ADMINISTRATIVE PROCEEDING
FILE NO. 3-5464

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of	:
WILLIAM R. CARTER and CHARLES J. JOHNSON, JR.	:
	:
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INITIAL DECISION

March 7, 1979
Washington, D.C.

Ralph Hunter Tracy
Administrative Law Judge

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APPEARANCES: Michael K. Wolensky, Richard E. Brodsky, Elisse B. Walter and Anthony W. Djinis for the Office of General Counsel.

W. Crosby Roper, Jr., Daniel M. Gribbon, George B. Reid, Jr., and Joanne B. Grossman of Covington & Burling for Respondents.

BEFORE: Ralph Hunter Tracy, Administrative Law Judge

This private proceeding was instituted by an Order of the Commission (Order) dated June 16, 1978,[1/] pursuant to Rule 2(e) of the Commission's Rules of Practice, to determine whether William R. Carter (Carter) and Charles J. Johnson, Jr. (Johnson) attorneys and partners in Brown, Wood, Ivey, Mitchell & Petty (Brown Wood), a partnership engaged in the practice of law with offices in New York, New York, should be denied, temporarily or permanently, the privilege of appearing or practicing before the Commission.[2/]

In substance, the allegations of the Office of General Counsel (OGC) contained in the Order charge respondents with having willfully violated, and with aiding and abetting violations of Sections 10(b) and 13(a) of the Securities Exchange Act of 1934 (Exchange Act) and Rules 10b-5, 12b-20 and 13a-11 thereunder. The Order charges, also, that respondents do not possess the requisite qualifications to appear and practice before the Commission in the representation of others and that they are lacking in character and integrity and have engaged in unethical and improper professional conduct.

1/ The Order was amended for purposes of clarification, without objection, at the commencement of the hearing.

2/ Rule 2(e) provides for the temporary or permanent suspension from appearing or practicing before the Commission of "any person who is found by the Commission after notice of and opportunity for hearing in the matter (i) not to possess the requisite qualifications to represent others, or (ii) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct, or (iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the federal securities laws (15 U.S.C. 77a thru 80b-20), or the rules and regulations thereunder."

Respondents were represented by counsel throughout the proceeding. All parties have filed proposed findings of fact and conclusions of law and supporting briefs pursuant to the Commission's Rules of Practice (17 CFR 201.16).

The findings and conclusions herein are based upon the record and upon observation of the demeanor of the various witnesses. The standard of proof applied is that requiring proof by clear and convincing evidence. 3/

Respondents

William R. Carter (Carter) was born at Newark, New Jersey, on January 6, 1917. He received an AB degree from Dartmouth College in 1939 and an LLB from Harvard Law School in 1942. Following three and one-half years of active duty with the Navy during World War II he joined the predecessor firm of Brown Wood and has been continuously engaged in the practice of law with this firm since, becoming a partner on January 1, 1954. His practice has been primarily in corporate finance involving registration statements, public offerings of securities, counsel to various companies and trade associations, anti-trust work, and advising as to mergers, acquisitions and

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3/ Collins Securities Corporation v. S.E.C., 562 F.2d 820 (C.A.D.C. 1977). In holding that in an administrative proceeding brought by the Commission to determine whether a broker-dealer and its president had violated anti-fraud provisions of the federal securities laws and in which the sanction in question involved "an expulsion or a substantial suspension order" the "clear and convincing" standard of proof rather than the long-standing "preponderance of evidence" standard of proof should have been applied; the court said: "Likewise the standard of 'clear and convincing evidence' is equivalent to that in cases which have dealt with the discipline of attorneys." (Citations omitted)

methods of doing business in the anti-trust field. He is admitted to practice in the State of New York and is a member of the New York State Bar Association and the American Bar Association.

Charles J. Johnson, Jr. (Johnson) was born at Jersey City, New Jersey, on January 23, 1932. He graduated from Yale in 1953 and from Harvard Law School in 1956. Since August 1, 1956, he has been continuously practicing law with the firm of Brown Wood, having become a partner on January 1, 1967. He is a corporate and securities lawyer and has participated in numerous public offerings of securities. He has, also, worked on mergers, acquisitions and private placements. He is admitted to practice in the States of New York and Connecticut and is a member of the American Bar Association, the New York State Bar Association, the New York County Lawyers Association and the Association of the Bar of the City of New York.

Background

The allegations set forth in the Order concerning Johnson and Carter arose from their representation of National Telephone Company (National) during 1974 and 1975. National was incorporated in the State of Connecticut on April 5, 1971, to engage in the designing, leasing, installing, and maintaining of telephone systems interconnected to the lines of the Bell Telephone System. The company grew rapidly from its beginning

in 1971 to March 31, 1974, opening 20 branch offices from New England to Kansas City, increasing its reported assets from $320,123 to $19,028,613 and its net income from $2,390 to $633,485. During the same period the equipment rental contracts written by the company increased from $255,422 to $13,292,549, and the backlog of such contracts grew from $66,000 to $2,610,000.

Since 1973, National's common stock has been registered with the Commission pursuant to Section 12(g) of the Exchange Act, and it has filed reports pursuant to Section 13(a) of the Exchange Act and proxy soliciting materials pursuant to Section 14(a) of the Exchange Act. In 1971 and 1972 National sold 125,000 shares of common stock at $4.00 per share in an offering pursuant to Regulation A of the Securities Act of 1933. In 1973 National sold $2,500,000 in 9% convertible subordinated debentures pursuant to a registration statement filed with the Commission. In 1974 National filed a registration statement on Form S-8, declared effective on August 9, 1974, with respect to 200,000 shares of common stock to be offered to employees pursuant to the company's Qualified Savings Investment Plan (QSIP). This registration statement was subsequently amended and remained effective until March 31, 1975.

National's rapid growth took place under the administration of Sheldon L. Hart (Hart), one of its founders, and

at all times relevant to this proceeding its controlling stockholder. From its incorporation in April 1971 until May 24, 1975, Hart was National's president, chief executive officer, treasurer and chairman of the board.

National leased telephone systems to its customers in accordance with purportedly non-cancellable leases with initial terms ranging from 60 to 125 months. National's cash receipts consisted almost exclusively of rental payments received throughout the duration of the lease terms. The greater part of National's costs associated with the leases, including equipment costs, selling expenses, and installation costs, were incurred before the rental payments commenced. Thus, cash expenditures with respect to new leases initially exceeded the lease payments received. National's overall negative cash flow worsened as National wrote increasing numbers of new leases and installed new telephone systems. National was dependent upon external financing, debt and/or equity to sustain its growth and operations. For the fiscal years ended March 31, 1971, 1972, 1973, 1974 and 1975, National's funds applied to operations were originally reported as $159,850, $403,348, $1,867,202, $7,084,916, and $10,403,000, respectively.

To meet its steadily increasing cash requirements between 1971 and 1973, National obtained capital from its initial stock offering, from short-term loans from two Connecticut banks (Hartford National Bank & Trust Company [HNB] and

Connecticut Bank & Trust Company [CBT]), and from the $2,500,000 debenture offering of September 1973. By November 1973, National had raised about $2,300,000 after expenses from the debenture offering, of which $1,000,000 was used to repay a portion of National's outstanding bank notes and the remainder applied directly to general corporate expenses. By November 1973, National had obtained approximately $3,500,000 in advances from HNB and $2,000,000 in advances from CBT. In November 1973, National obtained a letter of intent from a five-bank consortium headed by Bankers Trust Company of New York (BT) to provide a $15,000,000 revolving credit term loan to National to be secured by lease receivables. The five banks, collectively known herein as the "Banks," were BT, HNB, CBT, Mellon Bank NA (Mellon) of Pittsburgh, Pa., and Central National Bank (Central) of Cleveland, Ohio.

In order to negotiate substantial financing with the Banks it was necessary to create a subsidiary, National Telecommunications Systems, Inc. (Systems), a New York corporation, to conduct National's leasing operations and to enter into a credit agreement with the Banks. The loans were to be made to Systems, primarily because a Connecticut statute inhibits the making of secured loans to Connecticut borrowers by banks which do not have their principal offices in the state. National agreed to transfer all its leases and underlying equipment to

Systems and Systems agreed to grant a security interest in the leases and underlying equipment to the Banks. The leases and equipment transferred to Systems constituted substantially all of National's assets.

Accordingly, the Banks entered into a credit agreement with Systems, dated April 30, 1974, whereby they agreed to lend Systems up to an aggregate of $15,000,000 on interim 90-day notes until a conversion date of November 29, 1974, at which time Systems would have the option to convert the principal amount of the interim notes then outstanding into term notes. Systems agreed to a security agreement whereby it pledged and granted a security interest in all of its leases and equipment to the Banks. National was the guarantor under these agreements.

On or about June 17, 1974, BT advanced National $650,000 on an unsecured basis because two bankers' acceptances had matured and National lacked sufficient cash to meet the obligations. Again, on or about September 9, 1974, a $483,000 letter of credit from one of National's major suppliers came due and because of National's lack of cash the Mellon Bank was required to cover it by means of an unsecured demand loan. By September 11, 1974, National had obtained secured and unsecured loans from the Banks aggregating over $15,000,000.

Following a series of meetings with the Banks, National, on December 20, 1974, closed the credit agreement

of April 30, 1974 with the Banks by means of an amendatory credit agreement (the amended agreement). The amended agreement considerably revised the April 30 credit agreement, and in addition contained substantial restrictions concerning National's operations. Following the closing, National continued to encounter financial difficulties which led to the forced resignation of Hart on May 24, 1975. 4/

Respondents' Employment by National

Brown Wood first became acquainted with National in April 1973, in connection with a proposed financing to be underwritten for National by Agio Capital Corp. (Agio), a Brown Wood client. Kenneth Socha (Socha), an associate at Brown Wood since 1970, together with a Brown Wood partner represented Agio in connection with the financing. However, this financing never materialized, and National subsequently arranged with a broker-dealer, Advest Company, for a best efforts offering of convertible debentures. In response to Hart's request, Brown Wood acted as special counsel for National in preparing and filing the registration statement in connection with the debenture offering. In working on the registration statement Socha became generally familiar with National's business.

4/ On July 2, 1975, National filed a petition for an arrangement under Chapter XI of the Bankruptcy Act. On September 30, 1975, such a petition was filed on behalf of Systems. In March 1976, both proceedings were converted to a reorganization proceeding under Chapter X of the Bankruptcy Act.

