ATTORNEY LIABILITY IN PRIVATE OFFERINGS

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TODAY'S PRESENTATION: WHAT TO EXPECT

- Attorney Liability – In General
- Plaintiffs and Causes of Action
- Tips On Reducing Liability

SOURCES OF INFORMATION

- Federal and State Case law
- Federal and State codes
- Insurance industry reports
- Trial outcome data (The National Center for State Courts (NCSC) (indirectly)
- American Bar Association reports
- Scholarly Articles
- Communications with a number of former SEC lawyers, defense and plaintiff's lawyers, and receiver/trustees
- Presenter's subjective experience

Attorney Liability – In General

“LIABILITY” BROAD FOR THE PURPOSE OF THIS PRESENTATION

Triggered by threatening references in court papers, demand letters, and lawsuits:

- Emotional distraction
- Unbillable time spent on own defense
- Energy
- Out of pocket defense costs
- Write-off earned fees
- Stigma and reputational damage
- Impact on recruitment
- Settlement/judgment costs

EVERYONE AND ANYONE AT RISK

One commenter studying the area opined that:

- Targets of legal malpractice claims tended to be **older rather than younger** (see next slide)
- No relationship with **quality of law school** attended
- No relationship with having been **disciplined**
- No relationship to practicing in an **urban versus a rural** setting
- No relationship to **Martindale-Hubbell rating**
- His general conclusion was that "**nobody is safe**" and that "everyone and anyone commits [sic] malpractice

Source: *When The Lawyer Screws Up: A Portrait Of Legal Malpractice Claims And Their Resolution* Herbert M. Kritzer and Neil Vidmar summarizing Manuel R. Ramos' findings

MORE EXPERIENCED LAWYERS AT RISK

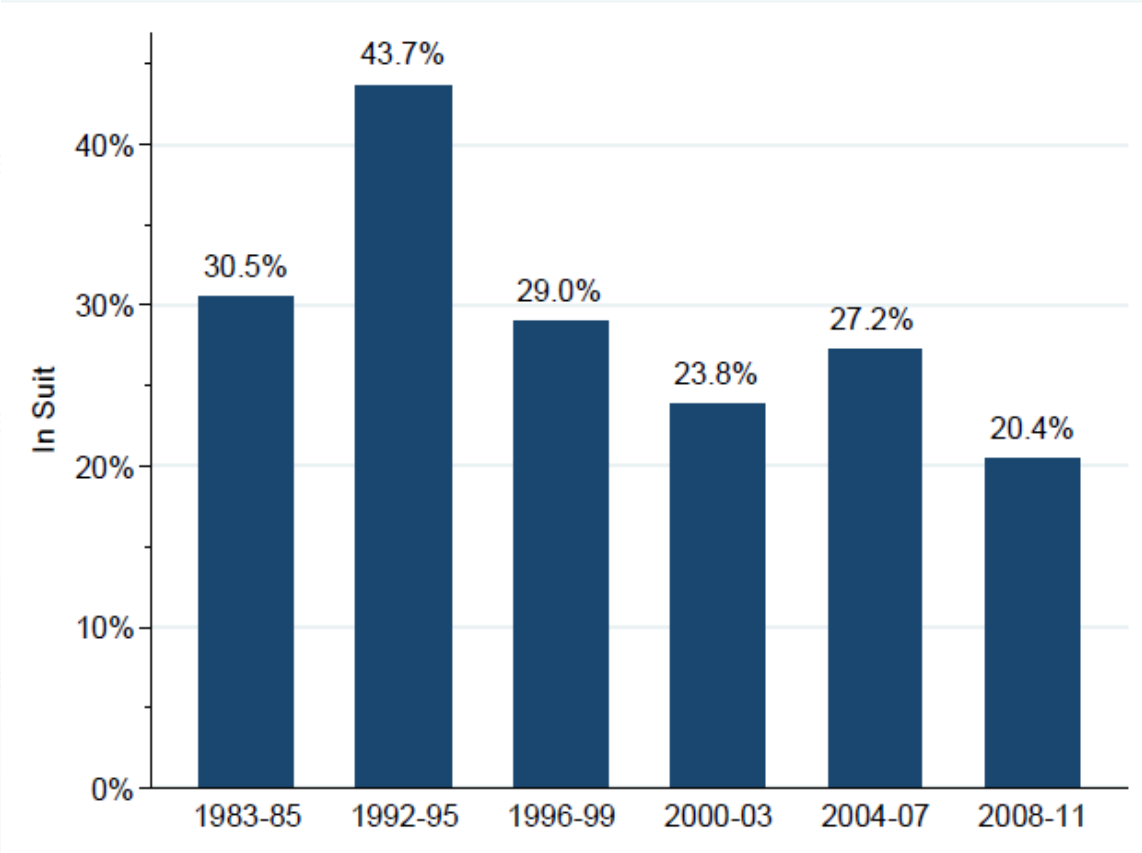
ABA Standing Committee on Lawyers' Professional Liability suggests:

- **More experienced lawyers are overrepresented** among those facing legal malpractice claims
- Possibly because this group of lawyers is the most **overwhelmed** by both the demands of their practice and outside demands such as those of family
- It may be that this cohort of lawyers is most likely to be experiencing **burnout** and hence get sloppy in their work

GENERAL TREND – REAL CLAIMS PER 1,000 LAWYERS

Liability Insurer Data as a Window on Lawyers' Professional Liability; Tom Baker & Rick Swedloff; UC Irvine Law Review 2015

PERCENTAGE OF CLAIMS THAT RESULTED IN SUIT



INCIDENCE OF TRIAL AND RESULTS

- Very few legal malpractice claims make it to a trial and verdict
- 2-3% of legal malpractice claims make it to trial (Kritzer and Vidmar)
- Similar to other tort claims
- ABA: number of claims resulting in payment after a judgment for the plaintiff averages 1.33%*
- Plaintiff prevails 48.7% of the time

* Averages from Profile(s) of Legal Malpractice Claims, 2008-2011 (2012) and 2000-2003 (2005).

LPL VIS-À-VIS OTHER PROFESSIONS

How often does a Plaintiff win a trial* against a professional?

- lawyers 48.7% of the time
- other professionals 38.9% of the time
- doctors 23.2% of the time
- dentists 27.9% of the time

LPL VIS-À-VIS OTHER PROFESSIONS

What do the MEDIAN judgment* amounts look like (2010 dollars)?

- Legal malpractice verdicts for plaintiffs ~ $100,000
- awards against physicians ~ $700,000
- Dentists, less than $100,000
- **Punitive damages rarely awarded** to prevailing plaintiffs, but more often against lawyers (v. lawyers 3.1% of wins; v. doctors 0.4%; v. other professionals 2.0%)

