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PRACTITIONER’S ESSAY

Liability of Issuer’s Counsel in the Wake of Central Bank of Denver – To Whom Is the Lawyer’s Due Diligence Due?

BY BARRY D. HUNTER*

Carolyn Counselor is a lawyer who has been hired by Isador Issuer to assist in the preparation of securities offering documents. Isador plans to raise one million dollars from private investors to finance the purchase of yearling thoroughbreds, which he plans to raise into champion racehorses.

As is customary practice for the securities bar, Carolyn alerts Isador of his risk of securities fraud liability to the investors if he fails to disclose all material circumstances pertinent to, and risks entailed by, the venture. Carolyn further advises Isador that his disclosure obligation will likely extend not only to those facts of which he is aware, but further to all facts that a due diligence investigation would reveal. Carolyn also offers to undertake the due diligence investigation and to hire the experts necessary to adequately perform the job.

Isador tells Carolyn that he cannot afford the substantial costs entailed by the investigation she proposes. At the same time, he assures her that because of his extensive experience in horse training, he already is quite knowledgeable about the proposed venture. After reiterating to Isador the liability risks he incurs by not exercising more extensive due diligence, and after documenting her warnings in writing, Carolyn proceeds to draft the offering documents based on the information Isador provides to her. Isador then uses those documents to raise his investment capital.

Unbeknownst to Carolyn, Isador had virtually no experience in horse training, and the information he supplied to Carolyn for insertion in the offering documents that she drafted was incomplete and misleading. After the venture collapses and Isador is left penniless as a result, the investors have only one way to recover their losses. They assert a securities fraud

claim under Section 10(b) of the Securities Exchange Act against Carolyn for her role in conveying the misleading information they relied upon in investing with Isador.

Carolyn at all times gave the proper advice to her client, and she properly documented that advice. Moreover, while she may have drafted the offering documents, the misleading information contained in those documents was provided to her by Isador—and it was Isador who signed the documents and delivered them to the investors. Nonetheless, as this Essay concludes, Carolyn should hire a good lawyer.

INTRODUCTION

Section 10(b) of the Securities Exchange Act of 1934 ("Section 10(b)")\(^1\) provides the statutory underpinnings for most of the federal securities fraud lawsuits filed in this country. Defendants who act deliberately or recklessly in misstating material facts are held liable under Section 10(b) when others have relied on these misstatements in purchasing or selling securities. Before the United States Supreme Court's decision in *Central Bank of Denver N.A. v. First Interstate Bank of Denver N.A.*,\(^2\) investors typically asserted Section 10(b) claims against anyone and everyone involved in providing information concerning a failed corporate venture.

One group of defendants against whom such claims frequently had been asserted were securities professionals such as attorneys, accountants, and underwriters who were retained to help their issuer clients prepare the offering documents used to sell securities. The typical securities claim sought to hold the issuer primarily liable for having made the misrepresentations alleged to appear in the offering documents and the retained professionals secondarily liable for having aided and abetted in the preparation of those documents.

In *Central Bank of Denver*, the Supreme Court held that Section 10(b) "prohibits only the making of a material misstatement (or omission) or the commission of the manipulative act."\(^3\) By adopting this interpretation of the statute, the Court specifically eliminated private actions predicated on aiding and abetting another party's fraudulent misrepresentations.\(^4\)

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\(^3\) *Id.* at 164.

\(^4\) *See id.* at 171.
Central Bank of Denver initially was hailed (or assailed) as a decision that would dramatically reduce the risks of liability for lawyers hired to help their clients prepare securities offering documents. With the limited exception of formal opinions specifically attributable to and signed by the securities lawyer, statements in the offering documents are made by the issuer—not by the attorneys who merely assisted in their preparation. Therefore, it was widely believed that the elimination of aiding-and-abetting claims under Section 10(b) would drastically curtail attorney liability.

Largely overlooked in the optimism of the securities bar (and the pessimism of the plaintiffs’ bar) was the warning with which the majority opinion in Central Bank of Denver concluded:

The absence of § 10b-5 aiding and abetting liability does not mean that secondary actors in the securities market are always free from liability under the securities Acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met. In any complex securities fraud, moreover, there are likely to be multiple violators.

This language was taken to mean only that professionals issuing their own opinions (for example, accountants who certify financial statements or lawyers who issue formal opinion letters) would continue to be liable under Section 10(b) as primary violators where their signed statements were disseminated to the investing public. It was not widely anticipated that the courts would extend primary Section 10(b) liability to securities lawyers who merely drafted their clients’ offering documents, which would require the courts to conclude that the attorney/scriveners themselves made the representations contained in these documents.

Of course, if courts extend primary liability to attorneys, Central Bank of Denver will not have the anticipated effect of decreasing the potential for attorney liability. Lawyers formerly sued for having aided and abetted their clients in making misstatements or omissions contained in the offering documents will now be sued for having themselves made the misstatements or omissions. Indeed, because several courts have concluded that aider and

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5 Id.

6 According to SEC Chairman Levitt, “[t]he extent to which the Central Bank
abetter liability requires a higher degree of scienter than primary Section 10(b) liability, lawyers' exposure to Section 10(b) liability after *Central Bank of Denver* might even increase if courts permit claims previously brought against attorneys for aiding and abetting to be repackaged as primary claims.7

Part I of this Essay examines judicial precedents - both before and after *Central Bank of Denver* - on the issue of whether attorneys for the issuer can be held primarily liable under Section 10(b) for statements they draft for their clients. Part II examines recent decisions involving common law negligence claims by investors against an issuer's counsel. It concludes that courts that are willing to impose primary Section 10(b) liability on lawyers who merely draft their clients' offering documents will also be likely to find that those lawyers can be liable to investors for simple negligence in failing to detect and correct misstatements or omissions in those documents. Finally, Part III examines the policy arguments that underlie judicial decisions in this area. It concludes that how the courts view the scope of securities lawyers' due diligence obligations - and to whom the lawyers owe those due diligence obligations - will largely determine the outcome of future Section 10(b) and common law negligence claims brought by investors against attorneys who draft offering documents.