Brown Wood's work for National had been as special counsel in specific legal matters under the direction of a partner who resigned from Brown Wood in February 1974. At that time Brown Wood was working on the credit agreement for National. In March 1974 Johnson learned that Socha required assistance on the credit agreement and asked Carter to assist. Thereafter Carter assumed primary responsibility for the credit agreement.

On May 22, 1974, Carter, Johnson and Socha met with Hart at National's headquarters in Hartford. Also present was Mark Lurie, the company's inhouse counsel. This was Johnson's first meeting with Hart and the latter subsequently asked Johnson to become secretary of National. Johnson agreed by letter of June 20, 1974, and was unanimously elected secretary of National by the board of directors at its meeting on July 1, 1974. Although Johnson's principal duty as secretary was to attend board meetings and prepare the minutes therefor, he testified that he attended only four meetings from his election on July 1, 1974 until his resignation on May 24, 1975. These were on July 1, August 19, and October 15, 1974, and May 24, 1975.

Board of Directors

National's board of directors during the pertinent period covered by this proceeding was elected at the June 27,

1974 annual shareholders' meeting for which Carter and Johnson had prepared the proxy soliciting material. The board, which Johnson met for the first time upon his election as secretary on July 1, 1974, was made up of Hart as chairman and six others. Three members were reelected: Ralph A. Hart (no relation to Sheldon Hart), consultant to and former chairman of the board of Heublein, Inc.; John S.G. Rottner, attorney and Sheldon Hart's father-in-law; and Lawrence H. Rustin, partner in a Hartford public accounting firm which had formerly been National's accountant.

The three directors elected for the first time were prominent Hartford businessmen. These were E. Clayton Gengras, chairman of the board of The Connecticut Company (bus line) and Gengras Motor Car Company (an auto dealership); Roger Wilkins, formerly chairman of the board of Travelers Corporation; and Dr. Eli Shapiro, a PhD in monetary economics, presently Professor of Management at the Sloan School of Economics at Massachusetts Institute of Technology and formerly Professor of Management at Harvard. Dr. Shapiro had, also, been a director and chairman of the finance committee at Travelers. All three of these men had had broad experience as directors of other companies.

Violations

The charges against respondents in the Order arise primarily from their conduct in connection with the credit

agreement, as amended, during the period from April 1974 until May 1975. During this period National's financial condition deteriorated rapidly, and Carter and Johnson are charged with failing to fulfill their professional responsibility to see that proper disclosures were made by the company in press releases, letters to shareholders, the 1974 annual report, and the Form 8-K for December 1974.

The violations alleged in the Order, based on specific enumerated charges, are that Carter and Johnson willfully violated, and aided and abetted violations of, Sections 10(b) and 13(a) of the Exchange Act, and Rules 10b-5, 12b-20 and 13a-11 thereunder. 5/

5/ Section 10(b) as here pertinent makes it unlawful for any person to use or employ in connection with the purchase or sale of a security any manipulative device or contrivance in contravention of rules and regulations of the Commission prescribed thereunder. Rule 10b-5 defines manipulative or deceptive devices by making it unlawful for any person in such connection: "(1) to employ any device, scheme or artifice to defraud, (2) 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 (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person...."

Section 13(a) provides that every issuer of a security registered pursuant to Section 12 shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security -- such information and documents as the Commission shall require to keep reasonably current the information and documents required to be included in or filed with an application or registration statement -- such annual reports -- and such quarterly reports, as the Commission may prescribe.

Rule 12b-20 provides: "In addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."

Rule 13a-11 provides, in pertinent part: ". . . every registrant subject to Rule 13a-11 shall file a current report on Form 8-K within the period specified in that Form unless substantially the same information as that required by Form 8-K has been previously reported by the registrant."

Summary of Charges and Findings

A summation of the specific charges in the Order and the finding made as to each is as follows:

1. The Order alleges that National's 1974 annual report was false and misleading because, among other things, it failed to disclose that certain projections made therein could not be achieved unless National obtained substantial additional financing, since it had already used a substantial portion of the $15,000,000 under the credit agreement.

It is found that the 1974 annual report was false and misleading but that respondents were not responsible for its being so.

2. The Order charges that the December 20, 1974 press release prepared by Carter was materially false and misleading.

It is found that the December 20, 1974 press release was materially false and misleading and that Carter was responsible for it.

3. The Order charges that on December 23, 1974 National disseminated a letter to shareholders which was materially false and misleading; that Johnson and Carter became aware of it on December 27, 1974, but took no steps to correct it or to see that adequate disclosure was made.

It is found that the December 23, 1974, letter to shareholders was materially false and misleading and that neither Carter nor Johnson did anything about correcting it or seeing that adequate disclosure was made.

4. The Order charges that National's current report on Form 8-K for the month of December 1974, filed on January 8, 1975, was materially false and misleading.

It is found that National's 8-K for December 1974 was materially false and misleading and that Carter was responsible for it.

5. The Order charges that Carter and Johnson failed to communicate with the board of directors of National or to ensure that required disclosures were made in filings with the Commission and otherwise, despite the optimistic information about the company then extant in the market place.

It is found that Carter and Johnson failed to communicate with the board of directors and did not see that adequate disclosures were made in filings with the Commission, press releases or letters to shareholders.

6. The Order charges that Carter and Johnson, during their representation of National, (a) assisted National's management in making materially false and misleading disclosures and concealing material facts concerning the amended agreement; and (b) at least from October 1974 to May 1975, failed to ensure that proper disclosures were made, or to communicate with National's board of directors concerning management's failure to make such disclosures.

It is found that Carter and Johnson (a) assisted management in its efforts to conceal material facts concerning its financial condition; and (b) failed to inform the board of directors concerning management's unwillingness to make such disclosures.

On the basis of the above findings, which are fully supported by the evidence in the record as detailed and discussed hereinafter, it is concluded that, pursuant to Rule 2(e), Carter and Johnson should each be suspended from practice before the Commission for periods of one year and nine months, respectively.

Findings of Fact and Conclusions of Law

Shareholders approval for the transfer of assets from National to Systems, its subsidiary, was solicited through the 1974 proxy statement which was prepared by Brown Wood with the active participation of Carter and Johnson. The proxy statement was transmitted to shareholders on June 17, 1974, and was accompanied by National's 1974 annual report, and each of these documents was filed with the Commission. The first draft of the proxy material omitted a statement of reasons concerning the importance of the credit agreement characterizing it as "self-evident"; but after receiving comments from the Commission's staff, a statement regarding its importance was included, and the proxy statement urged approval of the transfer, stating that the "future growth and operations of the company are dependent upon its ability to obtain financing such as supplied by the credit agreement." The 1974 annual report contained projections of future lease installations showing a doubling of yearly lease installations from approximately

$13,500,000 in 1974 to approximately $27,000,000 in 1975.

The Order alleges that the annual report was false and misleading because, among other things, it failed to disclose that the projections could not be achieved unless National obtained substantial additional financing, since it had already used a substantial portion of the $15,000,000 commitment under the credit agreement.

The record shows that on or about May 31, 1974 Hart had called Carter seeking advice on the inclusion of projections in the annual report that was then being prepared. Carter had reservations about a company making projections in a public document and discussed the matter with Johnson and other members of the Brown Wood firm. Following these discussions Carter advised Hart by letter dated May 31, 1974 that the company could include projections in its annual report.

Enclosed with the letter was a copy of Securities Act Release No. 33-5362 concerning the use of projections. In the letter Carter suggested that in view of the enclosed release the underlying assumptions for the projections be set forth in the annual report. On or about June 4, 1974, Hart called Carter and informed him that Price Waterhouse, National's auditors, had advised against including projections for earnings and suggested that projections of net income be deleted from the annual report. Accordingly, the only projections shown were for new lease installations in fiscal 1975, but the

underlying assumptions for such projections as suggested by Carter, based on the Commission's release, were not included.

At the July 1 board meeting, which Johnson attended, Hart stated that additional financing of at least $17,000,000 was required for National to achieve the lease installations projected in the annual report.

It is evident from Hart's statement to the board only a few days after the annual meeting that the annual report which had been sent to shareholders on or about June 17, 1974, with the proxy soliciting material, was false and misleading for, among other things, failing to disclose that the projections therein could not be met without substantial financing.

Accordingly, it is found that National's 1974 annual report was false and misleading. However, in view of Carter's advice to Hart concerning the use of projections, it is concluded that neither respondent was responsible for the violation and the charge will be dismissed. However, this does not mean that this example may not be cited later as one in a series of events which should have put respondents on notice as to Hart's attitude toward compliance with the federal securities laws.

On July 14, 1974, Form S-8 for National's qualified stock plan was filed with the Commission. Brown Wood, including Carter and Johnson, acted as National's counsel in connection with this registration statement. The S-8, which included National's 1974 annual report as an exhibit, became effective on

August 9, 1974, remaining effective until March 31, 1975.

In connection with their work on the credit agreement Brown Wood had prepared a draft memorandum dated June 14, 1974, reviewed by Carter, setting forth certain liquidity and net worth ratios which National was required to maintain in order to comply with certain provisions contained in the executed credit agreement. Also, in June 1974, National requested Brown Wood to begin working on a draft of a registration statement on Form S-1 in anticipation of additional financing.

On or about June 18, 1974 Hart sent a one-page letter to shareholders announcing that National had declared a stock dividend of 3% of the company's outstanding common stock payable in three equal installments of 1% each, on August 1, September 3, and October 1, 1974.

On August 19, 1974, another meeting of the board of directors took place at which Johnson was the secretary. At this meeting the directors expressed concern over National's growth rate due to its high financing costs, need for capital, and the lack of available capital. Dr. Eli Shapiro, one of National's outside directors, presented a memorandum which was discussed at some length. The memorandum suggested that National had overstated its borrowing ability and its projections and concluded that the company should seek equity financing immediately in order to enhance its ability to survive financial adversity. No term loans had yet been made under the

credit agreement, because it had not closed,[6] although the Banks continued to advance funds to National on a demand basis. By September 11, 1974, National's total secured and unsecured borrowings from the Banks exceeded $15,000,000 and the Banks ceased advancing funds to the company when the credit agreement's limit was reached. Beginning in September 1974 therefore, with only rental receipts providing cash income, National was in a severe cash crisis.

On September 11, 1974, National's management met with representatives of the Banks at the offices of Bankers Trust in New York. The purpose of the meeting was to update the Banks on the current operations of the company and to discuss what steps were necessary to close the credit agreement. It was disclosed that since the spring of 1974 National had been working closely with Smith Barney & Co. on various financial proposals. However, because of the deterioration in the stock market, it had been unsuccessful in generating straight equity and was continuing to explore other alternatives. The lack of additional equity or quasi-equity combined with the tremendous growth of the company had resulted in a serious cash problem, and as a result the Banks were told that effective September 1, 1974 the company had started "operation wind-down."[7]

6/ Upon execution an agreement becomes effective. Typically, however, a number of conditions must be satisfied before the transactions contemplated by the agreement can be consummated. When these conditions are satisfied the transaction is effected and the agreement is closed.