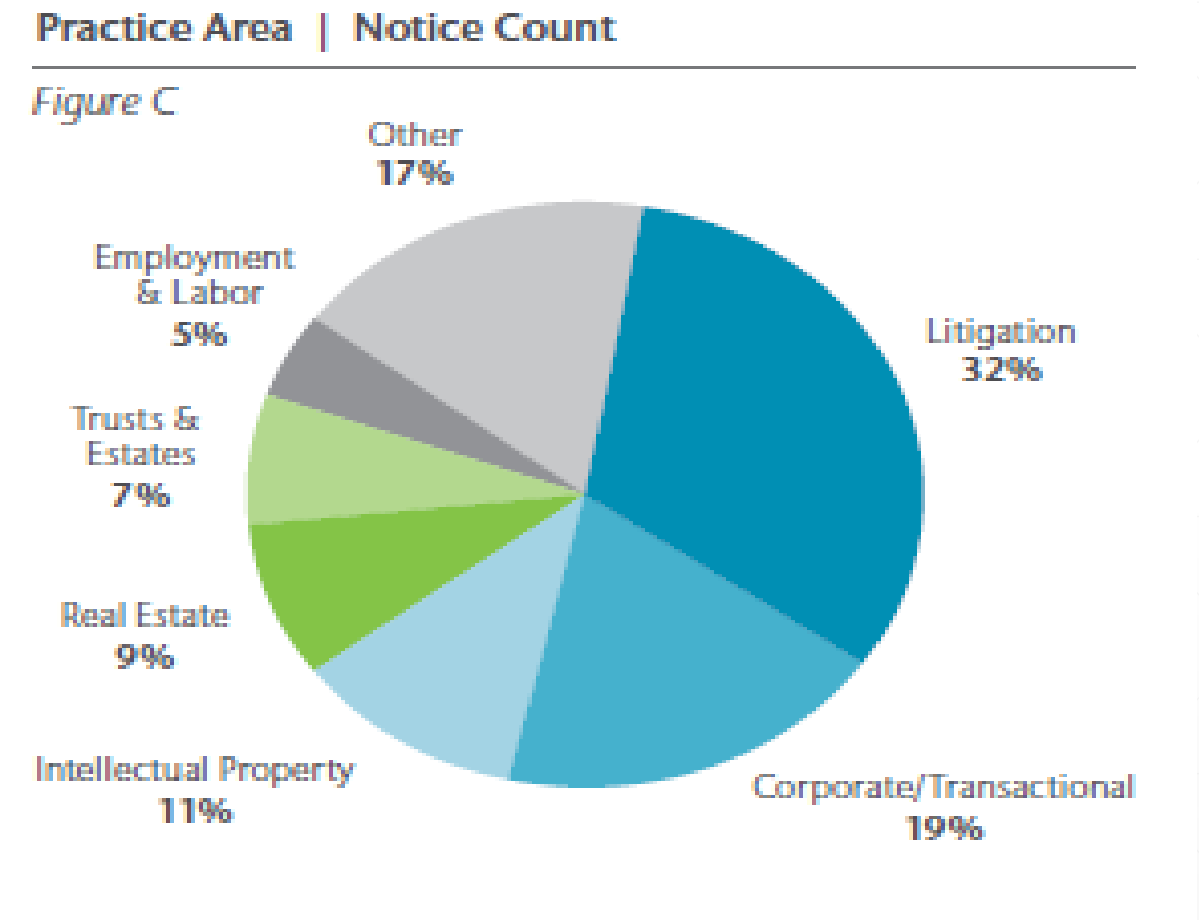
***** jury verdict data derived from U.S. Justice Department's Bureau of Justice Statistics by the National Center for State Courts.

CUMMULATIVE CLAIMS AND LOSS BY PRACTICE AREA 1983-2013*

	Number of Claims	% of all ALAS Claims	Gross Loss (000s Omitted)	% of All ALAS Gross Loss	Mean Gross Loss per Claim (000s Omitted)
Securities	522	4%	$747,800	13%	$1,432.6
Banking	262	2%	$294,600	5%	$1,124.4
Patent/Trademark/ Copyright	386	3%	$255,400	5%	$661.7
Corporate	3627	26%	$2,302,900	41%	$634.9
Tax/ERISA	564	4%	$303,300	5%	$537.8
Real Estate	952	7%	$312,100	6%	$327.8
Trusts & Estates	949	7%	$208,700	4%	$219.9
Other	1254	9%	$245,000	5%	$195.4
Litigation	5334	39%	$881,700	16%	$165.3