I. CASES ADDRESSING ATTORNEY LIABILITY FOR MISSTATEMENTS IN THEIR CLIENTS’ OFFERING DOCUMENTS

A. Pre-Central Bank of Denver Decisions

A number of courts have addressed whether attorneys alleged to have knowingly or recklessly prepared materially misleading solicitation documents in connection with a securities offering may be held liable for primary violations of Section 10(b). They have come to widely disparate conclusions.

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7 See, e.g., IIT an Int'l Inv Trust v Cornfeld, 619 F.2d 909, 924-25 (2d Cir. 1980); Woodward v. MetroBank of Dallas, 522 F.2d 84, 97 (5th Cir. 1975).
At one end of the spectrum are cases imposing primary liability on lawyers who issue formal opinion letters used to promote the sale of securities. In these situations, courts almost consistently have concluded that, because the statements in the opinion letters are expressly attributable to the lawyers who sign them, the attorneys may be held liable as primary 10(b)5 violators if their opinions contain materially misleading statements of fact.8

At the other end of the spectrum are cases where the attorneys perform legal services totally unrelated to the preparation of documents used in the solicitation of the securities transactions. In these cases courts have almost consistently concluded that lawyers cannot be held primarily liable for failing to disclose to investors what they knew or should have known about their clients’ affairs. The court in Schatz v. Rosenberg9 explained the basis for this conclusion:

[L]awyers do not vouch for the probity of their clients when they draft documents reflecting their clients’ promises, statements or warranties. Thus, [a lawyer’s] alleged transmission of [his client’s] misrepresentations does not transform those misrepresentations into those of [the lawyer] [A] lawyer or law firm cannot be liable for the representations of a client, even if the lawyer incorporates the client’s misrepresentations into legal documents or agreements necessary for closing the transaction.10

Numerous courts have refused to find attorneys liable in this context, reasoning that to do so would convert a lawyer’s duty from client advocate to public whistle-blower.11


10 Id. at 495.

11 See Barker v. Henderson Franklin Starnes & Holt, 797 F.2d 490, 495-96 (7th Cir. 1986) (stating duty to blow whistle is not found in Section 10(b)); In re Cascade Int’l Sec. Litig., 840 F. Supp. 1558, 1575-76 (S.D. Fla. 1993) (same); Alter v. DBLKM, Inc., 840 F. Supp. 799, 808 (D. Colo. 1993) (holding law firm has no duty to “tattle” on its client); Agapitos v. PCM Inv Co., 809 F. Supp. 939,
Where the documents that attorneys have drafted for their clients are securities offering documents used to solicit investors, the courts have been less protective of an issuer's counsel's right to preserve client confidences. The very courts that have so conclusively opined that lawyers cannot be held liable for misrepresentations or omissions contained in the documents they draft for their clients have been far less uniform when offering documents used to solicit investors are involved. In Schatz, for example, the court expressly noted that the lawyers "did not solicit any purchase of securities or prepare any solicitation documents."12

Many courts before Central Bank of Denver rejected primary Section 10(b) claims against lawyers by concluding that lawyers do not vouch for the probity of securities offering documents any more than any other documents they draft for their clients. About as many other courts deciding the issue before Central Bank of Denver concluded that lawyers drafting offering documents for their clients' signature did undertake special duties to investors that could make them primarily responsible under Section 10(b) for misstatements or omissions in those documents.

1. Cases Holding That Attorneys Drafting Offering Documents Are Not Primary Participants in the Misstatements or Omissions Contained in Those Documents

In Abell v. Potomac Insurance Co.,13 the United States Court of Appeals for the Fifth Circuit held as a matter of law that the plaintiff bondholders had no Rule 10(b)5 claim against the underwriter's law firm. The court characterized the plaintiffs' allegations as attempting to impose on the law firm "a duty to correct [its clients'] false statements"14 and rejected the existence of such a duty 15 The Abell court explained:

Traditionally, lawyers are accountable only to their clients for the sufficiency of their legal opinions. It is well understood in the legal community that any significant increase in attorney liability to third-

947 (M.D. Ga. 1992) (citing Schatz v Rosenberg, 943 F.2d 485 (4th Cir. 1991)).

12 Schatz, 943 F.2d at 492 (emphasis added); see also Barker, 797 F.2d at 493 (recognizing that the firm "had never reviewed or approved any of the materials used to sell the securities"); In re Cascade, 840 F. Supp. at 1564 (recognizing that the lawyers had never actively solicited or prepared solicitation documents in connection with their clients' offering).

13 Abell v Potomac Ins. Co., 838 F.2d 1104 (5th Cir. 1988).

14 Id. at 1125 n.22.

15 See id. at 1126.
parties could have a dramatic effect upon our entire system of legal ethics. An attorney required by law to disclose "material facts" to third-parties might thus breach his or her duty, required by good ethical standards, to keep attorney-client confidences. Similarly, an attorney required to declare publicly his or her legal opinion of a client's actions and statements may find it impossible to remain as loyal to the client as legal ethics properly require.\(^{16}\)

Following the Fifth Circuit's lead, the district court in *Buford White Lumber Co. Profit Sharing and Savings Plan & Trust v. Octagon Properties, Ltd.*,\(^{17}\) analyzed lawyers' duties to disclose misstatements or omissions in the offering documents they draft for their clients' use in selling securities. Recognizing that silence is not actionable under Section 10(b) in the absence of a duty to speak, the *Buford* court concluded that such a duty would arise only if the lawyer had made affirmative statements by way of a formal opinion that the lawyer had himself signed.