7/ This was a plan to curtail operations absent additional financing (see p. 20 - infra).

(This proved to be untrue.) Operation wind-down would take place over a five-month period during which the company would convert its inventory of telephone equipment into installed telephone systems and leases, phase out its marketing and new installation organization and become solely a maintenance organization.

However, in order to accomplish an orderly wind-down and liquidate the bulk of the company's inventory ($4,995,000 at August 31, 1974), it would be necessary for the company to install and lease approximately $10,000,000 of new systems. In order to finance these new leases, National requested that the Bank's revolving credit be increased from $15,000,000 to $21,000,000. The Banks unanimously agreed that no decision would be reached on additional funds until the current credit agreement was signed. As of September 11, 1974, the credit agreement had not closed, the principal reason for the delay in closing being the continued growth of the company and Bankers Trust's inability to review all of the leases and arrive at a borrowing base. As of September 10, 1974, all of the Banks had disbursed funds with total borrowings of $13,238,000.

Despite the serious financial problems of National and the concern of the Banks as expressed at the September 11 meeting, Hart on September 12 sent out a "Dear Friends" letter which was extremely optimistic and contained no hint of National's

precarious financial situation.[8] Enclosed with the letter was an optimistic research report prepared by a brokerage firm which stated that the company was confident that it could reach the projection previously set forth in the 1974 annual report. Johnson testified that he did not see this letter at the time and doubts that anyone at Brown Wood saw it.[9]

On October 15, 1974, Johnson was secretary for another meeting of National's board. The extent of National's borrowings, its tight cash position, its failure to obtain additional financing despite vigorous efforts, and the need to curtail operations if no additional financing was obtained were discussed at that meeting. Dr. Shapiro testified that what was known as the "wind-down plan" was discussed. This was a contingency plan which Hart had discussed with Bankers Trust and which had been prepared at the request of that bank to provide a blueprint under which National would wind down its operations in an orderly fashion if additional outside financing was not obtained. The board's consensus was that curtailment of operations and termination of sales were necessary if National did not obtain additional financing. The directors also believed that National would have little chance

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8/ Donald Porter, public relations officer at National, testified that there were a number of mailing lists: a legal list, which were places the lawyers said must receive information for dissemination to the public, such as wire services, newspapers and financial publications; a list of people important to National, such as dealers, suppliers, bankers, etc.; shareholders; and "Dear Friends," which encompassed all the other lists.

9/ Porter testified that Brown Wood was not on the "Dear Friends" list but was on the regular mailing list and was kept informed as Socha, Johnson and Carter worked with Lurie, Hart and others at National on a daily basis.

to obtain any additional financing unless National's demand loans from the banks were converted to term loans as contemplated under the credit agreement. Accordingly, although closing the credit agreement would provide no new funds, they instructed Hart to take immediate steps to close the agreement.

On October 17, 1974, despite the fact that National was facing a financial crisis, the company issued another very optimistic press release for the second fiscal quarter ended September 30, 1974.[10/]

On October 18, 1974 Johnson and Carter attended a meeting between representatives of National and the Banks to determine what was necessary to close the credit agreement. Also present at this meeting were attorneys from the firm of White and Case, special counsel to the Banks. The Banks agreed to modify the liquidity projection and to temporarily waive the present company debt-to-worth ratio of 1.6 to 1 until November 29, 1974, in order to eliminate a default at closing. The agreement prohibited the ratio being in excess of 1.5 to 1. In addition, the extent of National's unsecured borrowings, National's unsuccessful efforts to obtain other financing, National's past-due operational expenses and the steps already taken by National to curtail operations were discussed at the meeting. The contingency plan, not then a

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10/ National had, also, issued optimistic statements on June 18, July 19, 20, August 16, and September 12, 1974.

requirement for closing, was also discussed, and Hart stated that he believed the Banks, in order to preserve their loans in the amount of $15,000,000 would have to commit additional funds so as to ensure an orderly wind-down of the company's business.

Shortly after this meeting, on or about October 20, 1974, Johnson, who was aware that National had been publicly reporting growing sales and earnings, despite its tight cash position, failure to obtain needed financing, and proposed curtailment of operations, instructed Socha to draft a letter reflecting these matters to be sent by National to its shareholders. Johnson and Carter reviewed the draft letter prepared by Socha, and it was forwarded to National in early November 1974. Johnson advised Lurie that the letter was an appropriate communication for National to issue. Johnson believed that in the normal course of full and fair dealing with the shareholders such a communication should be sent by the company. National's management, however, did not issue the letter, and Johnson did nothing further regarding the disclosures he had advised. 11/

On November 18, 1974, National's management along with Carter again met with the Banks. The need for curtailment of National's business was again discussed and the company agreed

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11/ Among the disclosures advised by Johnson the letter stated that the company had determined that a curtailment of operations was prudent in view of the company's negative cash flow, its need for additional financing and the current economic conditions, both general and peculiar to the company, which had adversely affected its financing efforts.

to retain Exeter Management Corporation (Exeter) to evaluate the proposed wind-down plan. A November 26 draft of an amendment to the credit agreement worked on and reviewed by Carter indicates that the wind-down plan would be an exhibit to the amendment. Although the draft provided for a total commitment of $21,000,000 from the Banks, National had to implement the wind-down if it desired to borrow more than $17,000,000.

Sometime prior to December 9, 1974, Socha received a copy of National's quarterly report to shareholders for the quarter ended September 30, 1974. The report contained a series of graphs, illustrating the results of National's operations. Lurie informed Socha that Johnson had cleared the report for mailing, although this was not true, and Johnson noted on the document that Brown Wood had not approved it. However, neither Carter nor Johnson spoke with Lurie about his misrepresentation of prior approval of the graphs by Johnson or anyone at Brown Wood.

Following the November 18, 1974 meeting with the Banks, Exeter was hired by National for the purpose of giving the Banks an independent opinion regarding the wind-down program. Following a complete review Exeter concluded that the wind-down program as presented at the November 18 meeting was not feasible, nor was it in the best interests of the Banks.

Thereafter, several additional meetings were held with the Banks and a new plan was developed.

On December 11, 1974, another joint meeting was held with the Banks with Carter in attendance. Exeter informed the Banks of its conclusion that the most favorable alternative for the Banks would be to allow National limited growth financed through additional bank borrowings and that a wind-down should be implemented only as a last resort and only if the company was unable to obtain additional financing. A new agreement was reached under which the Banks agreed to advance $18,000,000 at the closing and an additional $1,000,000 at the company's request on or before April 30, 1975. An additional $2,000,000 would be advanced on or before June 30, 1975, to implement a "lease maintenance plan" if required. An event of default would occur if (1) the company attempted to borrow in excess of $19,000,000 from the existing Bank group or (2) the company's current liabilities at the end of any month plus the overhead expenses for the current month exceeded cash available to the company plus the balance to be advanced under the Banks' commitment of $21,000,000. If a default should occur before June 30, 1975, the mandatory "lease maintenance plan" would be instituted, using the balance of the Banks' commitment as needed. The plan included the wind-down concept under a new name, "lease maintenance plan" (LMP). The terms "wind-down plan," "contingency plan," and "lease maintenance plan" are synonymous.

The LMP provided that upon the occurrence of certain events National would terminate all sales activities and operate solely as a service organization. The terms of the LMP were discussed at the December 11, 1974 meeting, and as of that date the LMP was intended to be an exhibit to the amendatory agreement. At the December 11 meeting the Banks and the company reached agreement on the amendment that would be made to the credit agreement. A draft of the amendatory agreement was to be prepared and made available for review on Monday, December 16, 1974, and a closing was scheduled for later that week.

Another draft of the amendatory agreement, dated December 13, 1974, which was prepared by White and Case, provided for a commitment of $19,000,000 in Series A loans and $2,000,000 in Series B loans. The December 13 draft dropped the term "wind-down plan" and referred to the concept as "a lease maintenance plan," and indicated that the LMP was to be furnished by National and attached as exhibit C to the amendatory agreement.

On December 20, 1974, the credit agreement, as amended by the first amendatory agreement, dated December 18, 1974, (the amended agreement) was closed. Under the amended agreement National's subsidiary, Systems, could borrow up to $19,000,000 at any time on or prior to April 30, 1975. These borrowings were to be secured by the telephone leases and equipment and guaranteed by National. If either of the two

triggering events described above (p. 24, supra) occurred, National and Systems were required to implement the LMP and their failure to act in accordance with the provisions of the LMP would be an event of default.

On or about December 20 Hart had informed Carter that he did not want the LMP to be publicized or filed with the Commission because he was concerned about the effect the LMP would have on National's sales personnel if its nature became known. Carter, after reading the LMP, advised Hart that the LMP would have to be filed with the Commission if it were an exhibit to the amendment to the credit agreement as had been contemplated. However, Carter told Hart that the LMP need not be filed with the Commission and publicized if it were not an exhibit but rather was merely referred to in the amendment. Thereupon, this change was made in the amendment and the LMP was deleted as an exhibit. Before the close of the December 20 meeting Carter also reviewed and rewrote a press release which National had provided to him to be issued by National to announce the closing of the amended credit agreement.

On the closing of the amended agreement, National immediately borrowed $18,000,000 from the Banks. Approximately $16,500,000 was used to repay existing indebtedness to the Banks, and all or virtually all of the additional sum was used to pay expenses which National had already incurred. After applying the funds borrowed on December 20, National's short-term debt still totalled approximately $2,000,000. At the

time of the closing it appeared likely that the LMP would be triggered within 60 days. The December 20, 1974 press release prepared by Carter reads as follows:

> PRESS RELEASE - FOR IMMEDIATE RELEASE
>
> EAST HARTFORD, CONN., DECEMBER 20, 1974 - National Telephone Company today announced the execution of a $6,000,000 extension of a $15,000,000 credit agreement with a group of banksheaded by Bankers Trust Company of New York. Included in the $21,000,000 is a contingency fund of $2,000,000 which is available until June 30, 1975 and which may be utilized by the company only for the purpose of funding a lease maintenance program in the event additional financing is not otherwise available.
>
> Of the $21,000,000 the Company has borrowed $18,000,000 pursuant to a seven-year term loan, of which approximately $16,500,000 was used to repay outstanding short-term loans. The balance will be used for general operating expenses. Participating in the loans are Bankers Trust Company of New York, Mellon Bank N.A. of Pittsburgh, Central National Bank of Cleveland, The Connecticut Bank and Trust Company and the Hartford National Bank and Trust Company of Hartford, Connecticut.

