BYU Law Review

Volume 1982 | Issue 3 Article 2

9-1-1982

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I. INTRODUCTION

Securities lawyers are faced with some unusual pressures. These pressures arise, at least in part, from the fact that for the past several years there has been a lack of general agreement between the Securities and Exchange Commission (SEC), the courts, and the securities bar concerning lawyer duties in securities transactions. On the one hand, clients expect their lawyer to be something akin to a "secular priest" to whom they can confide their objectives and discuss business strategies without fear of disclosure to others, and from whom they can get the advice and counsel they need to make effective decisions. They tend to believe and expect that their lawyer will always "take their side." They certainly do not expect their lawyer to be an adversary or an extension of a government agency, who will police their conduct and perhaps report past indiscretions. On the other hand, to some degree the securities lawyer is limited in the type of aid and assistance he can render his clients by state and federal securities laws and by codes of professional responsibility.

Even more importantly, the Securities and Exchange Commission in recent years has been attempting to change the traditional role of the lawyer as a client advocate in order to get assistance from the private sector in maintaining the honesty and integrity of the securities markets. The changes suggested by the SEC would require lawyers to operate in a role similar to that of accountants—independent of their clients, with a responsibility to tell clients what they must do to comply with the securities laws and a duty to perform checks on client work to the extent necessary to verify its accuracy.[1] In addition, the SEC has sug-

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1. In a speech given in 1978, then SEC Commissioner Harold Williams made reference to the similar treatment the SEC was giving to accountants and lawyers:

> I would commend to your careful study the drama which is continuing to

gested that in certain circumstances lawyers have a duty to act as an enforcement arm of the Commission and report intended or past client violations of the securities laws to the Commission itself.[2] One way in which the SEC has attempted to enforce its views is by significantly stepping up the number and scope of its administrative proceedings against lawyers pursuant to Rule 2(e) of the SEC's Rules of Practice.[3]

This Article suggests the beginning of a conceptual framework for categorizing the securities lawyer's duties under the federal securities laws, assesses the current status of administrative actions brought by the SEC against lawyers pursuant to Rule 2(e), and concludes by applying that conceptual framework in the context of Rule 2(e) administrative actions in an attempt to identify the duties of securities lawyers under that section.

II. Lawyer Duties in Securities Transactions: A Conceptual Framework

When someone is faced with a problem, there is a natural reaction to attempt to break the problem down into subparts so that it may be analyzed more easily. For example, when a lawyer is faced with a fact situation and the question of whether his client is liable for the way he acted in that situation, the lawyer looks for relevant rules of law to determine the answer. These rules are analytical tools for breaking down and understanding factual situations. Thus, one possible way to classify a lawyer's duties in securities transactions is to examine the various provisions of law that set forth these responsibilities. For example, a

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

Hager, *S.E.C. Chief to Lawyers: You May Be Next,* Legal Times of Washington, August 14, 1978, at 1, col. 2 (Speech to the ABA Convention in New York, August 1978).

2. S.E.C. v. National Student Mktg. Corp., 360 F. Supp. 284 (D.D.C. 1973).

3. A sampling of sixty-three cases brought pursuant to Rule 2(e) demonstrates the recent trend toward increased use of administrative proceedings against lawyers involved in securities transactions. The sample uncovered only five administrative proceedings against lawyers under Rule 2(e) before 1960. During the period from 1960 to 1969, however, twelve Rule 2(e) proceedings were brought. From 1970 to 1974, nine such proceedings occurred. And then between 1975 and 1980, thirty-seven cases were brought against lawyers. *See* Marsh, *Rule 2(e) Proceedings,* 35 Bus. Law. 987, 988-89 (1980).

lawyer might study the provisions of sections 11, 12(1), 12(2), and 17 of the Securities Act of 1933 and Rule 10b-5 of the 1934 Act, and consider their applicability to the practice of law in securities transactions. This approach is helpful, but something more is needed. In order to get a more accurate assessment of a lawyer's legal duties in securities transactions, a more elaborate classification system is needed—one which takes into account factors in addition to the relevant rules of law. This Article suggests a classification system consisting of three variables: (1) the factual circumstances in which the duty arises, (2) the lawyer's role in the particular securities transaction, and (3) the nature of the proceeding brought against the lawyer.

A. The Factual Circumstances

That a more elaborate classification system would be helpful in guiding lawyer conduct becomes obvious from reading the securities cases involving lawyers. Take for example the case of *S.E.C. v. Coven,*[4] decided by the United States Court of Appeals for the Second Circuit in 1978. In *Coven,* the court discussed the standard of culpability for aiding and abetting a violation of section 17(a) of the Securities Act of 1933 in the context of an injunctive action brought by the SEC. The court concluded that the test was

> whether the alleged aider and abettor "should have been able to conclude that his conduct was likely to be used in furtherance of illegal activity," in light of all the circumstances . . . including the nature of the defendant's assistance to the primary wrongdoer, his participation in the challenged conduct, his awareness of the illegal scheme, and any duties to investigate or supervise that may be applicable.[5]

This is basically the statement of a negligence standard. Applying this standard, the court found that the lawyer had aided and abetted a violation of the securities laws by writing an opinion for the underwriter that resulted in the improper closing of an escrow. Although it stated a negligence standard, the court noted that the attorney's conduct had actually been reckless. The court rejected an allegation that the lawyer had aided and

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4. 581 F.2d 1020 (2d Cir.), *cert. denied,* 440 U.S. 950, *reh'g denied,* 441 U.S. 928 (1978).

5. *Id.* at 1028 (citation omitted) (*quoting* S.E.C. v. Management Dynamics, Inc., 515 F.2d 801, 811 (2d Cir. 1975)).

abetted the underwriter's stock manipulation scheme, but suggested that the result might have been different had the lawyer actually known (a scienter test) that the underwriter was manipulating the market.[6]

The *Coven* decision indicates that a court might find that a lawyer aided and abetted a violation of the securities law in one factual context based on the lawyer's negligence, and yet would find the lawyer culpable in another context only if there were a showing of knowing conduct, despite the fact that the same rule of law is applicable to both contexts.

B. The Lawyer's Role in the Particular Transaction

An additional factor that the courts consider in determining lawyer duties in securities transactions is the function or role of the lawyer in the transaction.[7] The beginning of a functional classification system for categorizing lawyer duties emerges by considering some of the important activities engaged in by lawyers in connection with securities transactions. These include: (1) Rendering advice. The complexity of the securities laws has resulted in extensive utilization of lawyers by issuers seeking to understand and comply with these laws. One of the most important functions of the securities lawyer is to render advice to clients concerning the securities laws and how to comply with them. (2) Drafting documents. Another important lawyer activity in securities transactions is drafting documents for the client. One type of document that a lawyer may be required to draft is a written opinion about the securities laws or the application of the securities laws to the facts of a specific situation. Written opinions may carry special significance because of the tendency of the client, and perhaps third parties, to rely on them in effect-

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6. 581 F.2d at 1028-30.

7. *See, e.g.*, S.E.C. v. Spectrum, Ltd., 489 F.2d 535 (2d Cir. 1973) (the court emphasized the critical role that the attorney played in drafting a written opinion advising the client that restricted securities could be sold without violating the Securities Act of 1933); Steinberg & Gruenbaum, *Variations of "Recklessness" After* Hochfelder *and* Aaron, 8 SEC. REG. L.J. 179 (1980) (at least four different legal standards of "recklessness" are identified). *See also* White v. Abrams, 495 F.2d 724 (9th Cir. 1974). In *White*, the United States Court of Appeals for the Ninth Circuit indicated that in determining whether the necessary intent is present in a Rule 10b-5 case, a "flexible duty" test must be applied which takes into account many factors, including "the relationship of the defendant to the plaintiff, the defendant's access to information as compared to the plaintiff's access, the benefit that the defendant derives from the relationship, the defendant's awareness of whether plaintiff was relying on their relationship, . . . and the defendant's activity in initiating . . . the transaction." *Id.* at 735-36 (footnotes omitted).

ing a securities transaction. In addition to rendering opinions on securities questions, the lawyer may be asked to assist a client in the preparation of various disclosure documents required by the securities laws. For example, the lawyer may assist in the preparation of a registration statement for a public securities offering pursuant to the 1933 Act, or in the preparation of various reports to be filed with the SEC as required of registered companies under the 1934 Act. Again, the lawyer's role in preparation of these disclosure documents may be of special significance in a securities transaction since many of these documents are filed with the SEC or stock exchanges, and are subsequently given to investors. Because these documents contain information that is relied upon by people intimately connected with the trading of securities in the securities markets, the potential liability of a securities lawyer is increased. (3) Representing the client in formal or informal proceedings. Finally, the lawyer may be called upon to appear on behalf of his client in court or before the SEC in formal or informal proceedings or discussions.