Similarly, in *Friedman v. Arizona World Nurseries Ltd.*,\(^{18}\) the court held that a lawyer's involvement in the drafting process does not make the lawyer the issuer of the statements nor impose duties on the lawyer to ferret out any misstatements the offering documents might contain. "[C]ounsel who merely draft [an offering memorandum] cannot be held liable for the general statements in the offering memorandum not specifically attributed to them."\(^{19}\)

2. *Cases Holding That Attorneys Drafting Offering Documents Are Primary Participants*

While the foregoing authorities establish a considerable body of precedent for the proposition that attorneys are not primarily liable under

\(^{16}\) *Id.* at 1124.


\(^{19}\) *Id.* at 533. *See also* *Austin v. Bradley, Barry & Tarlow, P.C.*, 836 F Supp. 36, 38-39 (D. Mass. 1993) (refusing to impose duty upon attorney to disclose negative facts that were material to statements in the prospectus the attorney helped draft, finding that to impose such a duty would conflict with attorney’s duty to client); *Kenney v. Deloitte Haskins & Sells*, 1992 WL 551108, at *3-5 (N.D. Cal. 1992) (stating lawyer’s drafting of the offering documents does not amount to making representation attributable to the lawyer; instead, the lawyer could face liability only for legal opinions directly attributable to him).
Section 10(b) for misstatements contained in the offering documents they draft for their clients, an equally substantial body of authority — including cases in the Sixth Circuit — is to the contrary. These courts hold that attorneys, merely by drafting their clients' offering documents, undertake duties of disclosure to investors and, thus, can be primarily liable under Section 10(b). The courts reach this result by finding either that the lawyers: (1) have themselves made the representations contained in the offering documents or (2) have undertaken a reasonable due diligence investigation of the information provided by the client for inclusion in these documents.

The Sixth Circuit cases have employed the former approach. In Molecular Technology Corp. v. Valentine, the court held that an attorney who drafted his clients' offering documents could be liable as a primary Section 10(b) violator for failing to disclose negative information that he knew (or was reckless in not knowing) about his client. According to the Molecular Technology Court, "'[a] person undertaking to furnish information'" assumes an affirmative duty to disclose, the breach of which subjects him to primary Section 10(b) liability. And because a lawyer who drafts a prospectus undertakes to "furnish information," he can be liable as a primary Section 10(b) violator if the statements he drafts contain misstatements or omissions. Commentators have recognized that Molecular Technology states the most expansive test of primary attorney liability under Section 10(b):

I'd like to make a comment on the Molecular Technology v. Valentine case. There the Sixth Circuit made an unusual statement with respect to primary liability. The Sixth Circuit said that primary liability can be imposed upon one who furnishes information to others, such as investors. And in that opinion, the Sixth Circuit asserted that a law firm, by drafting a prospectus, in effect, furnishes information to investors and can be held liable on primary liability grounds, making it unnecessary to go to an aiding and abetting analysis. I find this far reaching. It is more far reaching than any other appellate court decision that I have read on this subject.

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21 Id. at 917 (quoting SEC v. Washington County Util. Dist., 676 F.2d 218, 223 (6th Cir. 1982)).
22 See id. at 918.
23 Mark I. Steinberg (panel member), Corporate Securities Law: An Ohio Perspective, Presentations and Panel Discussion at the University of Cincinnati College of Law's Sixth Annual Corporate Law Symposium: Contemporary Issues
Lower courts within the Sixth Circuit have followed *Molecular Technology's* expansive view.\

Various courts outside the Sixth Circuit have concluded that, by undertaking to draft solicitation documents for their clients, attorneys undertake a primary Section 10(b) duty to investors to disclose material facts. In *Felts v. National Accounts Systems Ass'n*, for example, the attorney defendant was both an officer/director of the seller and the attorney responsible for drafting the offering documents. As an officer/director and signatory of the offering documents, the defendant could have been held primarily liable for misstatements in those documents irrespective of his role as counsel. The *Felts* court, however, held the defendant primarily liable under Section 10(b) because of his reckless or knowing incorporation of misstatements in the offering documents he drafted as the company's lawyer. The *Felts* court stated: "The duty of the lawyer includes the obligation to exercise due diligence, including reasonable inquiry, in connection with responsibilities he has voluntarily undertaken."\

The attorney's failure to undertake such inquiry, the court reasoned, made him responsible as a primary Section 10(b) violator for misstatements contained in the offering documents.

*Koehler v. Pulvers* also asserted the existence of a duty by counsel drafting offering documents to investigate the offering, the breach of which created primary liability under Section 10(b). Relying, like *Felts*, upon the duties of inquiry and disclosure arising out of the securities lawyers' role in his client's offering, the *Koehler* court held that the attorney's failure

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24 See *In re Rospatch Sec. Litig.*, 760 F Supp. 1239, 1250 (W.D. Mich.) (preparing a prospectus "certainly qualifies as 'furnishing' or 'supplying' information to potential investors in a sufficiently direct manner to imposes 10(b) liability") (quoting *Mercer v. Jaffe, Snider, Raitt & Heuer*, 713 F Supp. 1019, 1025 (W.D. Mich. 1989)), *aff'd*, 933 F.2d 1008 (6th Cir. 1991). The court in *Mercer* found that an attorney who had "assisted" in preparing an offering circular and had taken an "active role" in approving advertising literature could be liable as a primary Section 10(b) violator because he had undertaken to "furnish information." *Mercer*, 713 F Supp. at 1019, 1022, 1025.