The Order alleges that the press release was materially false and misleading in that, among other things, it did not disclose:

(a) the substantial limitations placed on National's operations by the amended agreement;

(b) the nature of the LMP, its material effect on National's operations, and the likelihood that National would be required to implement the LMP within several months; and

(c) that National's earlier predictions of growth were unlikely to be met, due to National's critical cash position and the limitations placed on its growth by the amended agreement.

The press release did not define the term "lease maintenance program" although it has no generally recognized meaning. Neither did it disclose the nature of the LMP nor its effect on National's operations, the limitations imposed by it, and the possibility that National would be required to implement it within the next few months. In addition, the statement that the balance ($1,500,000) would be used for "general operating expenses" was incorrect.

It is found that the press release was materially false and misleading, as charged in the Order.

Although Carter and Johnson had advised National not to issue any statement concerning the amended agreement which had not been cleared by Brown Wood, National issued a letter to its shareholders on December 23, 1974 concerning the amended agreement and other financing arrangements.

The Order charges the letter of December 23, 1974 as being materially false and misleading, in that, among other things:

(a) it indicated that National had received an additional $6,000,000 line of credit from the Banks which it could use for operating expenses;

(b) it did not refer to the LMP, its nature , its material effect on National's operations, or the likelihood that National would be required to implement the LMP within several months;

(c) it did not disclose that National's earlier predictions of growth were unlikely to be realized because of National's critical cash position and the limitations placed on its growth by the amended agreement; and

(d) it stated that National "was stronger now than ever before in its history"; referred to "a greater availability of capital, expanding productivity and growing earnings"; and further that "We shall continue to limit installations substantially below our capability until the end of our fiscal year. However, the leveling of volume will not mean any reduction in productivity, and will not be to the detriment of continuing earnings growth."

Carter and Johnson became aware of the letter to shareholders and its contents on or about December 27, 1974, after Brian Kay (Kay), Lurie's assistant, aware that National had ignored Brown Wood's advice when it issued the letter, telephoned Socha and dictated the text of the letter over the telephone. Socha, who thought that the description of the amended agreement contained in the letter was seriously inadequate, immediately gave a copy of its contents to Johnson. Carter also saw a transcript of the letter of December 23. Both Carter and Johnson agreed that the description of the amended agreement was not "adequate disclosure." However, although they did not know the extent of the distribution of the December 20 press release, they concluded that this letter,

if read with the press release, was not misleading. Johnson testified that while they were not wholly comfortable with the letter they were not uncomfortable with it. Accordingly, Carter and Johnson did nothing about correcting the letter.

It is found that the December 23, 1974 letter to shareholders was materially false and misleading, as charged in the Order.

National's 8-K

On or about January 8, 1975, National filed with the Commission a current report on Form 8-K for the month of December 1974. Attached thereto as exhibits were the credit agreement of April 30, 1974 and the amendatory credit agreement of December 18, 1974. However, the LMP was not included as an exhibit, although it is referred to in at least one place as Exhibit C to the amendatory agreement. Under Item 2 of Form 8-K, it was disclosed, among other things, that the "banks agreed to lend to Systems subject to certain terms and conditions, sums not to exceed $21,000,000 of which $2,000,000 is a contingency fund available until June 30, 1975, only for the purpose of funding a lease maintenance program in the event additional financing is not otherwise available."

The Order alleges that Form 8-K was materially false and misleading in that, among other things, it failed to disclose material facts concerning the LMP and the material

effect which the LMP's probable implementation would have on National's operations.

The first time that Carter saw the LMP plan was on or about December 20, 1974, at the meeting of the Banks when the credit agreement was closed. Hart brought the LMP to the meeting and asked Carter if it was necessary to include it as an exhibit to the amendatory credit agreement when filed with National's 8-K.

The principal reason Hart gave Carter for not wanting to include the LMP as an exhibit was that disclosure of the LMP would destroy employee morale.

After reviewing the LMP Carter said that it could be eliminated as an exhibit to the amendatory agreement if the amendatory agreement were revised so that instead of referring to the LMP as an exhibit it would refer to it as a document previously delivered to the Banks. Accordingly, the amendatory agreement was revised to eliminate reference to the LMP as an exhibit. Although the LMP was not included as an exhibit and the amendatory agreement was purportedly rewritten to eliminate any reference to it as an exhibit, there was one reference inadvertently left in, which refers to the lease maintenance plan being attached thereto as Exhibit C.

Although there are several references to the LMP in the amendatory agreement, there is no explanation as to just what it is or what effect its implementation would have on National. As a matter of fact, it is necessary to read closely

both documents and to skip back and forth between the agreements as there is no one document which contains the complete agreement of April 30 as amended on December 18. In addition, it is written in technical language which obfuscates rather than clearly discloses. It appears that the agreement and the amendatory agreement were both written by White and Case, the counsel for the Banks, but that Carter reviewed and revised drafts. Carter testified that he took full responsibility for the 8-K, as filed.

Some idea of the difficulty of ascertaining what was meant by the term lease maintenance plan as described in the 8-K filing may be gained by the following illustration from the first amendatory agreement, Section 7, page 7:

> 7. Section 5 of the Agreement is hereby amended by (i) adding the following Subsection after Section 5.11 and (ii) designating Section 5.12 of the Agreement as 5.13:
>
> "5.12 Lease Maintenance Plan. On and after the act or condition which would require the implementation of the Lease Maintenance Plan in accordance with Paragraph A13 of Exhibit G, annexed to this Agreement...."

Upon turning to Exhibit G, page 5, it is discovered that there is no Paragraph A13. However, by going back to the amendatory agreement and pursuing it to page 14, Section 30, the following is found:

> 30. Paragraph A of Exhibit G annexed to the Agreement is hereby amended by adding the following subparagraphs at the end thereof:

> 13. Lease Maintenance Plan. If on or before the Series B Expiry Date (a) the Company gives notice to the Agent of its intention to borrow from the Banks pursuant to this Agreement an amount which, together with the original aggregate principal of all Loans made hereunder, exceeds $19,000,000 or (b) on the last day of any month, the current liabilities (other than liabilities of the Company under this Agreement or in respect of term indebtedness permitted by paragraph B2-(c) of this Exhibit G) of the Guarantor and all of its Subsidiaries plus the Overhead Expenses (as hereinafter defined) of the Guarantor and all of its Subsidiaries for the month ending on such day exceed the cash of the Guarantor and all of its Subsidiaries (including amounts payable to the Company on such day from the Cash Collateral Account in accordance with the provisions of Paragraph All of this Exhibit G) plus the unutilized portion of the Total Commitments all determined as at any such day, then the company shall forthwith take all appropriate action to implement the Lease Maintenance Plan.

Respondents argue that the order does not allege that the omission of the lease maintenance plan as an exhibit rendered the December 8-K false and misleading. This is true. What the order does allege is that omitted disclosure of material concerning the LMP, among other things, made the 8-K materially false and misleading. When the LMP was omitted as an exhibit it became necessary to adequately describe the LMP either in the 8-K or in the amended agreement. Although, as respondents say, the lease maintenance plan is referred to in several places in the amendatory agreement, nowhere is there a description as to just what it is, or what effect its implementation would have on the company.

If, as Hart said, the publication of the LMP would have destroyed employee morale, it is equally probable that

it would have affected investors' decisions. It would seem to follow that if the LMP contained material information which would be important to employees, that it would likewise be a material fact for investors to know in making a decision. It would appear that stockholders should get the same consideration as employees.

As stated above, in order to read the exhibits attached to the 8-K, it is necessary to continually skip back and forth so that it becomes extremely difficult and almost impossible to ascertain the true meaning of the documents. In this connection the Commission has said:

> Adequate disclosure is not to be viewed in terms of a jigsaw puzzle which investors must piece together. While an expert, by analyzing the balance sheet and the information in the offering circular could calculate the amount of the dilution we do not think that the ordinary investor could or should be required to do so. Mutual Employees Trademark, Inc., 40 SEC 1092, 1095 (1962).

The concept of materiality has been described as the cornerstone of the disclosure system established by the federal securities laws. The standard for materiality has been stated by the Supreme Court as follows:

> What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered

the "total mix" of the information made available. TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976) 12/

An attorney from White & Case who testified in this proceeding produced a conformed copy of the amendatory agreement which includes both the amendatory agreement and the credit agreement as one document. However, even though it presents the agreement and amendment in a more readable form, all in one piece without having to skip back and forth between the various sections, it is still false and misleading in that it omits a material fact: that is, an explanation of the LMP. The LMP is only referred to and it is not described or properly defined. As testified to by all witnesses at the hearing who participated in the various meetings, "LMP" or "lease maintenance plan" was a phrase no one had heard of previously. It apparently was composed as a camouflage for "wind-down" and in that respect the terminology was in itself misleading as in all probability the term wind-down would have been more readily understood. In addition, the fact that a conformed copy was not prepared for filing with the 8-K permits the inference that the form of the filing as made was intended to obscure its meaning.

12/ Although the TSC decision related to proxy, rather than antifraud violations, post-TSC appellate decisions have held that the TSC standard also applies to antifraud violations. See, e.g., Haravy v. Industries, Inc., 571 F.2d 737, 741 n. 5 (2d Cir., 1978), where the court said: "This is not only the standard for proxy-related disputes, but for Rule 10b-5 disputes as well," citing Goldberg v. Meridor, 567 F.2d 209, 218-19 (2d Cir., 1977), cert. denied, 434 U.S. 1069 (1978), and Bausch & Lomb, Inc., 565 F.2d 8, 13-15 (2d Cir. 1977).

In view of the foregoing it is found that National's 8-K for the month of December 31, 1974 was materially false and misleading, as alleged in the Order.

On or about January 20, 1975, National and the Banks were given notice that National's borrowing from the Banks had reached $18,425,000 and that National was only $10,391 away from violating the liquidity test in the amendatory agreement. This information was contained in the required monthly report by Exeter Corp dated January 20, 1975. This report was sent to all the Banks with a copy to National. No disclosure of National's proximity to the implementation of the LMP, as indicated in the report, was made to the public or the Commission. On February 4, 1975, National issued an optimistic press release concerning its fiscal third quarter ended December 31, 1974.