In performing these functions, the securities lawyer has four potential legal and ethical duties: (1) a duty not to act as a principal in a transaction violating the securities laws;[8] (2) a duty to avoid rendering substantial assistance, by giving general legal advice or drafting documents, to clients violating the securities laws;[9] (3) a duty to investigate the background facts, the securi-

8. Suppose that *A*, a lawyer, is approached by *B*, a real estate broker, and asked if he will draft all of the documents necessary to effectuate a private offering of limited partnership interests in a syndication to buy one hundred acres of residential development property. *A* agrees to become a general partner with *B* and take his legal fees in the form of an interest in the partnership. Although he knows of material risks to investors in the proposal, *A* nevertheless fails to disclose these risks in the offering circular. Furthermore, *A* assists *B* in finding investors from among *A*'s clients. It turns out that one of the undisclosed risks (i.e., that high interest rates could prevent immediate development of the project) results in the partnership having to sell the property at a loss. The investors sue *A* and *B*. Can the investors prevail against *A*? *See, e.g.*, S.E.C. v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972) (court granted SEC's request for an injunction against attorney-principal for violations of § 17(a) of the 1933 Act and Rule 10b-5 of the 1934 Act); Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968) (lawyer-director held liable pursuant to § 11 of the 1933 Act for material misstatements and omissions in the issuer's registration statement).

9. For example, suppose that *A*, an attorney, knows from past experience in working with *B*, a real estate syndicator, that *B*, who knows all about the securities laws, will offer the deal to anyone he can, in any way he can, and that *B* will probably violate the securities laws relating to unregistered public offerings. Nevertheless, *A* drafts the partnership agreement, gives a tax opinion, and prepares the private offering circular for *B*. Furthermore, *B* brings his potential investors to *A*'s office to "spend a few minutes getting acquainted with my lawyer and to ask him any questions you like." Invariably, at *B*'s

ties laws, and the historical application of the law to analogous factual situations;[10] and (4) a duty to make disclosures of the client's past or intended future violations of the securities laws.[11]

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prompting, *A* ends up reassuring these people that the "deal looks like a good one." In fact, on one deal the ground purchased by the partnership is overpriced and *B* does in fact violate the private offering rules. The investors want to get their money back. What is *A*'s potential liability? *See, e.g.*, Croy v. Campbell, 624 F.2d 709 (5th Cir. 1980), *and* Katz v. Amos Treat & Co., 411 F.2d 1046 (2d Cir. 1969) (cases in which lawyers were sued under § 12(2) of the 1933 Act as "participants" in the unlawful sale of securities). *See also* S.E.C. v. National Student Mktg. Corp., 402 F. Supp. 641 (D.D.C. 1975) (lawyer sued by SEC to enjoin him from aiding and abetting a violation of Rule 10b-5 of the 1934 Act).

10. For example, liability to clients and third parties may be incurred under state law for malpractice by the lawyer who negligently fails to research the law or who fails to give proper advice on relatively clear points of the securities laws. *See* Brown v. Gitlin, 4 Ill. App. 3d 1040, 283 N.E.2d 115 (1972) (lawyer may be liable for failing to advise a client of the need to file a form in order to perfect an exemption under the state Blue Sky Laws).

Or suppose that *B*, whom *A* (a securities lawyer) has never met before, comes to *A* and asks him to draft a written opinion letter, without independent investigation of the background facts, so that he can sell some restricted stock in *XYZ* Corporation (a small over-the-counter reporting company) through a local brokerage firm. If *A* accepts *B*'s statement of the facts and drafts the opinion accordingly, and it turns out that *B* has misrepresented the facts, can *A* be held liable along with *B*? *See, e.g.*, S.E.C. v. Spectrum, Ltd., 489 F.2d 535 (2d Cir. 1973).

Or suppose that *XYZ* Corporation is contemplating its first registered public offering of common stock. *A*, a partner in a law firm, is the corporation's outside counsel. He drafts the registration statement using information given to him by the corporation's officers and auditors in response to questions that he told management must be answered in the registration statement. Suppose that the vice president of finance tells him that the company's receivables have been sold to a factor on a nonrecourse basis pursuant to the terms of a contract. It is obvious to *A* that the cash position of *XYZ* is not that good and that, in the current difficult economic climate, if the receivables were sold on a recourse basis and a significant percentage of them turned out to be bad, *XYZ* could be in real trouble. In a discussion with the president, the president reassures *A* that the receivables were sold on a nonrecourse basis and that he "should take the vice president's word for it." In fulfilling his duty as a securities lawyer in drafting the registration statement, must the lawyer investigate any further concerning the factoring contract or may he take the word of the vice president of finance and the president of the company? *See, e.g.*, Fert v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971); Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).

11. The following hypotheticals emphasize the importance of the factual circumstances and the role of the attorney in the particular transaction in determining the scope of the lawyer's duties. Suppose, for example, the client is an organization such as a corporation. Is there a duty of disclosure to the client itself when someone in the organization intends a future violation of the securities laws? Is there a duty of disclosure to other parties outside the organization (such as the SEC) when the client intends a wrongful act?

For example, suppose that *XYZ* Corporation is contemplating its first registered public offering of common stock. *A*, a partner in a law firm, is the corporation's outside counsel. He drafts the registration statement, using information given to him by the corporation's officers and auditors in response to questions which he told management must

The extent of the lawyer's duties will vary, of course, depending on the factual circumstances of the case and the lawyer's relationship with the issuer in the transaction. In many instances, a securities lawyer's involvement arguably goes beyond the role of an attorney. In handling the issuer's first registration and in drafting the registration statement, for example, is the lawyer acting *qua* lawyer, or is the lawyer also a member of the board of directors?

As part of the analysis of the lawyer's function, the uses to which the lawyer's work can reasonably be expected to be put should also be considered. For example, if a lawyer drafts a written opinion, is it clear that investors will rely on the written opinion rendered by the lawyer in making an investment decision? Compare the possible impact of a formal written opinion that restricted stock may be sold, with an informal letter drafted

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be answered in the statement. Suppose that *A* discovers that the description in the deed of the property on which the corporation's factory sits is defective and that the corner of the company's factory was built on a neighbor's property. Because there is a running feud between these two adjoining owners, a rapid and amicable resolution to the issue is not possible. Title will accrue by adverse possession in one year. *A* advises *B*, the president, that the factory problem is definitely a material fact and must be disclosed. *B* refuses to delay the offering for a year and does not want the problem disclosed in the registration statement. He suggests that *A* withdraw from the case if he can't overlook it. *B* says that he will simply hire another attorney to draft the registration statement. *B* also tells *A* not to go to the board of directors on this matter, that "I'll handle it in my way." *B* asks *A*, in any event, to continue to represent the company on all other matters.

Does *A*, the attorney have a duty to inform the board of directors about the defective title problem? Does *A* have a duty to resign as counsel to *XYZ* if the president or the board refuses to disclose the title problem? If *XYZ* goes ahead with the offering, does the attorney have a duty to inform his successor attorney about the title problem? What if the successor asks him whether he found any "problems"? If *XYZ* goes ahead with the offering, should *A* inform potential investors about the defect? Should the attorney inform the SEC? Do the answers to these questions change if the lawyer is in-house counsel to *XYZ* rather than outside counsel?

Does the securities lawyer have a duty of disclosure to the corporate client when someone in the organization has violated the securities laws in the past? Is there a duty to other parties (including, perhaps, the SEC) concerning the client's past wrongful acts? Suppose, for example, that *A* takes the word of his client's management and later discovers that not all the material facts were disclosed to him and that as a result (1) his recently drafted opinion letter, used by the company as part of the sale of a securities issue, concluding that a securities offering is a private rather than a public offering, is incorrect; or (2) a registration statement drafted by *A*, filed with the SEC, and used in the sale of a public offering, is incorrect in some material respect; or (3) a recent press release drafted by him and released by the company contained material misstatements of fact; or (4) a monthly Form 8-K report drafted by *A* and filed with the SEC pursuant to § 13(a) of the 1934 Act contains false and misleading statements of material fact. What are the lawyer's duties under each of these circumstances? *See, e.g.*, S.E.C. v. National Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978).

by a lawyer to a client outlining the possible routes under the securities laws for raising capital and the advantages and disadvantages of each route. The extent of the lawyer's duties and consequent liability should vary under each of these circumstances.

C. *The Securities Laws Involved*

In addition to a careful analysis of the factual setting and the functions of the lawyer in the securities transaction, it is necessary to consider the nature of the proceeding brought against the lawyer in determining the lawyer's possible duties and liabilities. The elements necessary to establish a cause of action, particularly the state of mind required to support a finding that the lawyer has breached a duty, will vary greatly depending on whether a Rule 10b-5 action or an SEC administrative proceeding is involved.

The discussion in the Article will focus on these issues in relation to SEC administrative proceedings pursuant to Rule 2(e) of the SEC's Rules of Practice. Specifically, the important recent cases of *In re William R. Carter*[12] (hereinafter referred to as *Carter (trial)*) and its subsequent appeal to the entire Commission[13] (hereinafter referred to as *Carter (appeal)*) will be examined to determine the direction the SEC is currently taking in these administrative disciplinary proceedings.