26 *Id.* at 67

27 See *id.*


29 See *id.* at 845.
to conduct a reasonable investigation of the offering documents he drafted, and his resulting failure to correct misstatements contained in those documents, constituted an actionable primary representation. 30

B. Authorities Post-Central Bank of Denver

Had Central Bank of Denver been followed by a clear line of authority limiting professional liability under Section 10(b) to cases where statements are directly attributable to the professionals, the pre-Central Bank of Denver cases could be explained by judicial inattentiveness to the line demarcating primary from secondary Section 10(b) liability 31 However, in the two post-Central Bank of Denver cases to address the issue, the courts have held that attorneys who merely draft their clients’ offering documents can be liable under Section 10(b). In Employers Insurance of Wausau v. Musick, Peeler & Garrett, 32 the court squarely held that attorneys who draft offering documents for their clients can be

30 See id., see also Siedel v. Public Serv. Co. of New Hampshire, 616 F. Supp. 1342, 1362 (D.N.H. 1985) (finding attorney who failed to conduct necessary due diligence investigation of the information contained in the offering documents that he prepared to be a primary participant under Section 10(b) for the misstatements in those documents). Other courts have similarly found that attorneys who draft offering documents owe a duty of disclosure to investors and have accordingly held that those attorneys can be primarily liable under Section 10(b) for misstatements or omissions in the offering documents they draft. See In re ZZZZ Best Sec. Litig., 1990 WL 132715, at *4-5 (C.D. Cal. July 23, 1990); Cohen v. Goodfriend, 665 F. Supp. 152, 156-57 (E.D.N.Y. 1987); Ahearn v. Gaussin, 611 F. Supp. 1465, 1489 (D. Or. 1985).

31 As SEC Chairman Levitt explained: [T]he line separating primary and secondary liability [is not clear primarily] because the distinction seldom had any practical significance before the Central Bank of Denver decision. Persons who aided and abetted a fraud were held jointly and severally liable with primary violators in private actions Concerning Litigation under the Federal Securities Laws, supra note 6, at *8-9. See also Anixter v. Home Stake Prod., 77 F.3d 1215, 1224 n.8 (10th Cir. 1996) (“Commentators have long recognized vagaries in the borders between primary and secondary liability. Central Bank of Denver requires courts to delineate primary liability much more clearly.” (citations omitted)).

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primarily liable under Section 10(b) for misstatements or omissions in those documents. Similarly, in *Klein v. Boyd*, the Third Circuit Court of Appeals ruled that attorneys are not liable under Section 10(b) unless the misstatements or omissions appear in opinions that they have themselves issued and signed. The court concluded that attorneys who do not issue or sign offering documents "may be liable for a primary violation of Section 10(b) and Rule 10b-5 when the [lawyer’s] participation in the creation of a statement containing a misrepresentation or omission of material fact is sufficiently significant that the statement can properly be attributed to the [lawyer] as its author or co-author.""34

The majority of the cases addressing the scope of professional liability under Section 10(b) post-*Central Bank of Denver* have involved accountants. The two circuit courts to address the issue of whether Section 10(b) liability can be premised upon an accountant’s mere assistance in the preparation of his clients’ offering documents have taken divergent views. In *In re Software Toolworks, Inc.*5 the Ninth Circuit stated that an accountant could be held primarily liable under Section 10(b) for misrepresentations contained in his clients’ letter to the SEC if the accountant played a “significant role” in drafting the letter. Conversely, in *Anlxter v. Home-Stake Production Co.*6 the Tenth Circuit declared that the offending statement must have been made by the accountant rather than by his client, and it disapproved, as inconsistent with *Central Bank of Denver*, decisions (including *Software Toolworks, Inc.*) that “allow liability to attach without requiring a representation to be made by [the CPA] defendant.""37

The district courts that have addressed the issue of accountant liability under Section 10(b) post-*Central Bank of Denver* have similarly split in their holdings. In *In re ZZZZ Best Securities Litigation*, the court held that it was not necessary for investors to know that statements in the offering

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34 *Id.* at *12. The court in *In re Towers Fin. Corp. Noteholders Litig.*, 1995 WL 571888, at *18 (S.D.N.Y Sept. 20, 1995), also held that issuer’s counsel who had no “direct communication” with the investor plaintiffs owed no Section 10(b) duty disclosure to them; however, in *Towers* the lawyers did not prepare any offering documents used to solicit investors.

35 *In re Software Toolworks, Inc.*, 50 F.3d 615, 628 n.3 (9th Cir. 1994).

36 *Anlxter v. Home-Stake Prod. Co.*, 77 F.3d 1215 (10th Cir. 1996).

37 *Id.* at 1226 n.10.

documents are attributable to the accountant; instead, where the accountant was "intricately involved" in the preparation of solicitation documents, it was up to the accountant to ensure that the statements contained in those documents were correct.39

Other courts have read Central Bank of Denver to foreclose Section 10(b) liability for accountants who merely review and approve their clients' offering documents but, at the same time, have indicated that liability might still attach where the accountant had "assisted in the drafting" of the documents.40

Finally, in Picard Chemical, Inc. Profit Sharing Plan v. Perrigo Co.,41 the court stated that after Central Bank of Denver an accountant's liability under Section 10(b) for misstatements or omissions would necessarily require those statements to have been made by the accountant. However, by citing O'Neil v. Appel,42 the Picard court left some doubt as to whether it would consider statements drafted by accountants to be made by them.43

The lack of clear judicial direction on the scope of Section 10(b) professional liability after Central Bank of Denver – and the possibility that even courts that limit Section 10(b) liability to those who "make" the statements would find liability where professional defendants assist in the drafting of those statements – is further demonstrated in the underwriter context. Some courts have held that claims for primary Section 10(b) violations can be asserted against underwriters in the wake of Central Bank of Denver merely based upon participation in the issuance of their clients' prospectus.44 In Phillips v. Kidder, Peabody &

39 Id. at 970; see also Adam v. Silicon Valley Bancshares, 884 F. Supp. 1398, 1401 (N.D. Cal. 1995) ("significant assistance" by CPA in preparing solicitation documents is sufficient to establish a primary violation of Section 10(b)); Cashman v. Coopers & Lybrand, 877 F. Supp. 425, 432-34 (N.D. Ill. 1995) (same).
While the court agreed that to subject an underwriter to primary Section 10(b) liability the underwriter must have himself made the statements in the offering documents, the court reasoned that an underwriter can make a statement in the offering documents merely by drafting or helping to draft the documents for the issuer.

In sum, many courts addressing Section 10(b) claims against professionals post-"Central Bank of Denver" appear ready to view a professional who merely assists the issuer/client in preparing offering documents as the "maker" of the representations and omissions contained in those documents in order to sustain Section 10(b) claims against the professional.