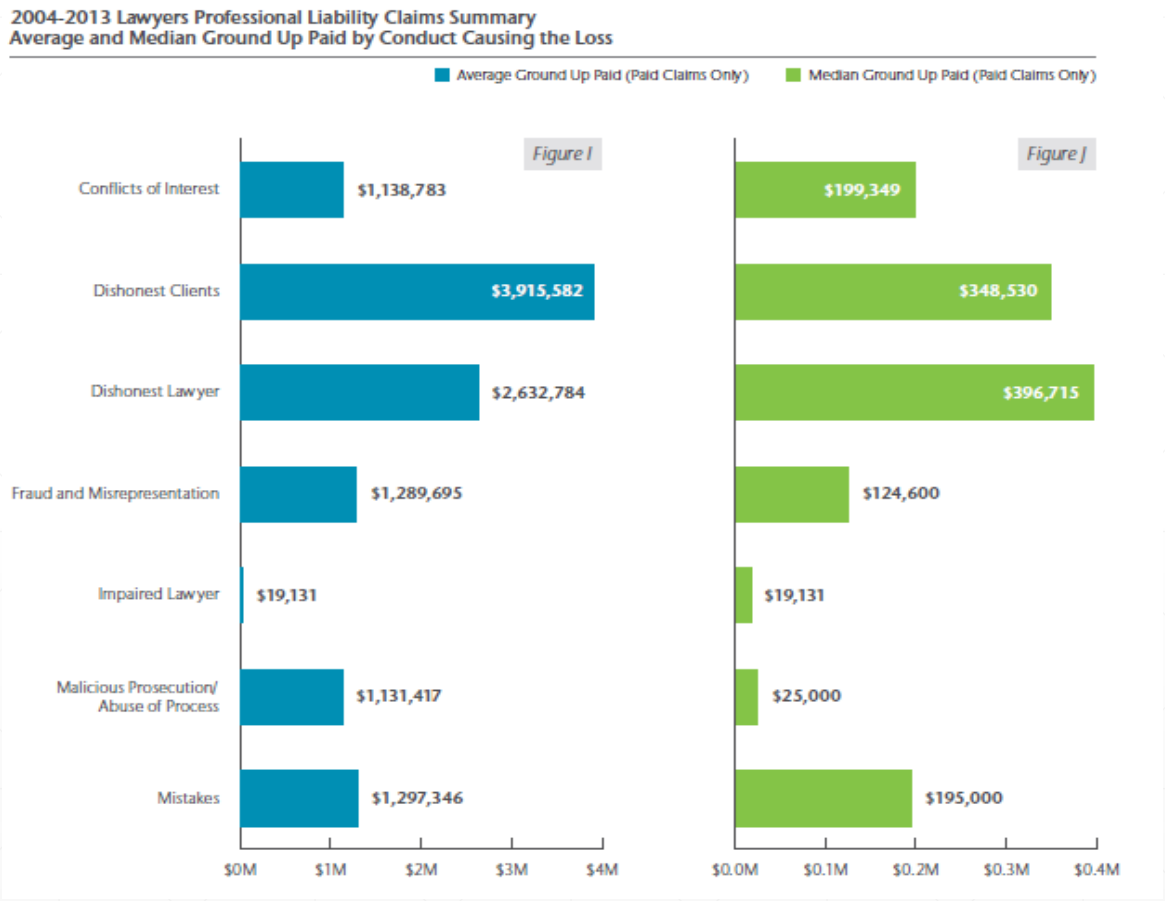
*Attorneys' Liability Assurance Society insurer, commonly referred to as ALAS, which is the insurer with the largest market share in the medium- to large-firm LPL insurance market.