III. SEC Administrative Disciplinary Actions Pursuant to Rule 2(e)

A. *History of the Use of Rule 2(e)*

The ethical conduct of lawyers has always been supervised by the general disciplinary system maintained by the courts and the state bar associations. Additionally, since 1935, the conduct of lawyers involved in securities transactions has been regulated by Rule 2(e) of the SEC's Rules of Practice. Initially, the bases for a disciplinary action under Rule 2(e) were a lawyer's (1) lack of qualifications to represent others, (2) lack of character or integrity, or (3) commission of unethical conduct.[14] Regulation pri-

12. *In re* William R. Carter, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,175 (Mar. 7, 1979)[hereinafter cited as *Carter (trial)*].

13. *In re* William R. Carter, [1981 Transfer Binder] Fed. Sec. L.Rep. (CCH) ¶ 82,847 (Feb. 28, 1981) [hereinafter cited as *Carter (appeal)*].

14. 1 Fed. Reg. 1753 (1936).

marily took the approach of policing and disciplining unethical lawyer conduct occurring in face-to-face contact with Commission members and employees, such as might occur in an administrative hearing.[15] Most of the early proceedings were ones in which the lawyer could be said to have attempted to subvert the integrity of the SEC's regulatory processes by intentionally filing false information in required SEC reports.[16]

In 1970, Rule 2(e) was amended to proscribe a willful violation or a willful aiding and abetting of a violation of the securities laws (if such were established after a hearing before the SEC).[17] Shortly thereafter, the SEC began to assert its present position that, in effect, it may discipline any lawyer who fails to perform what the Commission deems to be a duty to the SEC, even if the lawyer's conduct occurs in a securities transaction to which the federal securities laws apply only generally, and even if the conduct occurs in the privacy of the lawyer's office. In effect, the SEC began its attempt to conscript lawyers in private practice as an extended enforcement arm of the Commission.[18]

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15. It is understandable that federal or state administrative agencies might sometimes undertake the responsibility of disciplining professionals appearing before them in connection with their hearings, for it is when they conduct such hearings that the agencies act the most like courts. The reasonableness of courts disciplining lawyers for misconduct in their presence is widely accepted. *See* 18 U.S.C. § 401 (1976). However, even in this setting a court's freedom to use the contempt sanction may be limited. *See, e.g.*, United States v. Meyer, 462 F.2d 827 (D.C. Cir. 1972).

An example of the discipline imposed against a lawyer by the SEC in a Rule 2(e) proceeding is the case of *In re* Fleishmann, 37 S.E.C. 832 (1950). In *Fleishmann*, the SEC disbarred a lawyer from practicing before it because he concealed facts in an administrative proceeding before the Commission and falsely stated that a shareholder's committee had been formed by the shareholders when in fact he had instigated its formation. In this regard, see also Rule 2(f) of the SEC's Rules of Practice, which provides that "[c]ontemptuous conduct [of an attorney] at any hearing before the Commission or a hearing officer shall be ground for exclusion from said hearing and for summary suspension without a hearing for the duration of the hearing." S.E.C. Rules of Practice, 17 C.F.R. § 201.2(f) (1981).

16. *See, e.g., In re* James T. DeWitt, 38 S.E.C. 879 (1959) (lawyer alleged to have made false filings with the SEC and to have obtained money from his client on the representation that he would use it to bribe SEC employees).

17. Securities Act Release No. 5088, [1970 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,913 (Sept. 24, 1970).

18. *See In re* Lloyd Feld, Securities Exchange Act Release No. 11775 (Oct. 30, 1975). In *Feld* the Commission instituted a Rule 2(e) proceeding against an attorney on the basis that, acting as counsel for the underwriter in a Regulation A offering, he had failed to exercise due diligence to detect certain false statements in the offering circular. However, it should be noted that nowhere in any federal securities law, rule thereunder, or court opinion related thereto has it ever been determined that the attorney for an underwriter is under a due diligence obligation with regard to investigating the facts of a registration statement. *See In re* Keating, Muething & Klekamp, [1979 Transfer Binder]

This has caused much controversy since an enforcement role for the attorney conflicts with the traditional paradigm of the lawyer-client relationship.[19]

B. Sanctions Available to the SEC

The Securities and Exchange Commission enacted the SEC Rules of Practice[20] to provide for efficient and expeditious conduct of its own administrative proceedings. Rule 2 sets out the requirements for persons who may appear and practice before the Commission. If there is a sufficient basis under Rule 2(e), pursuant to the terms of Rule 2(e)(1), the Commission may deny a professional, either temporarily or permanently, the privilege of appearing or practicing before it "in any way."[21] Rule 2(g) defines "practicing before the Commission" to include: "(1) transacting any business with the Commission; and (2) the preparation of any statement, opinion or other paper by any attorney, accountant, engineer or other expert, filed with the Commission in any registration statement, notification, application, report or other document with the consent of such attorney, accountant, engineer or other expert."[22] This provision clearly prohibits a disciplined attorney from representing a client in a formal or informal administrative proceeding before the SEC. It also specifically prohibits participation in any way in preparing documents to be filed with the Commission. The SEC staff has also taken the position that the prohibition encompasses the giving of any advice relating to any of the federal securities laws.[23]

FED. SEC. L. REP. (CCH) ¶ 82,124, at 81,993 (July 2, 1979) (Karmel, C., dissenting).

The SEC has also instituted Rule 2(e) proceedings against corporate officers, based on their conduct as such, when the officers, who were only incidentally also certified public accountants, allegedly violated the securities laws or violated their duty to prevent others in the corporation from violating the securities laws. *See, e.g., In re* Paul N. Conner, Securities Exchange Act Release No. 14382 (Jan. 16, 1978). This suggests that the SEC might in similar circumstances bring a Rule 2(e) proceeding against an officer of a corporation, who incidentally happened to be a licensed attorney, for violating one of the myriad of rules or regulations of the federal securities laws.

19. The controversy exists even within the Commission itself. *See, e.g., In re* Keating, Muething & Klekamp, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124 (July 2, 1979). In this case, Commissioner Karmel dissents to the SEC's exercise of Rule 2(e) disciplinary proceedings against lawyers, arguing that its use should be restricted at least to situations involving direct practice before the Commission. *Id.* at 81,992-95 (Karmel, C., dissenting).

20. 17 C.F.R. § 201 (1981).

21. *Id.* § 201.2(e)(1) (1981).

22. *Id.* § 201.2(g) (1981).

23. For example, in *In re* Alan Lester Sitomer, Securities Exchange Act Release No.

There are several bases under Rule 2(e) for the SEC to deny a lawyer the privilege of practicing before the Commission. Some of these require an SEC hearing before the sanction may be imposed.[24] Rule 2(e)(1) authorizes the imposition of sanctions against attorneys found by the SEC as a result of a hearing (1) to lack the "requisite qualifications to represent others," (2) to lack the necessary "character or integrity," (3) to have engaged in "unethical or improper professional conduct," or (4) to have "*willfully* violated or *willfully* aided and abetted the violation . . . of the federal securities laws."[25] Unfortunately, no definitions are given for these key terms.

Paragraph 2(e)(2) of the Rule provides two bases for disbarment without a hearing before the SEC.[26] The first is suspension or disbarment by an agency or tribunal of an attorney's license to practice in the state from which he derives such authority, regardless of whether an appeal is pending or could be taken from such a decision. The second basis for automatic disbarment occurs when the lawyer is convicted of a felony, of whatever kind, or a misdemeanor involving moral turpitude. The order of suspension can be entered regardless of whether an appeal of the conviction is pending or could be taken.

Pursuant to paragraph 2(e)(3) of the Rule, there are two bases for the SEC to suspend a lawyer temporarily without a hearing.[27] The first basis is that the lawyer has been permanently enjoined (by reason of his misconduct) by a court, in an action brought by the SEC, from aiding and abetting a violation of the federal securities laws. (If the lawyer consents to the entry of such an injunction, the result is still the same.) The second basis is a finding, either by a court or the Commission in a proceeding to which the lawyer is a party, that the lawyer has willfully violated any provision of the federal securities laws or aided and

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12501 (June 1, 1976), the order entered against one respondent disqualifying him from appearing and practicing before the SEC included a prohibition against the "preparation and issuing [of] written or oral legal opinions with respect to matters involving or relating to the Federal Securities Laws where such matters are not the subject of litigation pending or to be pending [before] any court." *Id.*

24. For an excellent discussion of the uncertainties, ambiguities, and other conceptual problems that practicing lawyers have with these bases for disbarment or suspension, see Marsh, *supra* note 3, at 995-1003.

25. 17 C.F.R. § 201.2(e)(1)(i)-(iii) (1981) (emphasis added).

26. *Id.* § 201.2(e)(2).

27. *Id.* § 201.2(e)(3)(i).

abetted such a violation.[28] The suspended lawyer has a thirty-day period after service on him of the suspension order to apply to have the suspension lifted.