II. COMMON LAW NEGLIGENCE CASES

Review of the decisions addressing common law negligence claims by investors against attorneys who have drafted their clients' offering documents further suggests that "Central Bank of Denver" might prove insignificant in stemming the tide of attorney liability. Case law within the Sixth Circuit and elsewhere supports the proposition that attorneys can be liable for simple negligence—separate from their liability to investors under Section 10(b)—for failing to insure the accuracy of the statements contained in the offering documents they draft. Ultimately, a court's resolution of such a common law claim will be determined, as in the Section 10(b) context, by whether the court believes that attorneys owe duties to investors merely by virtue of drafting securities offering documents.

In "Molecular Technology Corp. v. Valentine," for example, the investor plaintiffs sued the issuer's lawyer for negligent misrepresentation under Michigan law as well as under Section 10(b). Noting that under Michigan law an attorney owes duties not only to his clients but also to third parties whose reliance on the attorney's representations is directly foreseeable, the "Molecular Technology" court held that investors could assert common law negligence claims against attorneys for misrepresentations contained in offering documents they draft for their clients.

1985) (holding that participation by the underwriter in the drafting and circulation of the prospectus does not create a primary Section 10(b) violation).


46 Molecular Tech. Corp. v. Valentine, 925 F.2d 910, 911 (6th Cir. 1991).

47 See id. at 919. The exposure of securities lawyers to negligent misrepre-
A growing number of courts have held that professionals, including lawyers, can be liable to non-clients for misstatements they negligently make. Section 552 of the Restatement (Second) of Torts so provides, and a number of states, including Kentucky, have held section 552 applicable to lawyers. If those courts further accept the proposition (accepted by the Sixth Circuit in Molecular Technology and in the various other cases cited above) that lawyers make the representations contained in the offering documents they draft, securities lawyers will face significant exposure in common law claims for negligent misrepresentation.

sentation claims under Michigan law was limited (but not eliminated) by the district court's holding in In re Rospatch Sec. Litig., 760 F Supp. 1239, 1250 (W.D. Mich.), aff'd, 933 F.2d 1008 (6th Cir. 1991). Distinguishing the offering at issue in Molecular Technology (which involved a limited group of private investors) from the situation at bar in Rospatch (which involved a public offering), the Rospatch court held that negligence claims against an issuer's counsel could not be extended to the potentially unlimited group of investors involved in a public offering. See id. at 1260-61. Notably, however, the Rospatch court, like the Molecular Technology court, had no problem with the notion that lawyers who merely draft offering documents for their clients' signatures could be held liable as having made the misrepresentations.

48 Section 552(1) provides:

One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.


50 Section 552(2) provides an important limitation to the group of potential investor plaintiffs:

[T]he liability stated in Subsection (1) is limited to loss suffered
(a) by the person or one of the limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and
(b) through reliance upon it in a transaction he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

RESTATEMENT (SECOND) OF TORTS § 552(2)(a)-(b) (1977). Application of section 552 to investor claims against an issuer's counsel might well lead to limitations similar to those adopted in the Rospatch case. See Rospatch, 760 F Supp. at 1260-61, see also Hines v. Data Line Sys., Inc., 787 P.2d 8, 21 (Wash. 1990) (holding section 552 claims against securities counsel do not extend to general investing
An alternative, albeit closely related, basis under which attorneys who draft their clients' offering documents may be held liable for simple negligence to investors is the tort of attorney malpractice. A malpractice claim provides a potentially broader basis for liability because it, more readily than the tort of negligent misrepresentation, encompasses liability for omissions as well as affirmative misstatements.

In many states, again including Kentucky, attorney malpractice claims can be asserted by non-clients against attorneys for the negligent provision of services to clients that the attorneys ought reasonably to have known would be relied upon by those third parties, to their detriment. In California, the courts have specifically held that attorneys who counsel their clients in structuring their securities offerings owe duties to the investors to competently perform those services.

In Ronson v. Sheppard, Mullin, Richter & Hampton, for example, the plaintiffs were limited partners in a dissolved California limited partnership. They brought professional negligence claims against partnership counsel retained to prepare certain disclosure documents designed to satisfy the general partners' fiduciary duty of full disclosure of material information to limited partners. In reversing the lower court's order granting summary judgment in favor of the attorney defendants, the appellate court concluded that triable issues of fact remained on the question of whether, under the circumstances presented, the attorney defendants owed a duty of care toward the limited partners. In reaching this conclusion, the court noted that the attorney defendants were retained

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51 Kentucky law permits non-clients to bring malpractice claims against lawyers for more than just misrepresentations. The determining factor is whether the non-client was "intended to be benefitted by" the lawyer's services. Hill v. Willmott, 561 S.W.2d 331, 334 (Ky. Ct. App. 1978) (quoting Donald v. Garry, 19 Cal. App. 769, 771 (1971)) (recognizing principle, though refusing to extend third-party standing to an adversary in litigation to sue a lawyer for failing to investigate the claim that the lawyer brought against it); see also Sparks v. Craft, 75 F.3d 257, 261 (6th Cir. 1996) (stating that a lawyer can be liable to intended third-party beneficiary for negligent handling of a lawsuit). It remains to be determined how broadly Kentucky courts will construe this expansion of attorney malpractice liability beyond the attorney's clients.


53 See id. at *29-30.

54 See id. at *44.
for the purpose of preparing documentation sufficient to satisfy their clients' duty of full disclosure of material information to the limited partners. Under these circumstances, the court determined, the attorneys' representation was for the purpose of achieving a goal common to the partnership and the limited partners, thereby rendering the two representations related:

Here the attorneys ghost-wrote the documents for the general partner, and thus did not intentionally induce knowing reliance on their participation in the transaction. Even so, if there are other factors leading to an implied attorney-client relationship, where the attorney has knowledge regarding the purpose of his or her work product, a duty may be established to those whose conduct has been influenced. In such a case, an attorney may owe a plaintiff a duty of care where the 'end and aim' of the attorney's advice, even to another, is to induce plaintiff's reliance on it.