On February 20, 1975, Exeter sent its required monthly report to the Banks with a copy to National. In a letter to a vice president of Bankers Trust, accompanying the report, attention was called to the fact that National had drawn down the entire $19,000,000 as of February 20, 1975 and had no more funds available from the lending group.

On February 25, 1975, E. Clayton Gengras, one of the directors of National, wrote a letter to Hart on behalf of other directors stating that if the board of directors was not

kept current on the financial condition of National they would resign. In a letter dated March 11, 1975 to Bankers Trust, the controller of National enclosed a certificate dated March 11, 1975, signed by Hart, that the LMP had been implemented pursuant to the amended credit agreement. On March 12, 1975, in a letter to Bankers Trust, the controller of National submitted a status report on the implementation of the LMP saying that National had implemented compliance with the LMP in February 1975.

On March 14, 1975, a vice president of Bankers Trust called an attorney at White and Case to inform him that the events requiring the implementation of the lease maintenance plan as set forth in the first amendatory agreement had occurred. The vice president stated that no public disclosure had been made by National and that Bankers had been receiving inquiries from trade creditors of Systems and National. He was asking White and Case for advice as to the proper method of responding to these inquiries.

On March 17, 1975, three attorneys at White and Case made a conference call to Carter at Brown Wood and informed him that they had been advised by Bankers Trust that events requiring the implementation of the lease maintenance plan had occurred. Carter indicated that he had not previously been aware of this. It was then indicated to Carter that the

guarantor (National) and its counsel had the responsibility to determine what public disclosure, if any, would be appropriate in light of the fact that the lease maintenance plan had been triggered and the attorneys had called to obtain assurances that appropriate public disclosure would be made if it were determined to be required. Carter responded, "Right, right -- we'll get ahold of the guarantor and see if we can get a statement out." The White and Case attorneys then called the vice president of Bankers Trust and related their conversation with Carter to him.

Carter's memorandum of the call from White and Case made by him at the time contains the notation "appropriate disclosure will be made." On March 18, Carter called Lurie at National and advised him of the call from White and Case and the need for disclosure if National was required to implement the LMP. Lurie, while admitting that things were "tight," did not confirm nor deny the accuracy of the information from White and Case that the LMP had been triggered. After the call to Lurie, Carter discussed the matter with Johnson, but they did not make any independent attempt to ascertain whether the LMP had been triggered. Johnson testified that his reaction was to find out what the facts were, but neither he nor anyone else at Brown Wood contacted anyone outside National's management in an attempt to determine whether the LMP had been triggered.

In early April Carter and Johnson discussed National's obligation to effect the LMP. As a result of a conversation with Hart, Johnson was morally certain that National was required to implement the LMP and reiterated Brown Wood's advice that disclosure was necessary. However, he and Carter believed that Hart did not intend to implement the LMP.

On April 14, 1975, National filed an amendment to its Form 8-K for December 1974. The amendment under Item 7 read as follows:

> Under the terms of the Credit Agreement Systems may borrow up to an aggregate principal amount of $21,000,000. Included in the $21,000,000 is a contingency fund of $2,000,000 which is available until June 30, 1975, and which may be utilized by the Company only for the purpose of funding a lease maintenance plan in the event additional financing is not otherwise available . . . .
>
> The issuance of the notes is considered exempt from registration under the Securities Act of 1933 as a transaction not involving any public offering within the meaning of Section 4(2) thereof.
>
> Additionally, the Credit Agreement may be deemed to be a security within the meaning of Section 3(a)(10) of the Securities Exchange Act of 1934.

The amendment did not correct the failure to adequately disclose the nature of the LMP, the effect its implementation would have on National's operations, or the fact that events had occurred which required that it be implemented.

On April 23, 1975, both Carter and Johnson met with Hart and advised that immediate disclosure of the LMP was required and that his hopes of obtaining additional financing

and his negotiations for the waiver of the LMP on the part of the Bank did not excuse National's legal obligation to make prompt disclosure. During the meeting Hart received a call from a representative of one of the Banks who threatened to report the facts to the Commission if Hart did not disclose the triggering of the LMP.

On April 28, 1975, Hart telephoned Johnson and informed him that one of the Banks had requested an opinion from Brown Wood regarding National's disclosure obligations with respect to the LMP. Hart requested that Johnson issue an opinion that disclosure was not necessary. Johnson testified "and I said to him,'I'm incredulous. I just can't believe this. You sat in my office last week and I told you as clearly and positively and precisely as I could that my advice was that you should disclose that you had gone into the lease maintenance mode.'"

In late April Johnson instructed Socha to draft a disclosure document for National to issue. Carter and Johnson reviewed and approved a draft shareholder letter prepared by Socha and it was forwarded to Hart on or about May 1, 1975, with the suggestion that Hart call Carter and Johnson about the letter. The respondents did not attempt to verify Hart's statements about a possible waiver of the LMP. Although they knew that National was required to implement the LMP, but had not done so, and that the company's failure to implement the plan was an event of default under the amended agreement, the

draft letter did not disclose that an event of default had occurred. National did not issue the letter and Carter and Johnson did not make any protest about it.

In the meantime on April 17, 1975, the vice president of Central Bank wrote to Hart stating that on March 18, 1975 a meeting had been held by the Banks at Bankers Trust Company to discuss the LMP and that as a result of that meeting a letter had been forwarded to Hart requesting certain information. The vice president stated that as of that date only a part of the requested information had been provided. He then went on to say "furthermore, I would like a written response from your counsel regarding National Telecommunication Systems, Inc. and National Telephone Company's obligation to make public disclosure regarding significant transactions which may have transpired during the last several months, particularly with regard to the implementing of the lease maintenance plan. I would like copies of all information provided to the Securities and Exchange Commission since January 1, 1975." Under date of May 8 Hart replied to this letter, in which he said "regarding the matter of public disclosure, no disclosure has been made because, in the opinion of the company such was not necessary."

On May 9, Kay, the assistant to Lurie at National, called Socha at Brown Wood to clear a draft of National's proposed Form 8-K for the month of April 1975. Socha told Kay

that he and Johnson were of the strong opinion that the 8-K should include disclosure of National's present condition under the amended agreement and the event of default which resulted from the company's failure to implement the LMP. Kay agreed to include the suggested disclosure and Socha so informed the respondents, but the report actually filed with the Commission, dated May 9, did not refer to National's obligation to implement the LMP because Lurie would not permit the disclosure to be made.

On May 12, 1975, two attorneys from White and Case called Brown Wood and talked to Socha. The purpose of their call was to be brought up to date on what if any, public disclosure had been made subsequent to their March 17 conversation with Carter. Socha described Johnson's and Carter's repeated advice to National with respect to the disclosure matter extending back to the time that White and Case had informed them of events that triggered National's obligations with respect to the lease maintenance program but, stated Socha, to his knowledge no such disclosure had been made.

On the same day, May 12, 1975, Socha called Kay at National and asked where the April 8-K was; Kay replied that Lurie would not permit him to mail a copy to Brown Wood or the SEC. However, the record shows that the April 8-K was filed with the SEC on May 15, 1975. Socha testified that he obtained a copy of it from the SEC.

The 8-K for April did not mention the LMP or the fact that it had been implemented. The 8-K discloses that an aggregate of $18,000,000 in notes was issued by Systems to the Banks on December 20, 1974. It states that as of April 30, 1975 Systems had issued additional notes, pursuant to the credit agreement, to the Banks in the aggregate amount of $2,161,000. This would have brought the outstanding amount of the loans to $20,161,000, which meant that the LMP had to be implemented since any borrowings over $19,000,000 were to be used only for the LMP according to the amended agreement. Instead, the 8-K says that the cash proceeds of the additional notes have been used for general operating expenses.

On May 16, 1975, Lawrence Rustin, one of the directors, wrote to Hart on behalf of himself and four other directors stating, among other things, that they insisted that there be complete, full and fair disclosure of the condition of the company. The letter said that "we must have your written response no later than next Thursday, May 22, to be followed as soon as possible thereafter by a meeting of the Board of Directors to consider our future course of action." On May 21, 1975 there was a special meeting of the board of directors at which they discussed the resignation of Hart. The directors also suggested to Hart that opinion of counsel be sought with regard to disclosure. The directors expressed considerable

concern as to their obligation to disclose the true situation of the company to the SEC and to the public. Hart was asked by the directors to contact the company's counsel and request that counsel immediately prepare a draft release to be reviewed by the directors in the hope that such a release could be prepared and distributed on May 22 or May 23.

On May 22, 1975, some of the directors held an informal luncheon meeting at which it was decided to have a formal directors' meeting on Saturday May 24, 1975, and they were insistent that Hart attend this meeting.

On Saturday afternoon, May 24, 1974, the meeting of the board of directors was convened in the office of Gengras in Hartford. Hart assumed the position of chairman of the meeting but Gengras was the de facto chairman. Johnson was there as secretary, having been asked to attend by Hart. Also present was John S. Murtha (Murtha) of the Hartford law firm of Murtha, Cullina, Richter & Pinney. Murtha explained to Johnson that he was present because he had been consulted by Gengras, who was a client, and the other directors as to their fiduciary responsibilities in the present situation. He had been asked to attend this meeting in the expectation that Hart had not requested Johnson to be present, as Hart had indicated that he intended to have his personal attorney present. At this meeting Hart resigned as chairman. Johnson prepared a press release which was unanimously approved by the board. It was

decided that Brown Wood would continue as company counsel but Johnson resigned as secretary.

Wilkins testified that it was at this meeting that Johnson read a draft of a letter which Brown Wood had sent to Hart a month earlier advising disclosure of the fact that implementation of the LMP had been triggered and its effect on National. Wilkins said that the directors had no indication prior to that time that Brown Wood had recommended disclosure to Hart and that when he heard the letter read he "was shocked to the core."

On May 27, 1975, Johnson and Carter called White and Case and had a telephone conference with the three attorneys at White and Case who had previously participated in the Bank negotiations. Johnson and Carter indicated in the conversation that they wished to reopen the lines of communication with the White and Case attorneys by bringing them up to date on the meeting which had been held in Hartford on Saturday, May 24, 1975. Johnson and Carter advised White and Case that as a result of the meeting Hart had been asked to resign as chief executive officer and had done so, that the directors were attempting to have Hart place his stock in a voting trust, and that Brown Wood had assisted the directors in formulating the press release. Johnson and Carter then discussed the reason for the delay in making the disclosure. At first they said

that Hart had never intended to implement the lease maintenance plan despite the agreement of National to do so, although representations had been made that it was being followed, including Hart's certificate that the LMP was in effect. Furthermore, Brown Wood had advised Hart to make disclosure after they became aware on March 17, 1975 that the LMP had been triggered. Hart apparently never refused to make disclosure, but put if off on the ground that he felt disclosure would be irrelevant since he was meeting with the Banks to negotiate a waiver of the LMP and expected that the waiver would be granted. At this point the White and Case attorneys told Johnson and Carter, as they had previously, that the Banks had never advised that they were willing to waive the LMP.