PIE CHART CLAIMS BY PRACTICE AREA



Courtesy AON

CONDUCT CAUSING LOSSES



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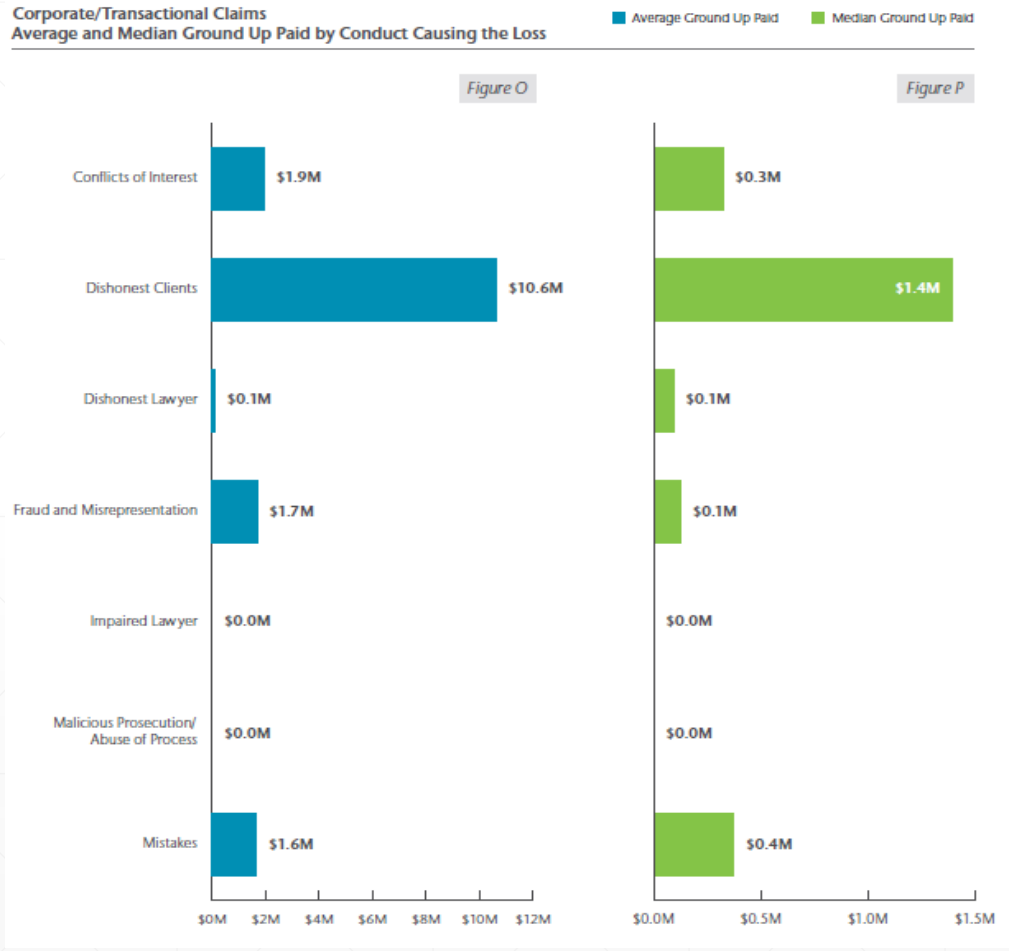
CORPORATE/TRANSACTIONAL CLAIMS



Courtesy AON

SECURITIES CLAIMS

Courtesy AON

BAD OR UNWORTHY CLIENTS

- Lawyers can face liability if they **failed to recognize** that a client was engaging in **illegal or shady behavior**
- AND
- the **lawyer's work somehow facilitated** that behavior
- many of the largest claims brought against major law firms arise from **client dishonesty**
- includes clients who are **dishonest with their lawyers**
- ALAS reported that over **36.5%** of LPL losses to insurance companies at least partially resulted from "**dishonest clients**"
- "In a nutshell, securities lawyers appear to be **especially vulnerable** to liability arising out of the representation of unworthy clients"

Plaintiffs and Causes of Action

PRIMARY DUTIES IN PREPARING A PRIVATE OFFERING

- **Bar associations and the ABA are generally silent** as to the standards of conduct of an attorney relative to preparations of private offering documents
- **Basic law: Do not assist or counsel a client in preparation of written material that the lawyer knows or *reasonably should know* is criminal or fraudulent**
- a lawyer is not to represent a client and may accordingly withdraw where the **client persists** in a course of action involving the lawyers services that the lawyer reasonably believes is criminal or fraudulent

SAMPLE CAUSES OF ACTIONS AGAINST PRIVATE OFFERING LAWYER

Greatest liability risk arises under state rather than federal law

- Malpractice/Negligence
  - Attorney-client relationship
  - **Duty** of care, skill, judgment, and diligence of similarly situated reasonably careful lawyers
  - **Breach** failure to use required care
  - **Damage** caused harm *must be damages caused by lawyer
- breach of fiduciary duty (conflict of Interest)
- breach of contract

Third Party

- negligent misrepresentation
- fraud
- aiding and abetting
- conspiracy
- state securities code
- NO 10b-5 aiding and abetting (Central Bank)
- NO RICO (securities fraud)
- YES 10b-5 primary violator

CORE THEORY OF ISSUER/COMPANY AGAINST PRIVATE OFFERING LAWYER

- "Part and parcel of effectively protecting a client, and thus discharging the attorney's duty of care, is to **protect the client from the liability which may flow from promulgating a false or misleading offering to investors**" *Federal Deposit Insurance Corp. v. O'Melveny & Meyers*, 969 F.2d 744 (9th Cir. 1992), rev'd on other grounds, 114 S.Ct. 2048 (1994)
- Can be on the hook for **insufficient due diligence or investigation**
- **Tension between an attorney's duties of loyalty and confidentiality** to its clients on the one hand, and a securities attorney's duty of disclosure to potential investors