Similarly, in Employers Insurance of Wausau v. Musick, Peeler & Garrett, attorneys retained to help their issuer/client prepare offering documents were held liable to the investors for misstatements in those documents under common law negligence principles as well as under Section 10(b). And in Koehler v. Pulvers, while the lawyer defendant was held not liable under Section 10(b) due to a lack of scienter, he was held liable to investors on their common law malpractice claims for failing to uncover and disclose fraud in the documents he drafted for his client.

The courts' findings that attorney malpractice claims could be asserted by non-client investors in Employers Insurance of Wausau and Koehler were predicated on the same view that led to their findings that primary Section 10(b) claims could be asserted—that attorneys undertake disclosure duties to investors by participating in the preparation of securities offering documents. Similarly, other courts that have rejected Section 10(b) claims against attorneys on the ground that no duty to investors is undertaken by the mere drafting of offering documents have rejected malpractice claims on the same basis.

55 See id. at *34 n.8.
56 Id. at *38-39.
59 See id. at 848-49.
For example, in *Buford White Lumber Co. Profit Sharing and Savings Plan & Trust v. Octagon Properties*, the court rejected a common law malpractice claim on the same basis as it rejected the primary Section 10(b) claim against a lawyer – that lawyers who draft offering documents owe no duties to investors unless those documents contain opinions that the attorneys have themselves issued and signed. Similarly, in *Austin v. Bradley, Barry & Tarlow, P.C.*, the court rejected a common law malpractice claim on the same basis as it rejected a Section 10(b) claim against the lawyer defendants – that because any duty by the issuer’s attorney to disclose information to investors would conflict with that attorney’s duty to his client, the attorney could not be held to owe a duty of disclosure to the investors.

The foregoing cases plainly demonstrate that the fate of common law negligence claims brought by investors against lawyers who draft offering documents turns upon the same issue as determines the outcome of post-*Central Bank of Denver* Section 10(b) claims against those lawyers – whether the lawyers owe a duty to the investors. To the extent that the desire to preserve Section 10(b) attorney liability encourages courts to find the existence of such a duty, *Central Bank of Denver*’s effect might well be to expand attorney liability in common law negligence claims.

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61 See id. at 1563-64.
63 See id. at 38-39. Conversely, in *Fortson v. Winstead, McGuire, Sechrest & Minick*, 961 F.2d 469, 473-74 (4th Cir. 1992), the court looked to the applicable state law of attorney malpractice to determine whether an attorney engaged to draft a tax opinion could be liable to investors under Section 10(b) for failing to disclose information material to other portions of the issuer clients’ private placement memorandum. Because the controlling law in that case (Texas law) limited the attorneys’ duties of disclosure to those in direct privity with the attorney, i.e., his clients, the *Fortson* court held that a Section 10(b) omissions claim would not lie.
64 Potential liability under state blue sky statutes must also be considered. In states like Kentucky that have adopted the civil liabilities provision of the Uniform Securities Act of 1956, liability for misstatements or omissions in offering documents extends, *inter alia*, to “every agent who materially aids in the sale” *KY. REV STAT. ANN.* § 292.480(2) (Banks-Baldwin 1995). Sellers and their “agents” are liable unless they can prove that they were unaware and could not reasonably have become aware of the misstatements or omissions. See id. § 292.310(2), which defines “agent” as a party who “represents [the] issuer in effecting or attempting to effect purchases or sales of securities.” Most courts to
III. THE POLICY CONSIDERATIONS UNDERLYING THE JUDICIAL PRECEDENTS

A. Ethical Considerations

One of the principal objections to holding issuer's counsel responsible for disclosing material facts about their clients' securities offerings is that it would subvert the attorney's role as advocate and protector of client confidences. In *Abell v. Potomac Insurance Co.*, the Fifth Circuit explained its unwillingness to extend the securities lawyer's duties to third-party investors because of its view that to do so would compromise the lawyer's ethical duty to devote his undivided loyalty to the client.65

While the concerns raised by the *Abell* court are compelling in cases where a lawyer with knowledge of negative information concerning his clients' offering plays no role in preparing misleading offering documents, attempts to invoke legal ethical duties to justify a lawyer's conduct in knowingly preparing materially misleading solicitation documents are not likely to sway many courts. As noted above, the courts have almost considered the question have concluded that lawyers who merely draft their clients offering documents – or even issue and sign formal opinions contained in those documents – cannot be held liable because they are not agents of the seller. See *Ackerman v. Schwartz*, 733 F. Supp. 1231 (N.D. Ind. 1989), *appeal dismissed* 922 F.2d 843 (7th Cir. 1991); *Allen v. Columbia Fin. Management, Ltd.*, 377 S.E.2d 352 (S.C. Ct. App. 1988); *Rendler v. Markos*, 453 N.W.2d 202 (Wis. Ct. App. 1990); *see also* *Jenson v. Touche Ross & Co.*, 335 N.W.2d 720 (Minn. 1983) (involving CPA who issued audit opinion). *But see* *Powell v. H.E.F Partnership*, 835 F. Supp. 762 (D. Vt. 1993) (stating that law firm that prepared offering documents was agent of seller and thus liable under Vermont Securities Act as having aided seller notwithstanding that law firm never solicited sales or met with potential purchasers). Because: (1) the duties of an issuer's counsel generally do not encompass the power to alter the legal relations between the principals and third parties, which the Restatement (Second) of Agency states is an essential characteristic of agency, see *Restatement (Second) of Agency* §§ 12-14 (1957); and (2) professional liability under section 12(2) of the Securities Act, 15 U.S.C. § 77l (1994) (upon which the civil liabilities provision of the Uniform Securities Act has been closely patterned), was sharply curtailed by the Supreme Court ruling in *Pinter v. Dahl*, 486 U.S. 622 (1988), it is not likely that many courts will construe the civil liabilities section of the Uniform Securities Act to cover lawyers performing the typical functions of issuer's counsel.