C. *The Statutory Basis for Rule 2(e)*

The SEC has never claimed that it has express statutory authority to discipline lawyers who appear before it. Rather, the SEC bases its authority on its general rulemaking powers under the separate federal securities acts[29] and on its inherent authority under the securities laws in general.[30] There has not been much judicial review of the SEC's position, but what there has been has generally supported the Commission.[31] The clearest affirmation to date of the SEC's position was stated by the Second

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28. An example of a type of decision that would be grounds for SEC action under this second basis is S.E.C. v. National Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978). In this case, the district court found that the attorneys involved had violated the federal securities laws, but refused to issue an injunction against them on the ground that the likelihood of recurrence of the activity was insufficient to warrant an injunction. According to the second basis of paragraph 2(e)(3), the SEC could have suspended the lawyers from SEC practice, without a hearing, because of the court decision.

29. For example, section 23(a)(1) of the Securities Exchange Act of 1934 authorizes the Commission "to make such rules and regulations as may be necessary or appropriate to implement the provisions of this chapter for which [it is] responsible or for the execution of the functions vested in [it] by this chapter." Securities Exchange Act of 1934 § 23(a)(1) as amended at 15 U.S.C. § 78(w)(a)(1) (1976).

30. *See In re* Keating, Muething & Klekamp, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124, at 81,990-92 (July 2, 1979) (Williams, C., concurring).

31. For cases dealing with the validity of Rule 2(e) proceedings and sanctions, see, for example, S.E.C. v. Ezrine, [1972-73 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,594 (S.D.N.Y. 1972); Schwebel v. Orrick, 153 F. Supp. 701 (D.D.C. 1957), *aff'd on other grounds*, 251 F.2d 919 (D.C. Cir.), *cert. denied*, 356 U.S. 927 (1958). However, neither of these cases holds squarely that Rule 2(e) is valid. For example, in *Schwebel* the district court upheld the SEC's authority to proceed under Rule 2(e), but the court of appeals refused to affirm on these grounds, affirming instead on the basis that the attorney failed to exhaust his administrative remedies. 251 F.2d at 919.

In the *Carter (trial)* case, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,175, the two lawyers challenged the SEC's authority to discipline them. The ALJ simply stated, "Suffice it to say [that] Rule 2(e) has been in effect for over forty years and has been upheld by the courts during that period as a proper exercise of the Commission's authority." *Id.* at 82,184. A close examination of the cases cited in *Carter* reveals that none of them represents a clear, unequivocal holding that Rule 2(e) is valid. *See e.g.*, S.E.C. v. Csapo, 533 F.2d 7 (D.C. Cir. 1976); Kivitz v. S.E.C., 475 F.2d 956 (D.C. Cir. 1973); Schwebel v. Orrick, 153 F. Supp. 701 (D.D.C. 1957), *aff'd on other grounds*, 251 F.2d 919 (D.C. Cir.), *cert. denied*, 356 U.S. 927 (1958). *Cf.* Koden v. United States Dep't. of Justice, 564 F.2d 228 (7th Cir. 1977); Herman v. Dulles, 205 F.2d 715 (D.C. Cir. 1953) (cases supporting federal adminsitrative agencies' inherent powers to discipline attorneys); Goldsmith v. United States Bd. of Tax Appeals, 270 U.S. 117 (1926) (Supreme Court rejected the need for a specific statutory provision for a federal adminsitrative agency to regulate the conduct of professionals).

Circuit in *Touche Ross & Co. v. S.E.C.*[32] In that case, an accounting firm requested a federal district court to intervene and halt a Rule 2(e) proceeding.[33] The firm alleged that the SEC exceeded its authority when it instituted the Rule 2(e) proceeding and that this lack of authority deprived the firm of its constitutional right of due process.[34] Touche Ross further contended that Congress had given the power to discipline professionals to state professional organizations, that the firm would be irreparably harmed if it were forced to first proceed administratively, and that the question of the SEC's statutory authority was strictly legal and thus was outside the special competence of an administrative agency, requiring the issue to be considered by the courts and not the SEC.[35]

Touche Ross lost in the district court[36] and appealed to the United States Court of Appeals for the Second Circuit. The court held that Touche Ross did not have to exhaust its administrative remedies before the court was authorized to make a final determination of the SEC's authority to bring Rule 2(e) proceedings because (1) to require Touche Ross to exhaust its administrative remedies would be to require it to submit to the very procedures it was attacking and (2) since the issue was purely one of statutory interpretation, there was no need for the exercise of agency discretion or for the application of agency expertise.[37] The Second Circuit concluded that Rule 2(e) was valid because (1) the Rule had been in effect for over forty years and

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32. Touche Ross & Co. v. S.E.C., [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,854 (2d Cir. 1979) [hereinafter cited as *Touche Ross (appeal)*].

33. Touche Ross & Co. v. S.E.C., [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,415 (S.D.N.Y. 1978) [hereinafter cited as *Touche Ross (trial)*].

34. *Id.* at 93,498.

35. *Id.*

36. *Touche Ross (trial)*, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,415 (S.D.N.Y. 1978). The district court ruled that before a court can intervene in a federal administrative agency proceeding, the court must find a flagrant violation by the agency of its statutory authority. *Id.* at 93,500. The court held that the SEC was not acting in excess of its authority and therefore had not abused its discretion by instituting the Rule 2(e) proceeding. *Id.* at 93,502. The basis cited for this decision was the forty-year history of Rule 2(e) and the judical precedents related to the Rule. *Id.* at 93,499-502. (The court cited the same precedents listed by the Administrative Law Judge in the *Carter* case.) The court next applied the general rule that Touche Ross had to first exhaust its administrative remedies before appealing to the courts. *Id.* at 93,502-03. The district court's opinion, therefore, did not represent a square holding on the substantive question of the validity of Rule 2(e).

37. *Touche Ross (appeal)*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,854, at 95,479.

no court had ever expressly held that Rule 2(e) was invalid;[38] (2) there was no express statutory prohibition against such a rule;[39] (3) the SEC was using Rule 2(e) merely to "preserve the integrity of its own procedures, by assuring the fitness of those professionals who represent others before the Commission," and not as an additional weapon in its enforcement arsenal to usurp the jurisdiction of the federal courts to deal with violations of the securities laws;[40] (4) the SEC had sufficient statutory authority to adopt Rule 2(e) under the general provisions of each of the securities laws, which authorize the Commission to adopt rules and regulations to implement the provisions of each of those statutes;[41] and (5) the powers exercised by the SEC under Rule 2(e) constitute a reasonable and direct adjunct to the Commission's explicit statutory power.[42]

The Second Circuit, in effect, gave approval to the Commission's position that it is entitled to conscript attorneys and accountants as an enforcement arm of the Commission.[43] Nevertheless, some important issues with respect to the SEC's authority to pursue Rule 2(e) proceedings remain after *Touche Ross*. In the first place, since the Supreme Court has never ruled on the validity of Rule 2(e), the issue is still open. Secondly, the Second Circuit is the only court of appeals to address the question, and there are many reasons to question the court's

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38. *Id.* at 95,480.

39. *Id.* at 95,479-83.

40. *Id.* at 95,481.

41. *Id.* at 95,481-82.

42. *Id.* at 95,481 (quoting United States v. Chesapeake & O. Ry., 426 U.S. 500, 514 (1976)). The court of appeals in *Touche Ross (appeal)* reasoned that since the SEC must rely heavily in the performance of its statutory duties upon the professionals that practice before it, rules relating to the discipline of such professionals are "reasonably related" to the purposes of the securities laws and to the protection of the public in general. *Id.* at 95,481-83. Therefore, the court concluded that Rule 2(e) was authorized by the statutes which grant the Commission general authority to adopt rules and regulations which are necessary and appropriate for the implementation of the basic statutes. *See id.* at 95,483.

43. The Second Circuit stated:

> By the very nature of its operations, the Commission, with its small staff and limited resources, cannot possibly examine, with the degree of close scrutiny required for full disclosure, each of the many financial statements which are filed. Recognizing this, the Commission necessarily must rely heavily on both the accounting and legal professions to perform their tasks diligently and responsibly. Breaches of professional responsibility jeopardize the achievement of the objectives of the securities laws and can inflict great damage on public investors.

Id. at 95,482.

analysis.[44]

D. The Carter *Opinions*

One of the most important recent Rule 2(e) cases is *In re William R. Carter*[45] (*Carter (trial)*), and its subsequent appeal by the disciplined lawyers to the full Commission[46] (*Carter (appeal)*).

In *Carter (trial)*, the SEC again asserted its authority to discipline an attorney for involvement in a securities transaction generally, not just for misconduct in an administrative proceeding before the Commission. A detailed discussion of the facts of the *Carter* case is necessary in order to fully understand what it portends for securities lawyers. National Telephone Company ("National") was in the business of installing and leasing telephone systems which interfaced with AT&T telephone lines. Carter and Johnson, partners in the law firm of Brown, Wood, Ivey, Mitchell & Petty ("Brown, Wood"), commenced representing National on an ad hoc basis in the spring of 1974. In July of 1974, Johnson was elected secretary of the company and, in this capacity, attended several of its board meetings. Johnson resigned from this position in May of 1975.[47] National also employed in-house counsel who apparently prepared most of National's reports for filing with the SEC.