Johnson and Carter continued the conference saying that in March they had talked with Hart to "put it on the line," that is, disclosure must be made. However, Hart then went to Europe and nothing was done. On April 1, 1975, Brown Wood had written to National advising disclosure and enclosing the text of a press release. Finally, when no disclosure was made, the Saturday, May 24, 1975 meeting was held and disclosure was made on May 27, 1975.

On May 28, 1975 Hart sent out a "Dear Friends" letter in which he announced the change in the officers of the company and that the company would curtail writing of telephone equipment leases and would concentrate servicing existing

leases "by the terms of the credit agreement the institution of such a lease maintenance program was required when the amount borrowed thereunder exceeded $19,000,000. Negotiations with the banks to obtain a waiver of the requirements had not been successful and the program will commence immediately."

Socha testified that this letter was reviewed by him and Carter and revised. The revised letter instead of Hart's was to be sent to "Dear Friends" including shareholders. However, Hart's letter was already being mailed to shareholders before the revised letter could be substituted. It was believed that the original letter which had been prepared by Hart and Lurie was mailed to stockholders and the revised letter was then sent to all who were on the other lists.

At the May 24 board meeting the directors requested that Brown Wood remain as company counsel. Subsequently, Carter and Socha spent a considerable amount of time attending meetings in Hartford with the directors and representatives of the Banks, preparing press releases and advising generally with respect to the federal securities laws. When it seemed likely that National would petition under Chapter XI of the federal bankruptcy laws, Johnson called the Division of Enforcement and asked that trading in National's stock be suspended.

Following the resignation of Hart, a management committee was appointed to run the company. As stated heretofore,

National and its subsidiary, Systems, are now in reorganization proceedings under Chapter X of the Bankruptcy Act. Among the creditors is Brown Wood which submitted a claim for legal fees in excess of $200,000.

Conclusions as to Violations

The facts in this proceeding, which have been detailed at some length, are not seriously disputed by the respondents. What is disputed is the application of these facts to the respondents and their responsibility in dealing with them. Basically, respondents' defense is that they repeatedly told Hart to comply with the applicable securities laws and regulations, and the fact that he continually ignored such advice is not their fault. Despite the urging of other attorneys and Bank representatives they took no steps to see that proper disclosure of the company's financial affairs was made to anyone, including shareholders, investors, the SEC or even National's board of directors.

While denying that they violated or aided and abetted violations of the securities laws or regulations, respondents admit that they had some measure of responsibility with respect to three of the disclosures challenged by the staff as primary violations of the securities laws: the annual report for 1974; the press release of December 20, 1974; and the 8-K for December 1974.

Although the annual report for 1974 has been found to have been false and misleading, the charge concerning the respondents' responsibility or connection with it has been dismissed. The dismissal is based on the record which does not show that up to that point the respondents were aware that their advice concerning federal securities laws and regulations was not going to be followed. However, from that point on they were on notice of Hart's callous disregard for complying with securities regulations and his complete indifference to respondents' advice, as can be seen from the foregoing summary of facts. The record is replete with incident after incident where the respondents advised, both orally and in writing, of the need for disclosure of National's financial condition, all of which were ignored. There are numerous incidents previously spelled out in this decision which show that respondents either should have been on notice or actually were on notice of the fact that their advice was being disregarded. These incidents should have, at the least, served as red flags to alert respondents to some course of action which would have prevented the violations found herein. However, the record shows that rather than taking steps to see that the violations did not occur the respondents participated and assisted in misrepresenting and concealing material information about National from its security holders and the public from May 1974 to May 1975.

Respondents argue that the elements necessary to establish a direct or primary violation of Section 10(b) and Rule 10b-5 are (1) an omission or misstatement of material facts (2) made with an intent to defraud, deceive, or manipulate.

As to respondents' first contention regarding materiality, that has already been dealt with at pages 34 and 35 supra. Accordingly, it is found that omissions in the press release of December 20, 1974, the shareholders' letter of December 23, 1974, and the 8-K for December 1974 were material.

Additionally, however, respondents argue that no category of facts is per se material without regard to their context. This, undoubtedly, refers to testimony by one expert witness that while there may have been omissions in some of the information put out by National in the 8-K, or a press release, or a letter, it was corrected by being included somewhere else, so that by reading all of the various publications the investor would be able to put everything in context and determine what was material and immaterial. This argument has been dealt with in Smallwood v. Pearl Brewing Company, 489 F.2d 579, 605 (5th Cir., 1974) where the court said:

> We cannot accept the premise that prior disclosure in one communication will automatically excuse omissions in another. As we indicated above, the adequacy of disclosure is a function of position, emphasis, and the reasonable anticipation that certain future events will occur. Perception of future events may take on a different cast as the future approaches, and what is more important, later correspondence may act to bury facts previously disclosed. 13/

13/ See also Ross v. A.H. Robins (Current) CCH Fed. Sec. L. Rep. ¶94,893 at 94,895 (S.D.N.Y. Jan. 8, 1979), notice of appeal filed, February 7, 1979.

Moreover, the record discloses that all of the other press releases, letters to shareholders and other communications, also either omitted or concealed the material facts which were omitted from the December 20 press release, the December 23 letter and the 8-K. Principal among these material omissions concerning the condition of the company was an adequate description of the LMP and its effect on National's operations. These three documents by themselves are materially false and misleading, but when put in context with the multitude of other incidents described herein, it becomes plainly evident that the omissions were material to any shareholder or investor faced with a decision concerning the purchase or sale of National's common stock which was traded on the over-the-counter market.

According to Standard & Poor's Daily Stock Price Record of Over the Counter Stocks, approximately 75,000 shares of National's common stock was traded from April 1, 1975 through May 23, 1975, at prices ranging from 13 bid to 16 asked. The aggregate amount of money involved in these transactions was over one million dollars.

As to their second contention, respondents state that scienter can be established only by proof that the respondents knew the falsity and materiality of the matters alleged and had an intent to defraud investors. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212-15 (1976).

The Commission has traditionally followed the standard of willfullness in administrative proceedings set by the court in Tager v. S.E.C., 344 F.2d 5, 8 (2d Cir. 1965), where it said:

> It has been uniformly held that "willfully" in this context means intentionally commiting the act which constitutes the violation. There is no requirement that the actor be aware that he is violating the Rules or Acts.

The record clearly supports the conduct of Carter and Johnson as being within the Tager definition. Further, the Commission has held Hochfelder to be inapplicable to its administrative proceedings. 14/

In a recent case, Securities and Exchange Commission v. Blatt, 583 F.2d 1325, 1334 (5th Cir., Nov. 15, 1978), the court stated:

> The record in this action reveals knowing omissions by each appellant....
> Their conduct, in our judgment, encompassed just the type of "knowing or intentional misconduct" that Section 10(b) was intended to proscribe. See Hochfelder, 425 U.S. at 197, 212-213; SEC v. Commonwealth Chemical Securities, Inc., 547 F.2d 90, 102 (2d Cir. 1978); cf. Arthur Lipper Corp. v. SEC, 547 F.2d 171, 180 (2d Cir. 1976). . . .
>
> We are confident that "knowing" conduct satisfies the scienter requirement.

The record here, as in Blatt, reveals knowing conduct on the part of the respondents. Therefore, the findings herein establish that the culpability standard of Hochfelder has been

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14/ FAI Investment Analysts, Inc., Securities Exchange Act Release No. 14288/ December 19, 1977; Steadman Security Corp., Securities Exchange Act Release No. 13695/June 29, 1977, appeal pending, 5th Cir., No. 77-2415; Arthur Lipper Corp. v. Securities and Exchange Commission, 547 F.2d 171, 180 (2d Cir., 1976), rehearing denied, 551 F.2d 915 (1977), cert. denied, 434 U.S. 1009 (1978).

met.

Accordingly, as to the foregoing charges in the Order, it is found under either the Tager or Hochfelder standard that respondents willfully violated and willfully aided and abetted violations of Sections 10(b) and 13(a) of the Exchange Act and Rules 10b-5, 12b-20, and 13a-11, thereunder.[15/]

Professional Responsibilities

In addition to the charges in the Order for which findings have been made, there remain the charges that respondents: (a) do not possess the requisite qualifications to appear and practice before the Commission in the representation of others; and (b) are lacking in character and integrity and have engaged in unethical and improper professional conduct.

Respondents attack the above charges as being unconstitutionally vague in that they indicate that respondents may be disciplined, even if no violation of law is shown, on the grounds that they acted "unprofessionally" and "unethically." They contend that these terms do not provide sufficient notice of their meaning and that prior to the hearing they were not apprised of any specific standards or rules of professional or ethical conduct which respondents allegedly violated. Respondents

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15/ The courts have recognized that conduct may violate both Rule 10b-5 and Section 13(a), and that in such situations, it is appropriate for the Commission to charge violations of both antifraud and reporting provisions. See, e.g., Securities and Exchange Commission v. Joseph Schlitz Brewing Co., 452 F. Supp. 824, 829-33 (E.D. Wis., 1978); Securities and Exchange Commission v. Falstaff Brewing Corp., (Current) CCH Fed. Sec. L. Rep. ¶96,583 at 94,470-94,971 (D. D.C., 1978); Securities and Exchange Commission v. General Refractories Co., 400 F. Supp. 1248, 1256-58 (D. D.C., 1975).

state that although the OGC now argues that American Bar Association (ABA) pronouncements may be taken as a standard by which to judge respondents' conduct, the Commission, in Securities Act Release No. 33-5953 (August 15, 1978), disavowed that it administers the ABA Code of Professional Responsibility (Code).

While the Commission may not administer the ABA Code, it is clear from reading the cited portion of the Release in its entirety that it incorporates the guidelines of the ABA Code in its own Conduct Regulation which it does administer.

The language of the allegations in question conveys sufficient notice of the proscribed conduct when measured by common understanding and practice.[16/] The actions of respondents and their counsel in defending the allegations in the Order disprove their contentions that they were vague and did not provide sufficient notice. The record shows that they fully understood the terms "professional" and "unethical" in the presentation of their defense and, in fact, produced two expert witnesses on this precise point.

