuant to the merger.[22]

In late November Schiffman entered the picture at the request of defendant Michael Gardner, a principal at the registered broker-dealer firm of Gardner Securities, to whom Marder had delivered for sale 125,000 shares of unrestricted Spectrum stock nominally owned by William and John Doyen. Gardner viewed Berger's two letters as constituting an insufficient basis on which to sell the securities since the opinion letter did not specify the persons to whom unrestricted stock was issued and the second letter, in which the names were listed, was not an opinion letter. Gardner asked Berger to prepare an opinion letter certifying that the Doyens' stock was exempt from registration, but Berger refused to issue such a

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[18] Id.

[19] [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,631, at 92,865. The term "dumping" is used colloquially to describe the process of distributing large amounts of securities to the public, sometimes at low prices.

[20] For an extensive practical discussion of opinion letters and attorneys' liability, see Fuld, Legal Opinions in Business Transactions—An Attempt to Bring Some Order out of Some Chaos, 28 Bus. Law. 915 (1973). Fuld defines a "legal opinion" as

> a written opinion delivered by a lawyer to his own client to enable the client to decide whether to take certain action, or at the request of his client delivered to another party to the transaction as a condition precedent to the closing of that transaction, or at the request of his client delivered to a government agency or other third party. The term also includes an opinion requested by a client and intended to be referred to in a prospectus or in an annual financial report.

Id. at 915-16.

[21] See notes 12 and 15 supra. For the statutory definition of "underwriter," see text at note 30 infra.

[22] 489 F.2d at 538. This second letter was not in the form of an opinion letter. Id. The purpose for which it was written is unclear since the district court made no finding on this point.

letter on behalf of any stockholder. Gardner then contacted Schiffman.

Schiffman's actions at this point are the subject of dispute among the parties.[23] Schiffman claimed that he spoke to one of the Doyens on the phone in Gardner's office and, after being shown Berger's two letters, agreed to write an opinion letter for Doyen in which he would "verify" Berger's opinion.[24] Gardner, on the other hand, claimed that Schiffman met Marder and defendant James Morse in his office, and that Marder asked Schiffman to write an opinion letter to be used in a securities sale by Marder and Morse. Schiffman then met with Berger—so Schiffman claimed—to learn more about the Spectrum stock for the sale of which he had agreed to write an opinion letter. Berger claimed that he warned Schiffman that he "suspected that this stock . . . was going to be traded by a control person and therefore the stock should not be freely traded."[25] Schiffman denied that Berger gave him such a warning.[26]

Following his meeting with Berger, Schiffman issued an opinion letter dated December 4 which closely paralleled the Berger opinion letter of November 10, but which also included the names of the shareholders, listed in Berger's second letter, who could sell their Spectrum stock without registration. Although the letter was addressed to one of the Doyens,[27] it was delivered to Gardner's office since Schiffman never received Doyen's address.[28] On December 8, Schiffman sent another letter to Doyen through Gardner's office, stating that the letter of December 4 was not to be used for the sale of unregistered Spectrum stock. The letter of December 4 had carried no such warning.[29]

The SEC charged Schiffman with being an "underwriter" within the meaning of section 2(11) of the 1933 Act. This section provides that

> [t]he term "underwriter" means 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, 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 . . . . As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person

[23] Id.

[24] Id. at 539.

[25] Id.

[26] Id.

[27] Neither the district court nor the Second Circuit specified to which Doyen the letter was addressed.

[28] 489 F.2d at 539. The district court found "some conflict as to whether Doyen was the client or whether it was Gardner who had Doyen's stock to dispose of." [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,631, at 92,866.

[29] 489 F.2d at 539-40.

> directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.[30]

Schiffman was claimed to have directly or indirectly participated in the distribution of securities from an "issuer" (Marder) to the public.[31] Although the SEC alleged that the December 4 letter had been used in January 1970 in a sale of unregistered Spectrum stock by Marder, no evidence was introduced to support the claim.[32] The SEC further claimed that even if Schiffman was not liable as an underwriter, he was nonetheless liable as an aider and abettor to the scheme as a whole.[33] The district court found no evidence to support a finding that Schiffman was liable as an aider and abettor.[34] The court applied the following standard of culpability:

> [B]efore one may be deemed an aider and abettor to any scheme, he must have knowledge of the improper scheme and must perform or neglect to perform an act the performance or omission of which is necessary to the furtherance of the scheme with the purpose of furthering the scheme.[35]

En route to denying the SEC's request for a preliminary injunction to enjoin Schiffman from further violations, the court noted that, while Schiffman

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[30] 15 U.S.C. § 77b(11) (1970).