DUTIES OF COMPLIANCE COUNSEL

- “Failure to Supervise” (Urban 2009; Gutfreund 1992). Did not commit illegal acts, did not aid and abet or cause others to commit illegal acts, and was not the line supervisor of any wrongdoer
- SEC asserted a theory of liability that a legal or compliance officer holding a senior position within the firm can be **held liable for a failure to take affirmative action** to investigate and to prevent misconduct that such officer had reason to suspect was taking place
- May be insufficient to be a mere bystander to events
- direct or monitor an investigation of [mis]conduct
- **institute procedures** reasonably designed to prevent future misconduct, ensure that such procedures are implemented
- as a last resort (if management fails to act on the supervisor’s recommendations) **disclosure to the board of directors or resignation**

CAUSES OF ACTIONS – THIRD PARTY (NON-CLIENT) AGAINST PRIVATE OFFERING LAWYER

- Drafts false securities documents and **reason to know documents will be shown** to investors. "Affirmative misrepresentation" "gratuitously tout". *Rubin v. Schottenstein*, 143 F.3d 263 (6th Cir. 1998) (concealment, opportunity to detect fraud, access to information)
- aiding and abetting (not under 10b-5 unless by SEC)
- conspiracy
- negligent misrepresentation
- fraud
- Offers securities to investor
- Participates in the sale of securities to investors
- Opinion Letters

CLAIMS BY BANKRUPTCY TRUSTEES

- If **fraud played a part in the downfall** of the client, professionals who provided services to the now-bankrupt entity are **likely to come under scrutiny** during this process as potential sources of recovery
- adversary proceedings in bankruptcy court or other state or federal litigation outside of the bankruptcy court possible
- Creates unique substantive and procedural issues
- **Trustee controls attorney-client privilege** and less (not) worried about what former management said
- Defenses: **contributory fault, statutes of limitations, causation and in *pari delicto*** (trustee steps into client corporation's shoes. Cannot recover from another when one is equally or more at fault)

BANKRUPTCY TRUSTEES ASSERTING 3RD PARTY CLAIMS

- Claims by third parties against former insiders and professionals **can be massive**
- particularly in bankruptcies that occur amid allegations of **fraud or mismanagement**
- The estate and its creditors (who are the investors in the failed company) have separate claims, though often against the same third parties
- Bankruptcy trustees **want to control as much of this litigation as possible**, so they draft plans of reorganization that allow the trustee to assert the claims of the creditors as well as the claims of the estate.
- This arrangement changes the dynamic of the litigation and forces the third-party defendants (including lawyers) to defend themselves against a trustee rather than against the real party in interest
- Unfair playing-field?
  - **Trustee likely better funded** and organized than disparate claimants
  - Trustee's **risk-reward may be skewed** as Trustee and counsel are economically rewarded for bringing claims and not take available revenue source when claims abandoned
  - By assigning claims to a Trustee, creditors can **sue under the banner of a fiduciary**

BANKRUPTCY TRUSTEES – POTENTIAL FLAWS WITH 3RD PARTY CLAIMS

- The Language of **Bankruptcy Code § 1123 limits trustees** to asserting claims that belong to the estate (i.e. trustee cannot prosecute third party claims)
- United States Supreme Court affirms that **trustee does not have standing to bring third-party claims** on their behalf, *Caplin v Marine Midland Grace Trust Co. of New York*, 406 U.S. 416 (1972)
- When Congress rewrote the Bankruptcy Code in 1978, it considered a proposal that would have authorized trustees to bring certain claims on behalf of creditors (legislatively overturning *Caplin*). **Congress rejected the proposal**
- Trustees attempt to **circumvent the law** by transferring third-party claims to trusts created by bankruptcy plans, then litigate them as ***post*-confirmation trustees**. Has been allowed in many jurisdictions; including Utah
- **Strategy rejected by Delaware Court of Chancery** in *Trenwick v. Am. Litig. Trust v. Ernst & Young, LLP*, 906 A.2d 168, 191 (Del. Ch. 2006) “even if the Litigation Trust Agreement or plan of reorganization did expressly assign the direct claims of Trenwick America's creditors to the Litigation Trust, federal bankruptcy law is clear that litigation trusts do not have standing to pursue the direct claims of creditors” then referenced *Caplin*
- If standing is characterized as a jurisdictional issue the defendant may raise it at any time, even after the trial court has rendered a final judgment