Although Brown, Wood was primarily concerned with matters arising under the securities laws, National also relied on the firm in connection with the negotiation of a bank loan. National's business was growing rapidly, but each new phone system it leased involved heavy front-end installation and equipment expenditures, well in advance of the receipt of any rental income; hence, the more it grew, the greater became its negative

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44. These arguments are lengthy and beyond the scope of this Article. For a general discussion of the arguments see Marsh, *supra* note 3; Downing & Miller, *The Distortion and Misuse of Rule 2(e)*, 54 NOTRE DAME LAW. 774 (1979). *See also In re* Keating, Muething & Klekamp, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124 (July 2, 1979) (SEC Chairman Williams argues for the validity of Rule 2(e) and Commissioner Karmel argues against its validity).

45. *Carter (trial)*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,175 (Mar. 7, 1979).

46. *Carter (appeal)*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,847 (Feb. 28, 1981).

47. *Carter (trial)*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) at 82,167-68 (Mar. 7, 1979).

cash flow.[48] In the spring of 1974, National arranged with a consortium of banks for a $15 million term loan to be secured by an assignment of its lease receivables. Before the term loan could be finalized, however, National began taking short-term advances and had used up substantially all of this line of credit by September of 1974.[49] In order to deal with this problem, National developed a "wind-down" plan which was to be resorted to if the company exhausted its available credit and could not expand further. The plan involved terminating all sales personnel, leasing sufficient additional systems to reduce its equipment inventory, and then becoming strictly a lease maintenance company, servicing the systems it had already installed, but "selling" no additional leases.[50] By the time the bank loan finally closed in December 1974, the company was facing a financial crisis.[51] The banks, acting on the advice of a consultant who recommended against the wind-down plan except as a last resort, increased the amount of the term loan from $15 million to $21 million. Under the terms of the $21 million loan, National had the right to borrow only $1 million more prior to May 1, 1975. The remaining $2 million available under the loan agreement could be used only to implement the wind-down program, which was now referred to as the "lease maintenance program" (LMP). Under the terms of the loan agreement, National was required to implement the LMP if it borrowed in excess of $19 million from the banks or if its cash position deteriorated below certain specified ratios.[52]

National's officers, many of its directors, and Johnson and Carter were all aware that the bank loan agreement would not provide adequate capital to sustain the growth that the company had projected for fiscal 1975 in its June 1974 annual report to shareholders.[53] By January of 1975, National was within $11,000 of exceeding the specified cash ratios for triggering the exercise of the LMP. In March it clearly became obligated to implement the LMP, but failed to do so.[54] In fact, no public disclosure of National's obligation to implement the LMP was made until

48. *Id.* at 82,166.
49. *Id.* at 82,167, 82,170.
50. *Id.* at 82,170.
51. *Id.* at 82,173.
52. *Id.* at 82,172.
53. *See, e.g., id.* at 82,169, 82,171.
54. *Id.* at 82,176-77.

May 28, 1975, the day after the directors removed Hart, the president of National.[55] (Although not emphasized by the Adminsitrative Law Judge (ALJ), it appears that through much of the crisis National and Hart were negotiating with an investment banking firm to undertake additional equity or other financing for National and there was some expectation that such financing might take place.[56] The financing never did materialize, however, because of generally unfavorable market conditions.)

During all of this time, Hart and National were releasing, in the form of letters, press releases, and reports to shareholders, optimistic statements about the company's earnings and growth prospects, without qualifications concerning the difficult cash position of the company.[57] Knowing that National had been giving very optimistic reports to the public despite a poor cash position and the inability to locate additional financing, Johnson, on October 20, 1974, drafted a letter which stated that the company regarded curtailment as advisable in view of the company's negative cash flow and the adverse market situation for financing. Johnson gave the letter to National's in-house counsel with the suggestion that the letter be sent to all shareholders. It was not sent.[58] In March of 1975, Carter and Johnson, having been informed by the banks' consultant that National was obligated under the loan agreement to implement the LMP, advised Hart that immediate disclosure was required. This advice was repeated on April 23.[59] On May 1, Johnson drafted a disclosure letter relating to the implementation of the LMP, but Hart did not send it to the shareholders. Brown, Wood also advised National's in-house counsel to disclose the LMP in the April Form 8-K report filed with the SEC, but was not successful.[60] Brown, Wood did nothing further until the directors of National called a meeting on May 24th, at which time Brown, Wood first informed the directors of Hart's prior failure to follow their advice regarding the necessity for disclosure.[61] Johnson shortly thereafter drafted a press release describing National's condition. The

55. *Id.* at 82,178.
56. *See id.* at 82,170.
57. *Id.* at 82,170-71, 82,175-76.
58. *Id.* at 82,171.
59. *Id.* at 82,176-77.
60. *Id.*
61. *Id.* at 82,178.

company went into Chapter XI bankruptcy on July 2, 1975.

The SEC instituted a Rule 2(e) proceeding against Carter and Johnson alleging that the attorneys had willfully violated and willfully aided and abetted violations of sections 10(b) and 13(a) of the 1934 Act and Rules 10b-5, 12b-20, and 13a-11 thereunder. The SEC also alleged that the attorneys had engaged in unethical and improper professional conduct.[62] The specific actions that were the basis of the SEC's charges all occurred in December 1974 and January 1975. Knowing that National was experiencing a severe cash crisis which could affect the continued viability of the company, that the credit agreement would not solve the problem, that National's growth projections could not be achieved if the wind-down plan were implemented, and that National's management was unreceptive to making the disclosure that they were urged to make, Carter and Johnson prepared a press release on December 20, 1974, and prepared a Form 8-K for the month of December, both of which described the loan agreement. The press release and the Form 8-K referred to the increase of the line of credit from $15 million to $21 million and reflected the fact that $16.5 million had been used to repay short-term debt.[63] The press release stated that $1.5 million was to be applied for "operating expenses," a statement found by the ALJ to be incorrect since it was actually used to pay off indebtedness existing at the time the loan was made.[64] In addition, the press release alluded to the lease maintenance program, without fully explaining it or its implications.[65] A third document, a letter to the shareholders sent out by National without Brown, Wood's approval, also explained the lease maintenance plan in a backhanded fashion. The letter assured shareholders that the LMP would not be detrimental to continued earnings growth, and that National was "stronger now than ever before in its history."[66] Carter and Johnson had earlier advised National not to issue any such statement unless it was cleared by them.[67] They became aware of the contents of the shareholder letter on December 27, when an assistant at National, realizing that the company had ignored the attorneys' advice, dis-

62. *Id.* at 82,165.
63. *Id.* at 82,173.
64. *Id.*
65. *Id.*
66. *Id.*
67. *Id.*

closed the contents of the letter.[68] Carter and Johnson concluded that the description of the amended loan agreement was not adequate disclosure, but argued that if read in conjunction with the press release of December 20, the shareholder letter was not misleading.[69] (Note that there was no determination that the shareholders would have been aware of the contents of the press release.) From January 1975 until Hart's resignation in May, the company continued to issue optimistic public reports.[70] Furthermore, on March 11, Hart falsely certified to the lending banks that the LMP had been implemented.[71]

In the initial hearing before the ALJ, the lawyers were charged with a duty of disclosure to the corporation's Board of Directors (and possibly to third parties as well) in the face of management's past and continuing disregard for the lawyers' advice that the federal securities laws required a public disclosure of material facts concerning the corporation's financial condition.[72] The ALJ found that the press release and the Form 8-K were misleading because they failed to disclose the likelihood that the LMP would have to be instituted and its implications for further company growth.[73] Carter and Johnson were not only held accountable with respect to the inadequate disclosure, but were also found to have assisted Hart in avoiding the inclusion of the LMP as part of the December 1974 Form 8-K by treating it as an instrument delivered to the banks and alluded to in the bank loan agreement, rather than as an exhibit to the loan agreement which would have had to be filed as an exhibit to the Form 8-K.[74] Hart did not want the LMP to be filed with the SEC because of his concern over its impact on employee morale.[75] The ALJ remarked that if the LMP was material to employees, it would have been material to investors as well.[76] The ALJ concluded:

> The record shows that respondents went from a short no knowledge period through a drift or culpable posture to an acquiescence of violations stage and, finally, to actual participa-

68. *Id.*
69. *Id.* at 82,173-74.
70. *Id.* at 82,175-78.
71. *Id.* at 82,176.
72. *Id.* at 82,168-69.
73. *Id.* at 82,173, 82,175.
74. *Id.* at 82,174.
75. *Id.*
76. *Id.* at 82,175.