[31] The Second Circuit declined "to decide whether the extent of Schiffman's alleged participation in the scheme would be sufficient to qualify him as an 'underwriter' " because the record was "unclear." 489 F.2d at 541 n.11. Although the court noted that the term "underwriter" had been "broadly defined to include anyone who directly or indirectly participates in a distribution of securities from an 'issuer' (Marder) to the public," id., it is questionable whether the author of an opinion letter who is otherwise unconnected with the illicit sale could or should be considered an underwriter. The district court in *Spectrum* noted that the SEC had submitted no authority that "the mere preparation of an opinion letter is sufficient to make the preparer an 'underwriter'." [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,631, at 92,867. The few cases in which parties other than obvious ones are deemed to be "underwriters" have so far included within the term only those persons who participated in some way in an actual transfer of securities, and not those who in some peripheral way may have influenced the sale. See cases collected at 15 U.S.C.A. § 77b, notes 9-17 (1974).

[32] 489 F.2d at 540.

[33] [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,631, at 92,867. Schiffman's role as an aider and abettor—should it be found that securities had indeed been sold on the basis of the representations contained in his letter of Dec. 4—would be analogous to that in criminal law of an accessory before the fact. See W. LaFave & A. Scott, Criminal Law 498 (1972). Liability for aiders and abettors in SEC injunctive actions was borrowed from criminal law and first recognized in SEC v. Timetrust, Inc., 28 F. Supp. 34 (N.D. Cal. 1939). The court noted that

> [p]ersons charged with aiding and abetting a criminal offense in violation of Sec. 17(a) [of the 1933 Act] may be joined as defendants, and no good reason appears why this same rule should not apply in an injunctive proceeding to restrain a violation of the same statute.

Id. at 43 (footnote omitted).

[34] [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,631, at 92,868.

[35] Id. at 92,867-68, citing SEC v. National Bankers Life Ins. Co., 324 F. Supp. 189, 195 (N.D. Tex.), aff'd, 448 F.2d 652 (5th Cir. 1971).

> may have been guilty of some negligence in preparing the opinion letter, there is insufficient evidence to support anything more serious than that. Furthermore, there has been no showing that, unless enjoined, Schiffman is likely to run afoul of the law in the future.[36]

The Second Circuit, finding a highly material factual conflict regarding Schiffman's role in the scheme, reversed and remanded for an evidentiary hearing. In discussing the standard of culpability the district court should apply to Schiffman should he be found liable as an aider and abettor, the court HELD: the district court's standard of actual knowledge of the improper scheme plus an intent to further that scheme was an improper departure from the negligence standard repeatedly held to be sufficient in the context of enforcement proceedings seeking equitable or prophylactic relief.[37]

This note will examine the above holding in the light of the growing administrative and judicial recognition of attorneys' responsibility to the public in the securities field and will compare the standard of culpability enunciated in *Spectrum* to that previously applied by the Second Circuit in SEC injunctive actions. It will be submitted that the Second Circuit, while correctly recognizing the key role lawyers play in securities transactions through their opinion letters, couched its opinion in language which raises an inference of a standard of culpability that unnecessarily goes beyond that previously established in the Second Circuit, and which, it is submitted, the court did not intend to imply.

The suggestion that attorneys in the securities field have a duty to the public is hardly revolutionary.[38] The SEC's concern with the reliability of attorneys' opinion letters in sales of unregistered securities is one of long standing. A 1962 SEC release stated that

> [o]bviously, an attorney's opinion based on hypothetical facts is worthless if the facts are not . . . considered. Because of this, it is the practice of responsible counsel not

[36] [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,631, at 92,868. It was not disputed that Schiffman had never before prepared an opinion letter. Id. at 92,867. The Second Circuit noted, however, that subsequent to the argument in the district court Schiffman had been enjoined from further violations of the securities laws in two other cases and had pleaded guilty to a third violation. The Second Circuit saw "no reason for precluding the SEC from introducing this evidence" on remand on the issue of "whether the defendant [Schiffman] has the propensity to commit future violations . . . ." 489 F.2d at 542. There appear to be differences among the circuits regarding the standard under which SEC injunctions should be granted. See Sporkin, SEC Developments in Litigation and the Molding of Remedies, 29 Bus. Law. 121 (1974), citing as examples SEC v. Bangor Punta Corp., 331 F. Supp. 1154 (S.D.N.Y. 1971), aff'd in part, rev'd in part & remanded, 480 F.2d 341 (2d Cir. 1973), and SEC v. First American Bank & Trust Co., 481 F.2d 673 (8th Cir. 1973).