65 *Abell v. Potomac Ins. Co.*, 858 F.2d 1104 (5th Cir. 1988).

66 *See id.* at 1124.
unanimously rejected attempts to impose so-called whistle blower liability upon attorneys who have performed legal services unrelated to the solicitation of the securities transaction or the preparation of the solicitation documents. Once the attorney undertakes to assist his client in preparing solicitation materials, however, the ethical imperatives clearly shift. There is no ethical mandate permitting lawyers to knowingly prepare solicitation documents that contain material misrepresentations or omissions of fact. To the contrary, the Model Rules of Professional Conduct preclude attorneys from assisting in client fraud. Courts have quite properly held that "a lawyer has no privilege to assist in circulating a statement with regard to securities which he knows to be false simply because his client has furnished it to him." 68

B. Due Diligence Considerations

While courts have not and ought not waste their concern on the plight of a securities lawyer who knowingly drafts materially misleading offering documents, far more significant policy implications are raised by subjecting lawyers engaged to draft those documents to liability to investors for unwittingly failing to ferret out their client's fraud. To protect against such liability, an issuer's counsel would be forced to independently confirm and corroborate virtually all the information that the client provides. The securities lawyer's due diligence function would be converted from a role designed to protect clients from liability to investors

67 See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2(d) (1996).
68 SEC v. Frank, 388 F.2d 486, 489 (2d Cir. 1968). The interesting ethical dilemma arises where the attorney only learns after he has completed his participation in the drafting process that the offering documents contain fraudulent misstatements. Rule 1.6 would seem, at the very least, to require the lawyer to withdraw from the representation. Moreover, while Rule 1.6 generally prohibits disclosure of client confidences to prevent the commission of a fraud, the ABA Standing Committee on Professional Ethics and Responsibility has concluded that an innocent lawyer who recognizes after the fact that the papers he has drafted contain misrepresentations communicated to him by the client could rectify the situation by withdrawing from the now fraudulent representation and disavowing the offending papers. See ABA Comm. on Ethics and Professional Responsibility Formal Op. 92-366 (1992); see also GEOFFREY C. HAZARD, THE LAW OF LAWYERING § 1.6:306 (Supp. 1996) (concluding that Rule 1.6(b)(2) can be construed to allow lawyers in such situations to engage in so-called "pre-emptive" self-defense and disclose material facts that were omitted from the offering documents in order to avoid becoming entangled in future proceedings).
for negligent oversights to a function designed to protect the public (and ultimately the lawyer) from the client's misstatements.

This is certainly a far cry from the statutory underpinnings of due diligence – let alone how the lawyers' due diligence role has traditionally been perceived by members of the securities bar. Pursuant to section 11 of the 1933 Securities Act, statutory sellers of securities are *prima facie* liable to investors for all material misstatements in the registration statement. Pursuant to section 12(2) of the 1933 Securities Act, similar liability attaches to unintentional misrepresentations contained in a private placement memorandum. To avoid liability, statutory sellers (officers, directors, general partners, etc.) must establish, by way of affirmative defense, that they have made a "reasonable investigation" and had "reasonable grounds to believe and did believe" that the offering documents contained only true statements. Consistent with the statutory scheme, the securities lawyer's role has traditionally been viewed as assisting clients in establishing such a defense against potential claims by investors – not to protect the investors from his clients' fraud.

Yet while most securities lawyers do not view their role in the due diligence process as serving the interests of investors, that is precisely how many courts have viewed the due diligence function of securities counsel. What started out as a defense designed to benefit the issuer client has been converted to a duty imposed upon the issuer's lawyer.

In the seminal case of *SEC v. Spectrum Ltd.*, Judge Kaufman referred to what he considered as the important role played by securities counsel in protecting the public from unscrupulous practices in the securities markets:

> The securities laws provide a myriad of safeguards designed to protect the interest of the investing public. Effective implementation of these safeguards requires the public to be shielded from misrepresentations and frauds. The securities laws and regulations are a manifestation of the public's expectations for fair and honest representation of securities. Securities counsel have a duty to inform themselves as to the conditions of the market, the requirements of the securities laws, and the rights of investors. If securities counsel fail to carry out this duty, they may be held liable for their clients' misrepresentations.

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70 Id. § 77k(b)(3)(A), (B); see also id. § 77(2).

71 For example, lawyers faced with clients unwilling or unable to shoulder the substantial costs of a thorough attorney due diligence investigation into the subject of the investment scheme traditionally have discharged their duties by advising clients of the potential risks of failure to conduct a reasonable due diligence investigation. To the extent the lawyers are held responsible for the veracity of the information their clients supply for inclusion in the offering documents, however, such an approach is insufficient to protect the lawyers from claims brought by investors.

safeguards, however, depends in large measure on the members of the bar who serve in an advisory capacity to those engaged in securities transactions.\footnote{\textit{Id.} at 536.}

Consistent with this view, many courts have expressly found that lawyers who undertake to draft their clients’ securities offering documents thereby undertake special due diligence obligations for the benefit of the investing public.\footnote{\textit{See} \textit{Escott v. BarChris Const. Corp.}, 283 F Supp. 643, 690 (S.D.N.Y. 1968). \textit{BarChris} addressed the liability of a statutory seller, a director of the issuer who signed the registration statement. This defendant, Grant, was an outside director and attorney who claimed to have been misled by his client as to the accuracy of the registration statement documents. The court noted that, although he was not being sued as a lawyer, the fact that he was a lawyer affected the degree of diligence he was required to show in order to establish his due diligence defense: “As the director most directly concerned with writing the registration statement and assuring its accuracy, more was required from him in the way of reasonable investigation than could fairly be expected of a director who had no connection with his work.” \textit{Id.} In rejecting Grant’s argument that an attorney in this situation was entitled to rely on the representations of his client without verifying the accuracy of these statements, the court opined:}

\begin{quote}
This is too broad a generalization. It is all a matter of degree. To require an audit [by the attorney] would obviously be unreasonable. On the other hand, to require a check of matters easily verifiable is not unreasonable. Even honest clients can make mistakes. The statute imposes liability for untrue statements regardless of whether they are intentionally untrue. The way to prevent mistakes is to test all information by examining the original written record.
\end{quote}

\textit{Id.} Because Grant could easily have verified errors in the record yet failed to do so, Grant’s due diligence affirmative defense on client-supplied information was rejected.