See, Clarifying The Authority Of Litigation Trusts: Why Post-confirmation Trustees Cannot Assert *Creditors'* Claims Against Third Parties by Andrew J. Morris*

SEC ACTIONS

Rule 10b-5: Manipulative and Deceptive Practices (17 C.F.R. 240.10b-5)

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

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

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

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

in connection with the **purchase or sale of any security**

SEC ACTIONS

- **Primary Violator** under Section 10(b) and Rule 10b-5 (any person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud)
- **Aider and Abettor** under 10b-5 aiding and abetting (any person who provides assistance to other participants in a scheme but does not himself engage in a manipulative or deceptive act can only be an aider and abettor)
  - Private Securities Litigation Reform Act of 1995 overrides *Central Bank*. Any person that knowingly provides substantial assistance to another person in violation
- **Deny Privileges** 102(e) action. Usually derivative to other findings; e.g. Federal Court finding

NOTE ON 102(e) CASES

- The SEC may censure the attorney or "deny temporarily or permanently," the privilege of appearing or practicing before the SEC if an attorney:
  - (a) does not possess the requisite qualifications to represent others
  - (b) lacks character or integrity, or engaged in unethical or improper professional conduct

  or
  - (c) willfully violated, or willfully aided and abetted the violation of, federal securities laws, rules, or regulations
- Virtually all 102(e) cases since 2007 have been "follow-on" proceedings in which he SEC issued its findings and disciplinary orders after a state or federal court, or a state bar tribunal's determination, concerning the attorney conduct at issue

SAMPLE COMMISSIONER QUOTES THEN AND NOW – NORMAN S. JOHNSON

“If we *** fail to achieve the right equilibrium and pursue lawyers too aggressively, we force lawyers to become ‘legal auditors’ of their clients, the result being to **drive away those who are already the least likely to seek -- but most need -- legal counsel**. Further, it is periodically popular to **whip the Bar**, citing what are characterized as its special position and privileges.”

"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." Quoting Carter & Johnson (1981 SEC case against two lawyers which set the standard for the SEC to analyze improper or unprofessional conduct.)

Before ABA Federal Securities Law Committee, Washington DC, November 8, 1996

SAMPLE COMMISSIONER QUOTES THEN AND NOW – KARA STEIN

"I am also strongly interested in seeking **greater individual accountability for gatekeepers**, including executives, compliance officers, accountants, and **attorneys**. . . . as the Commission is being tasked with overseeing more, with fewer resources, the focus on gatekeepers is both an efficient and effective approach to policing the securities marketplace. . . . **actions will be brought when professionals fail to fulfill their responsibilities**."

CURRENT CHAIRMAN JAY CLAYTON

- The SEC has a three-part mission: (1) to **protect investors**, (2) to maintain fair, orderly, and efficient markets, and (3) to **facilitate capital formation**. Each tenet of that mission is critical.

On Enforcement:

- "The SEC has strong and active enforcement and examination programs. I fully intend to continue deploying significant resources to root out fraud and shady practices in the markets, particularly in areas where Main Street investors are most exposed. Terms like "affinity fraud" and "microcap fraud" sound unremarkable and remote on paper, but they are **sinister behaviors** that strike at Americans' vulnerabilities."

On Capital Formation

- "I have been vocal about my **desire to enhance the ability of every American to participate in investment opportunities**, including through the public markets. I also **want American businesses to be able to raise the money they need to grow and create jobs**."

Speech at the Economic Club of New York, July 12, 2017

STATE BAR

Rule 8.4. Misconduct.