[37] 489 F.2d at 541, citing SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1096 (2d Cir. 1972); Hanly v. SEC, 415 F.2d 589, 596 (2d Cir. 1969); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854-55 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969).

[38] See Douglas, The Lawyer and the Federal Securities Act, 3 Duke B. Ass'n J. 66 (1935); Stone, The Public Influence of the Bar, 48 Harv. L. Rev. 1 (1934).

> to furnish an opinion concerning the availability of an exemption from registration under the Securities Act for a contemplated distribution unless such counsel have *themselves carefully examined* all of the relevant circumstances and satisfied themselves, to the extent possible, that the contemplated transaction is, in fact, not a part of an unlawful distribution. Indeed, if an attorney furnishes an opinion based solely upon hypothetical facts which he has made no effort to verify, and if he knows that his opinion will be relied upon as the basis for a substantial distribution of unregistered securities, a serious question arises as to the propriety of his professional conduct.[39]

This view was recently reemphasized in a speech by SEC Commissioner A.A. Sommer, in which he pointed out that

> [attorneys] are frequently called upon to give opinions with respect, principally, to the availability of exemptions from the requirements for registration and use of a statutory prospectus. None would deny the importance of these opinions: millions upon millions of dollars of securities have been put into the channels of commerce—not just sold once, but permanently into the trading markets—in reliance upon little more than the professional judgment of an attorney.[40]

The abuse potential in opinion letters has been recognized by the judiciary as well. In *United States v. Benjamin*,[41] the Second Circuit had stated that "[i]n our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar."[42] Thus, the Second Circuit in *Spectrum* was simply following the map already drawn by the SEC and itself in regard to attorneys' responsibilities in the securities field when it said:

> 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. . . .

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[39] SEC Securities Act Release No. 4445 (Securities Exchange Act Release No. 6721) (Feb. 2, 1962), 17 C.F.R. § 231.4445 (§ 241.6721), 27 Fed. Reg. 1251, 1251-52 (1962) (emphasis added).

[40] Address by Commissioner A.A. Sommer, Jan. 1974, entitled "The Emerging Responsibilities of the Securities Lawyer," reprinted in [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,631, at 83,688 [hereinafter cited as Sommer].

[41] 328 F.2d 854 (2d Cir.), cert. denied, 377 U.S. 953 (1964).

[42] 328 F.2d at 863.

> . . . 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 advisors than "customary" activities which prove to be careless.[43]

But despite the pre-*Spectrum* warning signals, the implications of the language of the SEC and the courts as regards the practicing securities lawyer did not become generally apparent until the filing of the complaint in *SEC v. National Student Marketing Corp.*[44] in February 1972.[45] Among the defendants named in the complaint were two prestigious law firms,[46] White & Case of New York and Lord, Bissell & Brook of Chicago, and partners thereof. The SEC, seeking injunctive relief, alleged against National Student Marketing Corporation (NSMC), its officers, directors, independent auditors, and outside legal counsel (White & Case), and the officers, directors, and legal advisors (Lord, Bissell & Brook) of Interstate National Corporation (Interstate), a company which was merged into NSMC, violations and aiding and abetting in violations of antifraud,[47] proxy[48] and reporting[49] provisions of the securities laws. Although the complaint covered numerous transactions between 1968 and 1970, the principal claim against the lawyers involved the issuance of opinion letters at the closing of the NSMC-Interstate merger. In the spring and summer of 1969, Interstate had explored the possibility of merging with NSMC, and in August 1969, its directors executed a merger agreement, subject to the approval of its stockholders.[50] Under the terms of the agreement Interstate was to receive from NSMC's counsel (White & Case) an

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[43] 489 F.2d at 541-42.

[44] 360 F. Supp. 284 (D.D.C. 1973). The case has not as yet been decided on the merits. Thus while it is apparent that the SEC intends to seek enforcement of securities lawyers' responsibilities to the public, it is by no means clear what the precise parameters of those responsibilities will be. Two other recent cases in which the SEC has sought injunctions against law firms and their members, among other defendants, are SEC v. Allegheny Beverage Corp., [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,183 (D.D.C. 1973), and SEC v. Vesco, [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,777 (S.D.N.Y. 1973), as has been noted in Cooney, The Implications of the Revolution in Securities Regulation for Lawyers, 29 Bus. Law. 129 (1974).