In announcing its decision, the \textit{BarChris} court expressly stated that Grant was not held liable as a lawyer: “Grant is sued as a director and a signer of the registration statement. This is not an action against him for malpractice in his capacity as a lawyer.” \textit{Id.} Nonetheless, cases such as \textit{Felts, Seidel,} and \textit{Koehler} have relied upon \textit{BarChris} to establish a generalized duty of attorneys to investigate the accuracy of offering documents, which duty, if not fulfilled, could ad to the imposition of primary Section 10(b) liability and common law negligence liability upon attorneys who draft those documents. \textit{See} \textit{Felts v. National Accounts Sys. Ass’n}, 469 F Supp. 54, 67 (N.D. Miss. 1978) (“The duty a lawyer includes the obligation to exercise due diligence, including a reasonable inquiry, in connection with the responsibilities he has voluntarily undertaken.”);}
As long as courts view an issuer's counsel's due diligence function in such a fashion, securities lawyers will continue to face primary Section 10(b) and common law negligence liability to investors for misstatements or omissions contained in the offering documents they draft for their clients. Indeed, this asserted obligation of securities counsel, to undertake due diligence for the benefit of investors, is far more than just a consequence of the judicial precedents holding attorneys liable to investors for failing to detect and disclose their clients' fraud—it provides an important basis for such liability.

As noted before, the primary obstacle investors face in asserting primary Section 10(b) and common law negligence claims against lawyers who merely draft offering documents for their issuer clients is establishing the existence of a duty running from lawyers to investors. Assuming the existence of a duty of investor protection based on the obligation of due diligence, courts need look no further in order to find a duty owed from issuer's counsel to the investors.

The supposed obligation of due diligence owed by securities counsel to investors has been expressly relied upon by the courts in Feltis, Koehler, and Seidel as the basis for finding that lawyers who draft offering documents containing material omissions can be held primarily liable to investors for those omissions under Section 10(b). Similarly this view of the lawyer's due diligence function was the basis of the Ronson court's finding that to recognize a duty of disclosure from issuer's counsel to investors would not conflict with that lawyer's ethical duties to his client. Indeed, because, according to the Ronson court, the purpose behind the representation of issuer's counsel is to serve a goal common to both his client and investors, i.e., to promote full disclosure, investors are among the intended beneficiaries of the issuer's lawyer's services.75

FDIC v. O'Melveny & Meyers, 969 F.2d 744, 749 (9th Cir. 1992), rev'd on other grounds, 512 U.S. 79 (1994) (In its high specialty field, O'Melveny owed a duty of due care “to make a 'reasonable, independent investigation [of its clients financial condition and] to detect and correct false and misleading materials.'” (quoting Feltis, 469 F. Supp. at 67). Other courts, including the Second Circuit, have viewed the lawyer's duty to conduct “some sort of independent investigation of the facts supplied [by the client]” as providing the basis for the finding of recklessness necessary to support a Section 10(b) claim against the lawyer. S. Breard v. Schnoff & Weaver, 941 F.2d 142, 144 (2d Cir. 1991); see also Goldman v. McMahan, Brafman, Morgan & Co., 706 F. Supp. 256, 259 (S.D.N.Y. 1989) (“An egregious refusal to see the obvious, or to investigate the doubtful, may some cases give rise to an inference of gross negligence which can be a functional equivalent of recklessness.”).

75 This view that issuer's counsel undertakes special duties of investigation,
LIABILITY OF ISSUER'S COUNSEL

Under the more traditional view of the due diligence function held by most securities lawyers, there is no such common goal. The role of securities lawyers vis-a-vis investors is no different that the role of any other lawyer vis-a-vis the party on the other side of the transaction from his client. The due diligence undertaking – quite to the contrary of protecting the investors rights – is designed to protect the client from potential claims by investors. Viewed in this fashion, the court’s holding in Austin v. Bradley, Barry & Tarlow, P.C., which rejected any duty by a law firm to investors to uncover misstatements in the disclosure documents they draft for their clients (because such duty would conflict with the lawyer’s obligations to his client) makes perfect sense.

CONCLUSION

The issue of whether lawyers hired to draft their clients securities offering documents can be held liable to investors under Section 10(b) remains a very open issue, notwithstanding the elimination of aider-and-abetter liability by Central Bank of Denver. Moreover, developments in the common law affording standing in attorney malpractice cases to non-clients raise the spectre that issuer’s counsel will be held liable to investors for simple negligence in failing to detect or correct misstatements in their clients’ offering documents. Until these issues are clarified by the courts, lawyers like Carolyn Counselor hired to draft securities offering documents would be well served to scrutinize all information supplied by their clients for inclusion in the offering documents – if not for the benefit of the investing public then at least for the benefit of their malpractice carriers.

disclosure when they draft offering documents could explain why – when offering documents are involved – the courts have deviated from the view that “lawyers do not vouch for the probity of their clients when they draft documents reflecting their clients’ promises, statements or warranties.” Schatz v. Rosenberg, 943 F.2d 485, 495 (4th Cir. 1991), cert. denied, 503 U.S. 936 (1992). See also Barker v. Henderson Franklin Starnes & Holt, 797 F.2d 490, 493 (7th Cir. 1986); In re Cascade Int’l Sec. Litig., 840 F. Supp. 1558, 1564 (S.D. Fla. 1993).

76 See supra note 19.