- It is professional misconduct for a lawyer to:
- (a) violate or attempt to violate the Rules of Professional Conduct, knowingly assist or induce another to do so, or do so through the acts of another; (e.g. **1.7. Conflict of Interest: Current Clients**)

**

- (c) engage in conduct **involving dishonesty, fraud, deceit or misrepresentation**

**

Tips On Reducing Liability

PROVIDE QUALITY WRITTEN ENGAGEMENT LETTERS

- Identity of the client(s)
- Clearly state the scope of the engagement
- The amount of any retainer required
- The fees to be charged by the attorneys and staff
- Costs, terms upon which counsel may withdraw from the representation
- Multiple representation disclosures (and client consents) that are applicable.
- Consider clearly limiting the scope of engagement to exclude the otherwise assumed duty to conduct due diligence and independent inquiry re accuracy and sufficiency of offering disclosures
- Will not shelter from “red flags”

“Tips” to Avoid Corporate/Securities Malpractice, by Marc I. Steinberg; Securities Regulation Law Journal was a useful resource for much of this section.

PROVIDE TERMINATION AND "CHANGE OF SCOPE" LETTERS TO CLIENT

- Letter of termination upon completion of scope
  - **eliminates** the argument that the subject party reasonably believed that the law firm was still engaged
  - aids in **distinguishing present from former clients** for attorney conflict of interest purposes.
- Write "change of scope" letters to affected clients
  - The duty to exercise due care and diligence incident to the attorney-client relationship terminates when the attorney-client relationship terminates
  - or when the services for which the attorney was retained are completed

ADEQUATELY SUPERVISE ASSOCIATES

- inadequate supervision of recent law school graduates
- Be wary of time and client pressures placed on more senior attorneys, monitor allocation of oversight resources
- Not a problem in small firms, but the most serious securities related judgments happen against larger firms

AVOID UNWORTHY CLIENTS

- Due diligence on prospective client's background:
  - Regulatory problems
  - Bankruptcy history
  - Fraud
  - Predecessor counsel
  - Current and predecessor accountants
  - Internet, Accurint, Lexis-Nexis searches
  - Contact referrals

AVOID MULTIPLE REPRESENTATION OR, AT MINIMUM, GET CLIENT WAIVER

- Avoid multiple party representation
  - the buyer and seller in the sale of a business
  - the corporation and its subsidiary in a related party transaction
- At least get waivers from parties where conflicts may arise
- Waiver alone not enough
  - Must at all times **remain disinterested and reasonably believe that such representation will not adversely affect** each of the client's best interests
- Beware of **relatively unsophisticated clients**; conflict possibly un-waivable

AVOID SENIOR PARTNER FLAWED OVERSIGHT

- Senior partner **loses of objectivity** over premier, prestigious and/or well paying clients
- **Partners assume** senior partner will provide capable representation
- **Lower-tier attorneys do not question** the advice rendered by the senior partner
- The most severe securities related judgments often happen against larger firms

AVOID INVESTING IN CLIENTS

- Being an investor in a client or **taking fees in stock increases the threat** of liability
- The anticipation of lucrative economic returns may justify this risk
- Dangerous. **Motives suspect** in litigation context
- Lawyer alleged misconduct in concealing or aiding the client's fraud **more believable** if lawyer owns stock

AVOID SERVING AS DIRECTOR AND COUNSEL

- Attorney/director is **subject to enhanced standards**
- Concerns relating to privilege preservation and insurance coverage arise with some frequency
- Prudent counsel should **attend board of director and appropriate committee meetings serving only as counsel**
- Lawyer-directors are **key targets for plaintiffs' lawyers**
- Attorneys who serve as directors of their clients "**have to be certifiably nuts**"

BE COMPETENT

- Know disclosure laws
- Be familiar with underlying business and industry
- The person who drafted that template you found may be incompetent and/or dead
- Consider textbook writers for technical portions of offering documents
- Do not assume that your own copied text is [still] appropriate
- Second set of eyes on documents
- Ensure exemption notices are filed; form Ds; state notices
- Avoid private offerings unaccredited investors
- Board resolutions approving offering and acknowledge review of offering documents

BE PROACTIVE IF PROBLEM ARISES

- Active claims management pays off
- potential circumstance; not just an actual lawsuit
- immediately notify your insurance company
- immediately evaluate how to best respond to the matter
- holds down the cost of claims

Ames & Gough 2015 Survey

THANK YOU

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