[45] Complaint, SEC v. National Student Marketing Corp., 360 F. Supp. 284 (D.D.C. 1973), reprinted in [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 93,360, at 91,913 (D.D.C., filed Feb. 3, 1972) [hereinafter cited as Complaint].

[46] Complaint, supra note 45, at 91,913 to 91,913-2. As Commissioner Sommer noted, up to the filing of the complaint in *National Student Marketing* "many attorneys had read the travails of other less well-known counsel with the thought that these were not really relevant because of their obscurity and the absence of recognition of their firms as expert and knowledgeable . . . ." Sommer, supra note 40, at 83,687.

[47] See notes 7-9 supra.

[48] Section 14(a) of the 1934 Act, 15 U.S.C. § 78n(a) (1970).

[49] Section 13(a) of the 1934 Act, 15 U.S.C. § 78m(a) (1970).

[50] 360 F. Supp. at 288-89.

opinion letter satisfactory to Interstate's counsel (Lord, Bissell & Brook) stating that NSMC had taken all actions required of it by law and that all transactions in connection with the merger had been duly and validly undertaken; NSMC would receive from Lord, Bissell & Brook a similar letter satisfactory to White & Case, affirming that Interstate had taken all necessary steps to effectuate the merger in accordance with law.[51] In addition, Peat, Marwick, Mitchell & Co. (PMM), NSMC's independent accountants, were to issue a "comfort letter"[52] to Interstate stating that there was no reason to believe that NSMC's unaudited nine month financial statements for the period ending May 31, 1969 were not prepared in accordance with generally accepted accounting procedures or that any material adjustments in these financials were required.[53] The letter would also indicate that NSMC had experienced no material change in its financial position from May 31 until five days prior to the merger.[54] The unaudited nine month financial statements of NSMC had been among the proxy materials sent to Interstate stockholders seeking their approval of the merger, and reflected a profit of approximately $700,000.[55] The shareholders of both corporations approved the merger in early October, and the closing meeting was held at the offices of White & Case in New York on October 31. During the meeting, PMM dictated over the telephone from its Washington, D.C. office an unsigned draft of its comfort letter; however, instead of confirming, as expected, that the financial statements were satisfactory, PMM reported that several significant adjustments should be made retroactively to May 31.[56] PMM then allegedly informed White & Case prior to the consummation of the merger that it desired to add to the draft letter an additional paragraph which would indicate that NSMC had not made a profit but rather had suffered a net loss as of May 31, and that the company would only break even as to net earnings for the year ending August 31. It was further alleged that White & Case did not inform the others present at the meeting of this information.[57]

Despite the unexpected information disclosed in the comfort letter, the closing was consummated and the articles of merger filed and recorded. Final copies of the comfort letter were received by

[51] Id. at 289.

[52] The accountant's comfort letter—more formally known as a "cold comfort letter"—is often required as part of a closing in a transaction in cases where the most recent financial statements have not yet been audited. The comfort letter, which purports to do no more than convey the idea that no significant financial changes have occurred since the last audit that might affect the transaction, is not an opinion letter; the standards of investigation are lower in a comfort letter, which is often based on nothing more than conversations with management and undetailed examination of unaudited financials.

[53] 360 F. Supp. at 289.

[54] Id.

[55] Id.

[56] Id. at 289-90.

[57] Id. at 290.

White & Case approximately one hour after the closing and by the Interstate representatives several days later.[58] The final letter included two paragraphs indicating that NSMC would merely break even for the year ending August 31 and that PMM believed the companies should consider submitting corrected interim unaudited financial information to the shareholders prior to closing.[59] After receiving the comfort letter, both counsels, as required by the merger agreement, rendered legal opinions that all transactions undertaken in connection with the merger had been duly and validly undertaken.[60]

The SEC complaint specifically claimed that

> [a]s part of the fraudulent scheme White & Case, Epley [White & Case partner], Lord, Bissell & Brook, Meyer and Schauer [Lord, Bissell & Brook partners] failed to refuse to issue their opinions . . . and failed to insist that the financial statements be revised and shareholders be resolicited, and failing that, to cease representing their respective clients and, under the circumstances, notify the plaintiff Commission concerning the misleading nature of the nine month financial statements.[61]

The idea, emerging from the complaint, that a lawyer should resign, and even further that he should report his client to the SEC should he be unable to stop his client's illegal conduct, greatly disturbed the legal community, which feared it might presage a fundamental alteration in the traditional attorney-client relationship.[62] But while it indeed appears that attorneys will be expected to assume a distinct responsibility to the public in the se-

[58] Id.