> tion in the violative activities.
>
> The matter of counsel responsibility when confronted with irregular or illegal client activity involves a delicate balance between judgment and courage. Counsel needs to guard against falling prey to blandishments of client by accepting repeated evasions and rationalizations, or worse, to allow himself to be drawn into or become a party to the illegal activity. Decision concerning the point at which further persuasion in the face of client defiance becomes futile cannot be postponed indefinitely. To drift may be as culpable as to connive. At some point it becomes necessary to take a stand.[77]

As a result of its findings the ALJ suspended Carter from practice before the Commission for a period of one year, and suspended Johnson for nine months.[78]

Perhaps the most important aspect of the *Carter* case is its interpretation of some of the broad, previously undefined terms set forth in Rule 2(e) as bases for disbarment or suspension. The broad statements in Rule 2(e)(1) authorizing disciplinary action against lawyers determined by the SEC to lack the "requisite qualifications to represent others" or the necessary general "character or integrity," or found to have "engaged in unethical or improper professional conduct," were attacked by the defendants in *Carter (trial)* as being unconstitutionally vague since they did not provide sufficient notice of their meaning, and did not apprise those charged of the specific standards or rules by which their conduct would be judged.[79] The ALJ rejected these arguments, and indicated that there were several sources from which the lawyers could have discovered the standards which the SEC relied upon in reaching its decisions: (1) While it did not administer the American Bar Association's Code of Professional Responsibility, the SEC was said to have "incorporated" the guidelines of the Code in its own lawyer conduct regulation.[80] (2) The language of Rule 2(e) was also said to give suffi-

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77. *Id.* at 82,186.

78. *Id.* at 82,169, 82,187.

79. *Id.* at 82,180-81.

80. *Id.* at 82,181. The ALJ referred to the following specific Code sections: DR 1-102(A)(4), "which states that a lawyer shall not engage in conduct involving dishonesty, fraud, deceit, or misrepresentation," *id.* at 82,181 n.18 (note that the general notion of these terms in the law is usually that the lawyer shall not "knowingly" or "intentionally" engage in such conduct); DR 7-102(A)(7), "which states that in his representation of a client a lawyer shall not knowingly counsel or assist his client in conduct that the lawyer knows to be illegal or fraudulent," *id.* (note that this disciplinary rule specifically prohibits "knowing" conduct); EC 5-18, which makes the entity or organization, rather than the

cient notice of the proscribed unethical conduct when measured by "common understanding and practice."[81] (3) Many pronouncements of professional standards were said to be contained in Commission decisions in past Rule 2(e) proceedings.[82]

The *Carter* case also involved the determination of the appropriate standard of culpability under Rule 2(e).[83] Subpart (iii) of Rule 2(e)(1), which imposes liability when a lawyer has "willfully violated" or "willfully aided and abetted" the violation of any federal securities laws, does define a specific standard. At the time of the *Carter* opinion, and as a result thereof, there was substantial debate concerning whether the SEC actually abided by this standard. Critics of the SEC have said that it did not, that in fact the Commission had brought actions based on negligent mistakes by lawyers.[84] A close analysis of the cases brought by the SEC under Rule 2(e) indicates that most are based on situations in which the defendants *actually knew* that their conduct was improper.[85] However, there are some cases which seem to be based on a less stringent standard.[86]

In the *Carter* case, the ALJ determined that omissions in the press release of December 20, 1974, the shareholder's letter of December 23, 1974, and the Form 8-K for December 1974,

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officers or directors connected with the entity, the lawyer's client, *id.* at 82,181 (note that no specific culpability standard is mentioned in connection with this provision in the ABA's Code). With respect to this last provision, the ALJ concluded that the defendant lawyers owed a specific ethical duty to go to the corporation's board of directors when the president and other officers refused to disclose to the public certain material facts, and that the lawyer's knowing failure to perform this duty was proper basis for disciplinary action against the lawyers pursuant to Rule 2(e). *See id.* at 82,182-83.

81. *Id.* at 82,181.

82. *Id.*

83. *See id.* at 82,179-80. This issue was raised in connection with the charges that Carter and Johnson had explicitly assisted National in its violations of the securities laws by drafting the faulty press release and the 8-K report filed with the SEC. *Id.* at 82,179. Many commentators contend that the *Carter* case is a good illustration of the SEC's use of Rule 2(e) to avoid the scienter requirement of suits brought, for example, pursuant to Rule 10b-5 of the 1934 Act. *See* Comment, *Attorney Liability Under S.E.C. Rule 2(e): A New Standard?*, TEX. TECH. L. REV. 83, 90-95 (1979).

84. *See, e.g., In re* Keating, Muething & Klekamp, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124 (July 2, 1979) (dissenting opinion of Commissioner Karmel); Miller, *The Distortion and Misuse of Rule 2(e)*, 7 SEC. REG. L.J. 54 (1979).

85. *In re* Irwin L. Germaise & Thomas F. Quinn, Securities Act Release No. 5216 (1971); *In re* Marshall I. Steward, Securities Act Release No. 4829 (1966); *In re* James T. DeWitt, 38 S.E.C. 879 (1959).

86. *See, e.g., In re* Jo M. Ferguson, Securities Act Release No. 5523 (Sept. 3, 1974) (lawyer held liable upon showing that he knew or should have known of violations); *In re* Haskins & Sells, Accounting Series Release No. 73 (Oct. 30, 1952) (accountant held liable despite fact that not found to have acted willfully).

contained material misstatements and omissions, and that the lawyers had willfully aided and abetted their publication.[87] The ALJ agreed with defendants Carter and Johnson that *willfully* meant *intentionally*.[88] Thus, the question in *Carter* focused on the meaning of the word *intentionally* in the context of a Rule 2(e) proceeding. Carter and Johnson argued that the standard required that it be shown that they (1) *knew* the falsity and materiality of the matters alleged, *and* (2) had an intent to defraud investors.[89]

The ALJ rejected this interpretation, noting that in administrative proceedings "intent" has usually been held to mean merely "intentionally committing the act which constitutes the violation."[90] There is no requirement that the actor know that he is violating the securities laws or is acting in a fraudulent manner. Moreover, the SEC had previously held that the *Ernst & Ernst v. Hochfelder*[91] standard of scienter for Rule 10b-5 causes of action was inapplicable to SEC administrative proceedings.[92] Furthermore, the *Hochfelder* "knowing" conduct test for scienter was satisfied anyway since the attorneys had committed a "knowing" violation.[93] The ALJ did not attempt to explain in detail what he meant by "knowing."[94]

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87. *Carter (trial)*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) at 82,168-69.

88. *Id.* at 82,180.

89. *Id.* The defendants cited Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1975), in which the U.S. Supreme Court set the culpability standard for Rule 10b-5 private causes of action for damages, as authority for their position. However, unlike Rule 2(e) of the SEC Rules of Practice, Rule 10b-5 has a statutory basis in section 10(b) of the 1934 Act.

90. *Carter*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) at 82,180 (quoting Tager v. S.E.C., 344 F.2d 5, 8 (2d Cir. 1965)).

91. 425 U.S. 185 (1975).

92. *Carter*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) at 82,180.

93. *Id.*

94. Some insight into what the ALJ meant by "knowingly" may be gained by examining the cases referred to by the ALJ. The ALJ cited the case of S.E.C. v. Blatt, 583 F.2d 1325 (5th Cir. 1978). The *Blatt* case refers to the case of Arthur Lipper Corp. v. S.E.C., 547 F.2d 171 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978), which involved a disciplinary proceeding brought by the SEC against broker-dealers pursuant to section 15 of the 1934 Act. In *Arthur Lipper*, the United States Court of Appeals for the Second Circuit assumed that the *Hochfelder* culpability standard applied. *Id.* at 181. The court suggested that the *Hochfelder* standard amounted to something more than negligence—something akin to "Thou shalt not devise any other cunning device." *Id.* The cunning device in *Arthur Lipper* was a scheme by the broker-dealers which they knew was complicated and likely to confuse the investors, inducing them to make certain investment decisions. The court stated that the fact that the broker-dealers may not have actually realized that the scheme was unlawful was not a defense. *Id.* Thus, the Second Circuit interpreted the *Hochfelder* standard to require proof of a general, knowing intention to deceive or defraud, but not to require proof of a knowing violation of the securi-

Having identified the culpability standard, the ALJ considered the next issue, the appropriate burden of proof. At the time of the *Carter* decision there was a debate among the federal courts of appeals concerning the required burden of proof in SEC administrative proceedings. Some circuits had held that when the SEC seeks to impose remedial sanctions for fraud in administrative proceedings against registered broker-dealers (pursuant to its authority under the 1934 Act), the Commission must establish its case by "clear and convincing evidence."[95] However, other courts had held that in these circumstances a "preponderance of the evidence" is sufficient.[96] Most writers on this issue have found it obvious that, under either standard, the SEC did not meet its burden of proof against Carter and Johnson,[97] despite the ALJ's conclusion that the SEC had satisfied even the more exacting standard of "clear and convincing evidence."[98]

In the appeal of *Carter* to the Commission itself,[99] (*Carter (appeal)*), the SEC, without abandoning the substance of the revolutionary positions it had staked out over the past several years, took some positions that are comforting to securities lawyers.