The Code of Professional Responsibility

In 1908 the American Bar Association promulgated 32 canons of professional ethics, which, subject to subsequent

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16/ Sword v. Fox, 446 F.2d 1091, 1099 (4th Cir.), cert. denied, 404 U.S. 994 (1971), quoting United States v. Petrillo, 332 U.S. 1 (1947).

opinions of the Committee of Professional Ethics and Grievances, remained in force until the adoption of the present Code on August 12, 1969 to become effective on January 1, 1970.

The Code consists of 9 canons, 137 ethical considerations (ECs) and 40 disciplinary rules (DRs). The canons establish the general principles to be followed. The ECs, some of which are set forth under each of the canons, are defined as aspirational in nature. The DRs, also set forth under each of the canons, "state the minimum level of conduct below which no lawyer can fall without being subject to disciplinary action." 17/

Relevant to an understanding of the duties reasonably expected of a securities lawyer practicing before this Commission and applicable to the respondents in this proceeding are the particular portions of the Code discussed by the parties and considered herein. 18/ The OGC states that respondents

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17/ Code of Professional Responsibility, Preamble, note 1.

18/ These are DR 1-102(A)(4), which states that a lawyer shall not engage in conduct involving dishonesty, fraud, deceit, or misrepresentation; and DR 7-102(A)(7), which states that in his representation of a client, a lawyer shall not counsel or assist his client in conduct that the lawyer knows to be illegal or fraudulent.

participated in activity which is clearly prohibited by recognized standards of proper ethical conduct, and has frequently been the occasion for the invocation of the Commission's authority to discipline professionals under Rule 2(e).[19/]

On the other hand, respondents contend that a lawyer is subject to the rules of conduct adopted by the particular jurisdiction in which he is admitted to practice and that most jurisdictions have adopted some version of the ABA Code. However, they maintain, there is no special code of conduct for securities lawyers. Respondents do not dispute that they would be subject to any Commission pronouncements having the force of law, but say there are no such pronouncements; that while respondents are subject to the federal securities laws and the decisions thereunder, absent a violation, they cannot be held accountable for their conduct in their representation of National.

Contrary to respondents assertion, there have been many pronouncements in Commission decisions clearly setting forth attorneys' responsibilities of which lawyers practicing before this Commission should be fully aware.[20/] Moreover,

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19/ See e.g., Albert J. Fleischmann, 37 SEC 832, 836 (1950); In re Irwin L. Germaise, Securities Act Release No. 5216/Dec. 7, 1971; In re Lloyd Feld, Exchange Act Release No. 11775/Oct. 30, 1975, 8 SEC Docket 291 Milton Loewe, Exchange Act Release No. 11776/Oct. 30, 1975, 8 SEC Docket 294.

20/ See footnote 19, supra.

counsel interested in determining the standards appropriate to his conduct before the Commission should make reference to the ABA Code, particularly EC 5-18 and DRs 1-102(A)(4) and 7-102(A)(7).

Basic to any consideration of the professional or ethical conduct of respondents in the instant proceeding is an understanding as to who is the client. EC 5-18 of the ABA Code says:

> A lawyer employed or retained by a corporation or similar entity owes his allegiance to the entity and not to a stockholder, director, officer, employee, representative, or other person connected with the entity. In advising the entity, a lawyer should keep paramount its interest and his professional judgment should not be influenced by the personal desires of any person or organization.

While EC 5-18 is not much help in establishing who the client is to whom the securities lawyer owes his allegiance the consensus in articles on the subject indicates the client to be the corporation and its board of directors.

In 1975, the Committee on Counsel Responsibility and Liability of the Section of Corporation, Banking and Business Law of the ABA, issued a report, "The Code of Professional Responsibility and the Responsibility of Lawyers Engaged in Securities Law Practice," 30 Bus. Lawyer 1289 (1975). In its report the Committee focused on the "lawyer's obligation to disclose, or duty not to disclose, material misstatements or omissions made by a client to the SEC, to the independent public

accountants, or to any other person." In discussing the question of who is the client, the Committee, after quoting from relevant portions of EC 5-18, concluded that where the question is one of material misstatement or omission, the client clearly is the corporation, it having made the disclosure. The Report then states:

> In instances where the lawyer learns of a misstatement or omission which originated with a member of management, an employee or representative, a shareholder, a director, or any combination of the foregoing, his initial duty traditionally has been considered to be disclosure of the facts to the board of directors, as the embodiment of the corporate entity,*/ together with the lawyer's analysis of the relevant considerations for and against public disclosure. In this connection, EC 7-8 provides:
>
> A lawyer should exert his best efforts to insure that decisions of his client are made only after the client has been informed of relevant considerations. A lawyer ought to initiate this decision making process if the client does not do so. Advice of a lawyer to his client need not be confined to purely legal considerations. If at this point the board decides, as it often will, that it is in the best interests of the corporation to make full and complete disclosure to the public and to the SEC, the lawyer will have little doubt that he has fulfilled his duties to his client.
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> */ See ABA Comm. on Professional Ethics Opinions, No. 202 (1940). By analogy, this interpretatin is consistent with EC 7-12, which, in cases where a client is incapable of making a considered judgment in his own behalf as a result of disability, requires a lawyer to look to the legal representative of the client. 30 Bus. Lawyer (1975 Report) at 1293-4 (emphasis supplied).

Respondents assert that it is elementary and they do not dispute that their client was National not the management, the directors or the shareholders. Nor do they dispute that the final decision-making body of their client was not its

officers but its board and ultimately its shareholders.[21/] However, they do dispute whether respondents were derelict in failing to recognize extraordinary circumstances which might require an outside lawyer to seek out his client's board.

In 1975, the ABA House of Delegates adopted a resolution on the duties of securities lawyers, 61 ABA Journal 1085-86 (1975). Paragraph 4 of the ABA resolution states, in pertinent part:

> 4. Lawyers have an obligation under the C.P.R. to advise clients, to the best of their ability, concerning the need for or advisability of public disclosure of a broad range of events and circumstances, including the obligation of the client to make appropriate disclosures as required by various laws and regulations administered by the S.E.C. In appropriate circumstances, a lawyer may be permitted or required by the disciplinary rules under the C.P.R. to resign his engagement if his advice concerning disclosures is disregarded by the client and, if the conduct of a client clearly establishes his prospective commission of a crime or the past or prospective perpetration of a fraud in the course of the lawyer's representation, even to make the disclosure himself.

Additionally, respondents argue, on the basis of testimony elicited from their expert witnesses, that it was not the

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21/ The By-Laws of National, adopted March 25, 1971, and amended December 12, 1971, as certified by the secretary (Johnson) on December 20, 1974, state, in pertinent part:

> The stock, property and affairs of this corporation shall be under the care and management of the Board of Directors, who shall be chosen annually at the annual meeting of the stockholders....
>
> The business, property and affairs of this corporation shall be managed by its Board of Directors. ...
>
> The officers of the corporation shall be elected by the Board of Directors....

custom and practice of securities lawyers during the period covered herein to go to the board when management disregarded their disclosure advice. However, commentators on the subject disagree. At the 1977 Airlie House Conference on the Ethical Responsibilites of Corporate Lawyers several participants expressed their views in this regard. See 33 Bus. Lawyer (March 1978 Special Issue) as follows: Marsh, "Relations with Management and Individual Financial Interests," 1227, 1234; Cooney, "The Registration Process: The Role of the Lawyer in Disclosure," 1329, 1335; Small, "Commentary," 1428; Cutler, "The Role of the Private Law Firm," 1549, 1556. See also Sonde, "The Responsibility of Professionals under the Federal Securities Laws - Some Observations," 68 Nw. U.L. Rev. 1, 9 (1973).

Further, the reliance on custom and practice does not preclude liability for criminal violations of the federal securities laws. E.g., United States v. Simon, 425 F.2d 796, 805-806 (2d Cir., 1969), cert. denied, 397 U.S. 1006 (1970); United States v. Brookshire, 514 F.2d 786, 789 (10th Cir., 1975) where the court said: "... custom and usage involving criminality do not defeat a prosecution for violation of a federal criminal statute."

In Securities and Exchange Commission v. Spectrum, Ltd., 489 F.2d 535 (1973), the court said, at 542: "The legal profession plays a unique and pivotal role in the effective implementation of the securities laws.... The public trust

demands more of its legal advisers than 'customary' activities which prove to be careless."

At Proceedings of the ABA National Institute in 1974,[22/] Lewis H. Van Dusen, Jr., in a discussion concerning the "Responsibility of Lawyers Advising Management," stated:

> (the lawyer) is customarily retained by management and his contacts with the corporation and its stockholders are largely through management. Thus, he has a normal tendency to feel a sense of loyalty to management and subconsciously to consider management alone as his client. Further, the lawyer is only too well-aware that he faces the prospect of losing the corporation as a client if his actions are not to management's liking. Despite his personal stake in the matter, however, it is encumbent upon the lawyer not to be a "rubber stamp" for management but to exercise his independent professional judgment on behalf of his true client, the corporate entity. In some circumstances, this may require his strongly counseling management against a course of action which the lawyer believes is clearly contrary to the interests of the corporate entity. If there are outside directors, it may require his bringing the matter to their attention. In the extreme case, it may be the lawyer's responsibility under the Code to withdraw entirely from his representation. (Underscoring supplied)

It is concluded that respondents failed to carry out their professional responsibilities with respect to appropriate disclosure to all concerned, including stockholders, directors and the investing public, of the material facts described herein, and thus knowingly engaged in unethical and improper professional conduct, as charged in the Order.

Expert Witnesses

Respondents called two experienced securities lawyers

22/ 30 Bus. Lawyer (March 1975 Special Issue).

who have had distinguished careers as professors at leading law schools as well as practical experience in representing corporate clients. Also, they both were members of the ABA Committee which issued the unanimous report, "The Code of Professional Responsibility and the Responsibility of Lawyers Engaged in Securities Law Practice," (see page 57, supra). They were qualified as experts concerning the ordinary custom and practice of securities lawyers during this period (1974-75) and the professional and ethical responsibility of such lawyers in rendering advice under the federal securities laws.

They both testified that the corporation is the client and not the president and that counsel should go over the head of the president or chief executive only if he knows of a violation and that the directors are not being advised by the president.

One of the experts testified that the Code is amphorous and not very helpful here, as in many other instances. He said: "Well, a relationship between a lawyer and a corporate client is an evolving one. The Code of Professional Responsibility, I regret, is not as explicit or as informative as — or as helpful as I wish it were." He went on to say that the responsibility for governing a corporation is in the board of directors on matters committed to it and the officers on matters committed to them, with the board having the right of review; ultimately, in some respects, the shareholders.