[59] Id.

[60] Id.

[61] Complaint, supra note 45, at 91,913-17.

[62] The [NSMC] suit shocked lawyers across the nation because it indicated the [C]ommission believes a lawyer has an obligation, beyond protecting his client's interests, to protect the public interest if he learns the client is acting illegally. If, in a securities matter, the lawyer can't convince the client to stop illegal conduct, he should withdraw from the case and possibly notify the SEC, according to the [C]ommission view. If the attorney doesn't do this, he also is violating the law, the SEC feels.

> Some lawyers object that this view puts them in the role of policeman rather than advocate and jeopardizes the confidentiality of the lawyer-client relationship.

Wall Street Journal, Jan. 14, 1974, at 13, cols. 2-3. Some commentators have expressed similar fears. See, e.g., Karmel, Attorneys' Securities Laws Liabilities, 27 Bus. Law. 1153 (1972):

> The [NSMC] action is significant and unprecedented not only because it is the first such action against a major law firm, but even more importantly because it posits novel theories as to the duties and obligations of lawyers, which would appear to significantly expand their liabilities.

Id. However, whether the theories are indeed "novel" is questionable. For a discussion of attorneys' duties to report their clients' frauds, see Freeman, Opinion Letters and Professionalism, 1973 Duke L.J. 371, 431-33.

curities area, the effect of enforcing this responsibility, once these new standards become established and clients realize that they can no longer shop for an attorney who is willing to close his eyes to an illegal course of action, will likely be a salutary one of raising the standards of securities practice rather than jeopardizing the confidentiality of the attorney-client relationship.

However, assuming that an attorney does indeed have newly enforced responsibilities to the public, there remains the question of the standard of culpability to which to hold him. Commissioner Sommer noted in his speech that what was disturbing about the Second Circuit decision in *Spectrum* was not the fact that an attorney was involved, but the suggestion "that *simple negligence* in the rendering of an opinion concerning exemption from registration might expose counsel at least to Commission injunctive action."[63] It is submitted that such fears may be unfounded, at least on the basis of the holding in *Spectrum*, and that the apparent imposition of a "negligence" standard is in reality nothing more than an application of the scienter standard already recognized by the Second Circuit, a standard which falls decidedly short of "simple negligence."

Scienter is a slippery term that has been defined at various times as actual knowledge, intent, bad faith, recklessness and even negligence.[65] Although the traditional scienter requirement in common law fraud actions encompassed only actual knowledge, the generally accepted modern standard has been expanded to include at least constructive knowledge—a "should have known" standard.[66] And even though it is generally accepted that a nominal negligence standard may be applied in an SEC injunctive suit,[67] it is

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[63] Sommer, supra note 40, at 83,688 (emphasis added).

[64] The term "simple negligence" as used by Commissioner Sommer probably means "ordinary negligence," which has been defined as "a slight want of ordinary care." W. Prosser, Handbook of the Law of Torts 183 (4th ed. 1971). However, Prosser also notes: "The prevailing view is that there are no 'degrees' of care or negligence, as a matter of law; there are only different amounts of care as a matter of fact . . . ." Id. at 182. Since it is submitted that the standard of culpability applied in *Spectrum* is in fact a scienter standard, it is unnecessary for the purposes of this note to try to differentiate among degrees of negligence, to the extent that such distinctions survive.

[65] 2 A. Bromberg, Securities Law: Fraud—SEC Rule 10b-5, § 8.4(501) (1973). See also 3 L. Loss, Securities Regulation 1432 (2d ed. 1961).

[66] See Note, 63 Mich. L. Rev. 1070, 1075-76, 1079 n.43 (1965).

[67] In SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963), the Supreme Court emphasized that

> 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 . . . securities legislation [, having been] "enacted for the purpose of avoiding frauds," [to be construed] not technically and restrictively, but flexibly to effectuate its remedial purposes.