The *Carter (trial)* opinion did not make a precise distinction between its stated conclusions relative to primary violations of the securities laws and aiding and abetting liability. The SEC in *Carter (appeal)* did so, holding that the lawyers' involvement in the affairs of the company was not sufficient to justify a finding that they were primary violators of the securities laws.[100] With respect to the question of whether the lawyers had affirma-

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ties laws. If a general intent to deceive or defraud (without actual knowledge) is sufficient to establish a cause of action under the *Hochfelder* standard, it seems logical that a knowing violation of the securities laws should also be sufficient, since a knowing violation of a law meant to prevent investors from being misled implies an intent to defraud the investors.

95. *E.g.*, Collins Securities v. S.E.C., 562 F.2d 820, 824-26 (D.C. Cir. 1977).

96. Steadman v. S.E.C., 603 F.2d 1126, 1137-40 (5th Cir. 1979). The Supreme Court has recently adopted the preponderance rule argued for in *Steadman*. Steadman v. S.E.C., 450 U.S. 91, 100-02, *reh'g. denied*, 451 U.S. 933 (1981).

97. *See, e.g.*, Dockery, *Attorney Liability Under SEC Rule 2(e): A New Standard?* 11 TEX. TECH. L. REV. 83 (1980).

98. *Carter (trial)*, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) at 82,165.

99. *Carter (appeal)*, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,847. The Commission essentially made the same findings as the ALJ had made on the material omissions or misstatements. *Id.* at 84, 150-64.

100. *Id.* at 84,165.

tively and "willfully" aided and abetted their client's violations of the securities laws, the Commission somewhat remarkably abandoned the position on the culpability standard taken by the ALJ in *Carter*, holding instead that in an aiding and abetting charge pursuant to Rule 2(e) the SEC is required to prove a specific intent to defraud or, at least, recklessness.[101]

In analyzing whether the lawyers had violated this standard, the Commission began with a common statement of the aider and abettor concept: the aider and abettor is one who, where there has been a primary violation of the laws, (1) knows that the primary violator is engaged in activity that will deceive another or is illegal, (2) renders substantial assistance to the primary violator, and (3) is aware or knows that his role was part of the improper or illegal activity.[102]

Concerning the issue of whether the lawyers in *Carter* rendered "substantial assistance," the SEC adopted an expansive definition, indicating that this element of an aiding and abetting charge is intrinsically easy to prove against any securities lawyer who "is inevitably deeply involved in his client's disclosure activities and often participates in the drafting of documents."[103] The Commission stated:

> [W]e do not distinguish between the professional advice of a lawyer given orally or in writing and similar advice which is embodied in drafting documents to be filed with the Commission. Liability in these circumstances should not turn on such artificial distinctions, particularly in light of the almost limitless range of forms which legal advice may take. Moreover, the opposite approach, which would permit a lawyer to avoid or reduce his liability simply by avoiding participation in the drafting process, may well have the undesirable effect of reducing the quality of the disclosure by the many to protect against the defalcations of the few.[104]

The SEC then focused on the critical issue—whether the lawyers had "willfully" aided and abetted their client's violations—that is, whether they had the necessary intent for culpability. The SEC stated:

> It is axiomatic that a lawyer will not be liable as an aider

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101. *See id.* at 84,167.
102. *Id.* at 84,165-67.
103. *Id.* at 84,166.
104. *Id.* at 84,166-67.

> and abettor merely because his advice, followed by the client, is ultimately determined to be wrong. What is missing in that instance is a wrongful intent on the part of the lawyer. It is that element of intent which provides the basis for distinguishing between those professionals who may be appropriately considered as subjects of professional discipline and those who, acting in good faith, have merely made errors of judgment or have been careless.
>
> Significant public benefits flow from the effective performance of the securities lawyer's role. The exercise of independent, careful and informed legal judgment on difficult issues is critical to the flow of material information to the securities markets. Moreover, we are aware of the difficulties and limitations attendant upon that role. In the course of rendering securities law advice, the lawyer is called upon to make difficult judgments, often under great pressure and in areas where the legal signposts are far apart and only faintly discernible.
>
> If a securities lawyer is to bring his best independent judgment to bear on a disclosure problem, he must have the freedom to make innocent—or even, in certain cases, careless—mistakes without fear of legal liability or loss of the ability to practice before the Commission. Concern about his own liability may alter the balance of his judgment in one direction as surely as an unseemly obeisance to the wishes of his client can do so in the other. While one imbalance results in disclosure rather than concealment, neither is, in the end, truly in the public interest. Lawyers who are seen by their clients as being motivated by fears for their personal liability will not be consulted on difficult issues.[105]

In reaching a decision on the charge of willfully aiding and abetting the violation of the securities laws, the Commission stated that with respect to the press release and the 8-K filing, the judgment was close but that the "available evidence [was] insufficient to establish that . . . respondent acted with [either] sufficient knowledge and awareness or recklessness to satisfy the test for willful aiding and abetting liability."[106] The lawyers may have known about their client's financial condition and the failure to disclose the details of the lease maintenance plan and its effect if implemented; however, they may not have known that failure to disclose such information was material since, among other things, they relied on the chief executive officer's assur-

105. *Id.* at 84,167.
106. *Id.*

ances that other financing sources were available and that he was pursuing them.

With respect to the client's continued failure to make material disclosures after January 1975, the Commission stated that the lawyers' failure to act did not manifest the required intent to foster or aid a violation of the securities laws by inaction or silence; rather, the SEC noted that the lawyers had made numerous attempts to get the client to make disclosures, but were continually rebuffed and were "at a loss for how to deal with a difficult client."[107]

This part of the opinion seems very positive and reassuring for securities lawyers. In the first place, the language quoted above seems to be sensitive to the securities lawyer's problems in dealing with the complexities of advising clients concerning the securities laws, and is more deferential to the traditional notions of the lawyer's role as a client advocate, than any recent SEC statements on the subject. Second, the opinion seems to indicate that hindsight prosecutorial judgments that an attorney's opinion or conduct was erroneous, or that something more should have been done will not necessarily lead to enforcement actions.

In *Carter (appeal)*, the SEC also addressed the issue of whether Carter and Johnson had engaged in unethical or improper professional conduct. The Commission found that although their conduct was improper, they should not be sanctioned because "elemental notions of fairness dictate that the Commission should not establish new rules of conduct and impose them retroactively upon professionals who acted at the time without reason to believe that their conduct was unethical or improper."[108] The SEC noted that there are many generally accepted norms of professional conduct which it feels free to apply without prior formal announcement; however, the responsibility of a lawyer in the situation of a client violating its disclosure obligations under the securities laws, in the Commission's view, had not been "firmly and unambiguously established."[109]

The SEC suggested that considerable consensus did exist about certain ethical standards. For example, (1) the corporation, not management, is the security lawyer's client, (2) the lawyer must not knowingly provide substantial assistance to a client

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107. *Id.* at 84,169.
108. *Id.* at 84,169-70.
109. *Id.* at 84,170.

engaged in illegal conduct, and (3) the lawyer must make all reasonable efforts to prevent a client from engaging in proposed illegal conduct.[110] However, the SEC stated that applying these general principles when members of the corporation's management refuse to take the lawyer's advice to make material disclosures is not "a simple task."[111] For example, if the company's management took the position from the beginning that it would disclose only what it absolutely had to, this would not be a basis for resignation or for extraordinary action by the lawyers.[112] But if as time went by and it became clear that the company's management was not looking to the lawyers for disclosure advice but instead was resisting such advice and seeking to avoid the required disclosure altogether, the normal lawyer-client relationship could be said to have terminated and the lawyer would be required to do "more than stubbornly continue to suggest disclosure when he knows his suggestions are falling on deaf ears."[113]The SEC then stated its rule of law to cover this situation:

> When a lawyer with significant responsibilities in the effectuation of a company's compliance with the disclosure requirements of the federal securities laws becomes aware that his client is engaged in a substantial and continuing failure to satisfy those disclosure requirements, his continued participation violates professional standards unless he takes prompt steps to end the [client's] noncompliance.[114]

What steps does this rule require if corporate management refuses to make the required disclosures? The SEC suggested that this is for the lawyer to determine:

> Resignation is one option, although we recognize that other considerations, including the protection of the client against foreseeable prejudice, must be taken into account in the case of withdrawal. A direct approach to the board of directors or one or more individual directors or officers may be appropriate; or he may choose to try to enlist the aid of other members of the firm's management. What is required, in short, is some prompt

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110. *Id.* at 84,170-71.

111. *Id.* at 84,171.

112. *Id.*

113. *Id.* at 84,172.

114. *Id.* The SEC has sought public input on the appropriateness of this standard and whether it should be expanded or modified in some way. S.E.C. Release No. 18106, FED. SEC. L. REP. (CCH) ¶ 83,026 (Sept. 21, 1981).