[Footnote omitted.] This language has been widely interpreted as allowing something less than a strict scienter standard of culpability in SEC injunctive suits. See 2 A. Bromberg, supra note 65, § 8.4(585)(6). The question of whether to apply scienter or negligence standards to private civil actions, as distinguished from SEC injunctive actions, is the subject of debate both within and among the circuits. For discussions of the problem, see Bucklo, Scienter and

not at all clear that in this context negligence means anything more in practice than some form of scienter. It would be simplistic to pretend that scienter and negligence do not overlap; at the very least they have a hazy interface. Negligent failure to obtain knowledge has been equated with constructive knowledge.[68] Thus, conduct falling between strict scienter and simple negligence, but fitting some scienter standard, can be termed "negligent," and in fact has been so termed by the Second Circuit. In *SEC v. Texas Gulf Sulphur Co.,*[69] cited by the court in *Spectrum* as standing for "the negligence standard which we have repeatedly held to be sufficient in the context of enforcement proceedings seeking equitable or prophylactic relief,"[70] the Second Circuit set its standard of culpability as regards an SEC injunctive suit brought under Rule 10b-5:

> Absent any clear indication of a legislative intention to require a showing of specific fraudulent intent, . . . the securities laws should be interpreted as an expansion of the common law both to effectuate the broad remedial design of Congress, . . . and to insure uniformity of enforcement . . . . Moreover, a review of other sections of the Act from which Rule 10b-5 seems to have been drawn suggests that the implementation of a standard of conduct that encompasses negligence as well as active fraud comports with the administrative and the legislative purposes underlying the Rule. Finally, we note that this position is not, as asserted by defendants, irreconcilable with previous language in this circuit because *"some form of the traditional scienter requirement,"* . . . sometimes defined as "fraud," . . . is preserved. This requirement, whether it be termed *lack of diligence, constructive fraud, or unreasonable or negligent*

Rule 10b-5, 67 Nw. U.L. Rev. 562 (1972); Mann, Rule 10b-5: Evolution of a Continuum of Conduct to Replace the Catch Phrases of Negligence and Scienter, 45 N.Y.U.L. Rev. 1206 (1970); 2 A. Bromberg, supra note 65, § 8.4(585). For further discussion, with emphasis on disagreement within a circuit, see Comment, *Lanza v. Drexel & Co.* and Rule 10b-5: Approaching the Scienter Controversy in Private Actions, 15 B.C. Ind. & Com. L. Rev. 526 (1974).

Some cases have discussed whether the language of section 10(b) of the 1934 Act, with its emphasis on manipulative and deceptive devices, can support a negligence standard, but it has been generally accepted that in fact it can in suits for equitable or prophylactic relief. See, e.g., SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 868 (2d Cir. 1968) (en banc) (concurring opinion).

[68] "Negligent failure to obtain knowledge is equivalent to constructive knowledge." 2 A. Bromberg, supra note 65, § 8.4(582). Bromberg cites Heit v. Weitzen, 402 F.2d 909, 914 (2d Cir. 1968), cert. denied, 395 U.S. 903 (1969), in which the Second Circuit stated that, at least on the question of the sufficiency of the complaints, "[t]he charge that defendants 'knew or should have known' adequately alleges actual knowledge of the falsity of the statements . . . ."

[69] 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969), on remand, 312 F. Supp. 77 (S.D.N.Y. 1970), aff'd in part, rev'd in part & remanded, 446 F.2d 1301 (2d Cir. 1971).

[70] 489 F.2d at 541.

conduct, remains implicit in this standard, a standard that promotes the deterrence objective of the Rule.[71]

The court in *Texas Gulf Sulphur* was dealing with corporate insiders who, among other things, bought their company's stock immediately prior to dissemination to the public of information describing a rich mineral strike by the company. Although the insiders claimed that they were justified because they honestly believed the news had become public, the court found that their belief was not reasonable under the circumstances.[72] The finding of unreasonable belief was grounded in "some form of the traditional scienter requirement."[73] Put another way, the defendants should have known that the information had not yet become public. This standard of constructive knowledge, although not expressed as such, was also implicitly relied upon in the two other cases cited in *Spectrum* as representing the "negligence" standard to be applied in SEC enforcement proceedings.[74]

Thus, when Schiffman's actions are examined in light of the Second Circuit's language in *Texas Gulf Sulphur*, it is apparent that his failure to check to see if the information in Berger's letters was in fact correct can fit either "lack of diligence" or "unreasonable or *negligent* conduct."[75] This standard, although articulated in terms of "negligent conduct," is actually a form of constructive knowledge when viewed in the context of the case, and fits more closely a scienter standard than a traditional "simple negligence" standard, which has no requirement of scienter in any form.