> action that leads to the conclusion that the lawyer is engaged in efforts to correct the underlying problem, rather than having capitulated to the desires of a strong-willed, but misguided client.[115]

The SEC went on to state that the lawyer need not actually succeed in persuading the client to follow his advice or resign in order to avoid SEC discipline: "So long as a lawyer is acting in good faith and exerting reasonable efforts to prevent violations of law by his client, his professional obligations have been met."[116]

The American Bar Association initially responded negatively and with substantial resistance to the SEC's position that the lawyer should act like an accountant vis-a-vis his client.[117] But over the subsequent years, there has been a grudging movement, however slight, toward adopting at least some of the points being argued for by the SEC, even if only in modified form and only on some very narrow issues. This movement is reflected in the ABA's recently proposed Model Rules of Professional Conduct (MRPC).[118]

Under the standards set forth in the final draft of the MRPC, if a lawyer knows that a person associated with a corporate client is engaged in or intends to engage in illegal conduct, he must take the steps that are reasonably necessary, in the best interests of a corporate client, to prevent a violation of law which is likely to result in a material injury to the corporation.[119] In determining how to proceed, the lawyer must give consideration to several factors, including the seriousness of the possible consequences of the violation, and then take action designed to minimize the disruption to the corporation and the risk of revealing information to persons outside the organization.[120] The MRPC suggests several possible measures for the lawyer to take.

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115. *Carter (appeal)*, [1981 Transfer Binder] FED. SEC. L. REP. at 84,172 (footnotes omitted).

116. *Id.* at 84,172-73. However, the Commission pointed out that there may, nonetheless, be situations where the client's conduct is so serious and extreme, or the involvement of the client's board of directors so pervasive, that the lawyer has no choice but to resign. *Id.* at 84,173.

117. *See Statement of Policy Adopted by American Bar Association Regarding Responsibilities and Liabilities of Lawyers in Advising with Respect to the Compliance by Clients with Laws Administered by the Securities and Exchange Commission*, 31 BUS. LAW. 543 (1975).

118. MODEL RULES OF PROFESSIONAL CONDUCT (Discussion Draft 1980).

119. *Id.*, Rule 1.13(b).

120. *Id.*

He may (1) get a second lawyer's opinion, (2) ask the client to reconsider his actions, or (3) reveal the alleged violation to a higher authority in the corporate organization, including the highest possible authority if the matter is of sufficient seriousness.[121] Furthermore, if the highest authority (i.e., the Board of Directors) refuses to take action, a clear violation of law is involved, and substantial injury to the corporation is likely, then the lawyer may take further remedial action which he believes to be in the best interests of the corporation.[122] This action may include disclosure of confidential communications of the client only if the lawyer reasonably believes that revealing such information is in the best interests of the organization.[123]

Members of the securities bar have expressed much concern about this possible whistle-blowing duty ever since *S.E.C. v. National Student Marketing Corp.*,[124] in which the SEC argued that the securities lawyer had a duty to report his clients' violations of the federal securities laws to the appropriate authorities.[125] Significantly, in *Carter (appeal)*, the SEC reaffirmed its position that there are circumstances that might require the securities lawyer to blow the whistle on his client.[126] Thus, on the specific, narrow point of the securities lawyer's duty to inform the board of directors of a corporate client (and possibly the shareholders) of corporate management's actual or intended violations of the securities laws, the SEC and the ABA are now in broad general agreement (assuming that the new MRPC is adopted). Of course, the ABA's position states the lawyer's duties in careful, limiting language and grants the lawyer discretion to protect the client's interests by refusing to disclose client confidences to third parties, including the SEC.[127] The SEC, as

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121. *Id.*

122. *Id.*, Rule 1.13(c).

123. *Id.*

124. 457 F. Supp. 682 (D.D.C. 1978).

125. *Id.* at 712-15.

126. *See Carter (appeal)*, [1981 Transfer Binder] FED. SEC. L. REP. at 84,173 n.78. The Commission indicated, however, that *Carter (appeal)* was not one of these situations. The SEC stated that DR 7-102(B) of the *ABA Code of Professional Responsibility* might require disclosure by the lawyer of client confidences when the client is committing active fraud vis-a-vis third parties and using the lawyer's services in furtherance of the fraud, while no such duty exists in situations analogous to *Carter* in which the lawyer failed to act when the client refused to follow the lawyer's advice to make appropriate disclosures. *Id.*

127. See, for example, Rule 1.7(b), which provides that the lawyer shall reveal matters relating to the representation of his client if the lawyer believes it is necessary "to

might be expected, takes a more expansive view of the lawyer's duties in order to protect the public interest.

III. Conclusion

A. *Trend Toward a Consensus on the Duties of Securities Lawyers*

In summary, there appears to be a gradual coming together of the positions relating to lawyer duties in securities transactions taken by the SEC (as represented by the SEC's decision in *Carter (appeal)*), the legal profession (as represented by the ABA's positions in the MRPC, although the final draft is substantially more reserved in its general terms than was the earlier discussion draft), and the courts (as represented by the trend started by the *Hochfelder* case). For example, *Carter (appeal)* affirms that specific intent must be proved to make out a Rule 2(e) case for "willful" conduct (an approach similar to that taken by the courts since *Hochfelder*). In addition, the SEC has indicated that before liability will be found for improper ethical conduct, clear and unambiguous ethical standards must exist to guide the attorney's conduct,[128] thus leaving all but the most obvious disciplining to the professional organizations. It also appears that there is some agreement that, at least in some circumstances, a lawyer representing a corporate client may have a duty to make disclosures to the board of directors and possibly to third parties concerning matters relating to the lawyer's representation of his client. Of course, there is yet much disagreement to resolve over the issue of whether the lawyer has a duty to disclose a corporate client's confidences, relating to securities laws violations, to the SEC. And finally, the SEC seems to have adopted a more conciliatory point of view toward the difficulties faced by the securities lawyer in applying the law to the specific facts of a case.

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prevent the client from committing an act that would result in death or serious bodily harm to another person, and to the extent required by law or the rules of professional conduct." Model Rules of Professional Conduct, Rule 1.7(b) (Discussion Draft 1980). Compare Rule 1.7(c) which provides that the lawyer *may* reveal information about his client "to the extent it appears necessary to prevent or rectify the consequences of a deliberately wrongful act by the client." *Id.*, Rule 1.7(c)(2).

128. *See Carter (appeal)*, [1981 Transfer Binder] Fed. Sec. L. Rep. at 84,169-70.

B. *The Authority of the SEC to Establish Professional Standards: A Continuing Issue*

In *Carter (appeal)* the SEC reiterated its position that it has authority to discipline lawyers practicing before it, and to independently establish and issue ethical and professional standards for lawyers generally engaged in a federal securities law practice. Although the first such ethical standard announced by the SEC seems reasonable, and its application to the facts of *Carter (appeal)* appears to be eminently appropriate, the fundamental issues of whether the SEC does in fact have, or ought to have, such authority, and whether the authority is as broad as it claims, still remain undecided by the Supreme Court. Furthermore, since the SEC's position on lawyer duties in securities transactions is, and is likely to remain, more expansive than that taken by the ABA on behalf of the legal profession, the issue of the SEC's authority pursuant to Rule 2(e) to discipline lawyers will remain an important issue for some time to come.[129]

C. *Implications for the Practicing Lawyer*

Given the continued assault by the SEC on the traditional role of the securities lawyer in representing his or her clients, the availability of Rule 2(e) adminsitrative proceedings to enforce these views, and the current activity of the SEC in bringing such proceedings against lawyers, it behooves the careful securities lawyer to develop a compilation of securities practice checklists, one for each of the major functional roles he may play in a securities transaction.[130] In developing these checklists, the lawyer would be wise to remember that his potential liability may vary greatly depending on the factual circumstances of the particular case and the particular securities law or ethical canon under which the action is brought. For example, the lawyer's duty of care and scope of potential liability is likely to increase as the lawyer's involvement in the transaction approaches that of a

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129. On the subject of the validity of Rule 2(e), see Daley & Karmel, *Attorneys' Responsibilities: Adversaries at the Bar of the SEC*, 24 EMORY L.J. 747 (1975); Downing & Miller, *supra* note 44; Marsh, *supra* note 3. *See also In re* Keating, Muething & Klekamp, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124, at 81,989-97 (July 2, 1979) (SEC Chairman Williams argues for the validity of Rule 2(e) and Commissioner Karmel argues against its validity).

130. *See e.g.*, Committee Reports, *Report of the Special Committee on Lawyers' Role in Securities Transactions*, 32 REC. A.B. CITY N.Y. 345 (1977) (an excellent article on the lawyer's duties in drafting an issuer's first registration statement).

principal. Only by carefully outlining and analyzing his duties under different factual circumstances, his functions within those circumstances, and the potential sources of liability can a securities lawyer effectively deal with the pressures of acting as a fiduciary in a confidential relationship on the one hand and as a private enforcer of the securities laws on the other.