In conclusion, the *Spectrum* decision need not be the source of any major discomfiture within the legal community. Seen as a decision rendered closely upon the facts, *Spectrum* sets no trap into which a reasonably conscientious securities lawyer will be likely to fall, since Schiffman's actions were conspicuously imprudent. As the Second Circuit pointed out, Schiffman could have protected himself through the simple expedient of including a caveat in his opinion letter to condition its contents.[76] And although the Second Circuit

[71] 401 F.2d at 855 (emphasis added) (citations and footnotes omitted).

[72] Id. at 856.

[73] Id. at 855.

[74] See SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1097 (2d Cir. 1972) (beneficiaries of stock sale should have discovered that stock sale was not fully subscribed as required), and Hanly v. SEC, 415 F.2d 589, 595-96 (2d Cir. 1969) (brokers violated duty to investigate stock they sold), cited in *Spectrum*, 489 F.2d at 541.

[75] 401 F.2d at 855 (emphasis added).

[76] [W]here expediency precludes thorough investigation, an attorney can 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.

489 F.2d at 542. See Fuld, Legal Opinions in Business Transactions—An Attempt to Bring Some Order out of Some Chaos, 28 Bus. Law. 915 (1973).

If there is truth in Berger's claim that he warned Schiffman that the stock was going to be traded by a control person, Schiffman's failure to heed such a warning would have been a

was correct in characterizing its standard of culpability as one "repeatedly held to be sufficient in the context of enforcement proceedings seeking equitable or prophylactic relief,"[77] it may have been misleading in characterizing the standard as "negligence" since the concept of scienter has been expanded by the Second Circuit in previous decisions to include the "negligent" action of Schiffman in *Spectrum.*

RANDOLPH H. ELKINS

Antitrust Law—Class Actions—Tolling of Federal Statutes of Limitations—*American Pipe & Construction Co. v. Utah.*[1]—On June 19, 1964, the United States District Court for the Central District of California found American Pipe & Construction Company and five other steel and concrete pipe companies[2] guilty of violating section 1 of the Sherman Act.[3] Four days later, the United States filed civil complaints against the same six companies which, as amended, sought to recover damages and to restrain further violations of sections of the Sherman,[4] Clayton[5] and False Claims[6] Acts.[7] On May 24, 1968, a negotiated "final judgment" was entered against the companies.[8]

On May 13, 1969, the State of Utah instituted a civil antitrust suit against the same defendant pipe companies,[9] seeking treble damages for violations of section 1 of the Sherman Act. The complaint, which was based on the same events as those involved in the government's suits, was brought in the United States District Court

reckless disregard of available information and probably culpable under the strictest scienter standard.

[77] 489 F.2d at 541.

[1] 414 U.S. 538 (1974).

[2] The other five companies indicted were United Concrete Pipe Corp., Kaiser Steel Corp., United States Steel Corp., United States Industries, and Smith-Scott, Inc. Maricopa County v. American Pipe & Constr. Co., 303 F. Supp. 77, 79 (D. Ariz. 1969).

[3] 15 U.S.C. § 1 (1970). The indictments alleged that the six companies had combined and conspired to restrain interstate trade by submitting collusive and rigged bids for the sale of pipe and had divided the business thus obtained among themselves. 414 U.S. at 540.

[4] 15 U.S.C. § 4 (1970).

[5] 15 U.S.C. § 15(a) (1970).

[6] 31 U.S.C. § 231 (1970).

[7] 303 F. Supp. at 80.

[8] Id. In *Maricopa County,* the district court determined that although five of the defendant pipe companies settled their suits with the government on Dec. 8, 1967, and a "partial final judgment" was entered which was, for all practical purposes, a final judgment against all the defendants except American Pipe, the conspiracy linking the companies together required that the "final judgment" as to all of the defendants not be entered until the case of the last defendant, American Pipe, was terminated on May 24, 1968. Id. at 87.

[9] Utah v. American Pipe & Constr. Co., 49 F.R.D. 17 (C.D. Cal. 1969). In addition to the six companies involved in the government's suits, Utah also named Utah Concrete Pipe Co. and W.R. White Co. as defendants in the case. Id.