He believes that there are cases interpreting lawyers' obligations, in addition to the Code, which are also authorative. "Public interest is better served on a long, broad basis by holding lawyers to their proper responsibilities. What these proper responsibilities are, I will concur with several other persons, probably ought to be much better defined than they are."

The second expert testified that in ascertaining a lawyer's professional obligation he looks to the ABA Code of Professional Responsibility and official pronouncements of the SEC which have the force of law. He was of the opinion that the LMP was merely a blueprint and of very minor importance, so there was no reason to attach it as an exhibit to the 8-K, and that anyway it was apparent to anyone who understood the leasing business. "The average investor who would invest in a leasing company would understand how this works."

He also testified concerning the letter of December 23, 1974 (page 28 supra): "In my opinion, the first paragraph, which is the only relevant paragraph, is an inadequate summary of the amendatory credit agreement." He went on to say: "I do not know of any obligation to correct a document which is not being used in the sale of securities."

As to counsel informing the board he said that someone else — here the Banks — would do the job of apprising the corporation, which did happen. He thought it surprising that

White and Case called respondents concerning need for disclosure. He testified: ". . . that the respondents had every reason to suppose that the facts would be brought out in ordinary course without the extraordinary situation of counsel going — outside counsel — going over the head of the chief executive officer and over the head of inside counsel and approaching the board of directors."

The witness further testified: "I feel strongly that . . . lawyers have a professional responsibility to themselves to have in mind the purpose and policies of the securities act . . . and to do their best to effectuate them. But given the structure of the statutes, the statutes do not impose affirmative duties on lawyers such as the affirmative duties which the statutes very positively and expressly impose on accountants. . . . It may well be that the statute may be obsolete in that respect."

Careful consideration has been given to the testimony of the expert witnesses in view of their reputations in the field.

Other Matters

Jurisdiction. Respondents challenge the Commission's jurisdiction and authority to discipline them. Although they admit that the Commission's power to discipline professionals

has been upheld, they state, without support, that "such decisions are not precedent on the merits of respondents challenge," and contend, also, that the Commission should and is required to defer to the courts of New York in judging the professional competence and activities of respondents.

Suffice it to say, 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. 23/

Although the respondents are members of the Bar of the State of New York, that does not mean that the states have exclusive jurisdiction over professional discipline. There is no assurance that state courts are the proper forum to protect a legitimate interest underlying the promulgation of Rule 2(e) or the Commission's administration thereof. In this connection it is noted that other agencies have also promulgated disciplinary rules relating to professionals appearing or practicing before them.

23/ Securities and Exchange Commission v. Csapo, 533 F.2d 7 (D.C. Cir., 1976), (appellate court recognized right of Commission to institute disciplinary proceedings); Fields v. Securities and Exchange Commission, 495 F.2d 1075 (D.C. Cir., 1974), (Rule 2(e) order affirmed without opinion); Kivitz v. Securities and Exchange Commission, 475 F.2d 956 (D.C. Cir. 1973), (Rule 2(e) order reversed for lack of substantial evidence but court of appeals rejected argument that Commission lacks authority to discipline attorneys); Schwebel v. Orrick, 153 F. Supp. 701 (D.D.C., 1957), affirmed on other grounds, 251 F.2d 919 (D.C. Cir., 1958), cert. denied, 356 U.S. 927 (1958); Securities and Exchange Commission v. Ezrine, C.A. No. 72-3161 (CBM) (S.D.N.Y., August 2, 1972), summary reported at [1972-1973] CCH Fed. Sec. L. Rep. ¶93,594. Cf. Goldsmith v. United States Board of Tax Appeals, 270 U.S. 117, 122 (1926); Koden v. United States Department of Justice, 564 F.2d 228 (7th Cir., 1977); Herman v. Dulles, 205 F.2d 715 (D.C. Cir., 1953).

Laches. Respondents claim that this proceeding is barred because of unreasonable delay on the part of the staff in bringing it after announcing in December 1976 that it would be recommended. The date of the Order is June 16, 1978, and the period covered is from May 1974 to May 1975.

Respondents have failed to demonstrate how the passage of time involved here constitutes an unreasonable delay in a proceeding of this kind. "Absent proof of normal time necessary to dispose of a similar proceeding or of facts tending to show a dilatory attitude on the part of the Commission or its staff ...." the defense of unreasonable delay is inadequate, Federal Trade Commission v. Weingarten, 336 F.2d 687, 691 (5th Cir., 1964), cert. denied, 380 U.S. 908 (1965).

Further, respondents have not shown how the passage of time has affected the presentation of their defense or resulted in any other specific harm. In the absence of such proof of injury, a defense of unreasonable delay has been disallowed because petitioner "failed completely to show how the Commission caused him prejudice by waiting (over 6 years from the time of the institution of the proceedings until issuing an order) to revoke his registration." Irish v. Securities and Exchange Commission, 367 F.2d 637, 639 (9th Cir., 1966).

In any event, the law is clear that the doctrine of laches or estoppel cannot be invoked against the Government

acting in a sovereign capacity to protect the public interest.[24]

Estoppel. Respondents contend that the Commission is estopped from disciplining respondents because of its prior actions. Respondents argue that as a result of investigation of National the Commission instituted an injunctive action against National's officers and issued a report criticizing the conduct of National's directors, and therefore the Commission and its staff have publicly prejudged this case. However, as the OGC points out, respondents ignore the well-established principle that the doctrine of equitable estoppel does not apply to Government instituted actions undertaken in the public interest, Haight & Company, et al., and Richard N. Cea, (supra, n. 24). The fact that the Commission has taken action concerning others in relation to the National matter does not mean the Commission has prejudged the respondents' liability therefor, if any.[25] If this were not so, the Commission would be estopped any time it brings an injunctive action from also authorizing any administrative proceedings arising out of the same transactions. This result is contrary to the enforcement scheme of the federal securities laws.[26]

24/ Haight & Company, et al., 44 S.E.C. 481, 511 (1971); Richard N. Cea, 44 S.E.C. 8, 21 (1969); Costello v. United States, 365 U.S. 265, 281-284 (1961); Guaranty Trust Co. v. United States, 304 U.S. 126, 132 (1938).

25/ A.J. White & Company v. Securities and Exchange Commission, 556 F.2d 619, 624-5 (1st Cir., 1977), cert. denied, 434 U.S. 969 (1978).

26/ Wright v. Securities and Exchange Commission, 112 F.2d 89, 95 (1940). See also Withrow v. Larkin, 421 U.S. 35, 55-58 (1975).

Inadmissible Evidence. During the proceeding the OGC called John W. Phelps, National's former controller as a witness. Phelps claimed his constitutional privilege against self-incrimination and, accordingly, was "unavailable."[27/] The sworn investigative testimony of Phelps (and exhibits thereto) were received in evidence.

Respondents contend that they have been afforded no opportunity to cross-examine Phelps and therefore his evidence was inadmissible. They argue that no reliance should be placed on this evidence.

These contentions are without merit. The prior statement and exhibit were properly admitted in this proceeding.[28/] In any event, the Phelps testimony and exhibits have not been relied on in reaching the findings herein concerning Carter and Johnson. The only reference to the Phelps evidence is to company records (p. 37, supra)

Public Interest

The remaining issue concerns the remedial action which is appropriate in the public interest with respect to Carter and Johnson. The OGC asserts that the respondents have

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27/ Federal Rules of Evidence, Rule 804(a)(1); United States v. Wood, 550 F.2d 434, 441 (9th Cir., 1976).

28/ Charles P. Lawrence, 43 S.E.C. 607, 612 (1967), affirmed, 398 F.2d 276 (1st Cir., 1968); Moshe Avraam Shaltiel, Securities Exchange Act Release No. 15501/January 17, 1979.

evidenced no contrition for their wrongful conduct, and, presumably, would follow the same course of conduct should they again be faced with similar circumstances. Accordingly, the OGC recommends that Carter and Johnson both be permanently denied the privilege of appearing and practicing before the Commission with the opportunity to reapply to practice before the Commission after periods of two years, and eighteen months, respectively.

Respondents state that even if it is assumed that they violated the securities laws or their professional responsibilities, the record is devoid of any showing that they are likely to engage in future violations. On the contrary, they maintain, the record is uncontradicted that respondents are well-qualified to render advice concerning compliance with the securities laws; moreover, there is ample evidence that respondents acted in accordance with the standards of attorney conduct prevalent at the time of their actions; and such evidence is sufficient to dispel any inference of future misconduct raised by the finding of past violation; therefore, the public interest or the interest of investors does not require that any discipline be imposed on respondents.

The violations found herein are serious and respondents' conduct as securities lawyers must be judged by standards

which the Commission can reasonably expect and demand from professionals practicing before it. In considering the discipline of an attorney the Commission has stated:

> Very little of a securities lawyer's work is adversary in character. He doesn't work in courtrooms where the pressure of vigilant adversaries and alert judges check him. He works in his office where he prepares prospectuses, proxy statements, opinions of counsel, and other documents that we, our staff, the financial community, and the investing public must take on faith. This is a field where unscrupulous lawyers can inflict irreparable harm on those who rely on the disclosure documents they produce. Hence we are under a duty to hold our bar to appropriately rigorous standards of professional honor. 29/

The Commission's position is reflected in statements by members of the securities bar. At proceedings of the ABA National Institute in 1974, concerning the responsibility of lawyers advising management, it was said:

> A lawyer should not participate in a continuing fraud. The great refuge of clients and lawyers in this area is the elasticity of the concept of materiality. In many cases you can conclude that an error is not material. But it seems to me that if clearly there is a continuing material matter which is materially defective, thinking in terms of a prospectus and whether someone who bought securities on the basis of that prospectus would be misled, I do believe that in that case the lawyer comes right up against these considerations and should either find a way to disclose, or resign. It is not always clear that he need to do more than resign. No lawyer is obligated to represent a client he doesn't trust, like or agree with, except in very limited circumstances. He should quit even if it hurts. 30/

29/ In the Matter of Emanual Fields, Securities Act Release No. 5404 (June 18, 1973), affirmed without opinion, 495 F.2d 1075 (D.C. Cir., 1974).

30/ Bialkin, "The Securities Laws and the Code of Professional Responsibility," 30 Bus. Lawyer 21, 27 (March 1975 Special Issue).

In the instant case the disclosures in question were not in a prospectus although there was a prospectus effective until March 31, 1975. However, respondents were involved in a false and misleading disclosure situation to which the above observations would be applicable.

The succession of dilatory evasions surrounding the disclosure issue during the period in question would have been suspect to any reasonably intelligent observer and should have been discerned by astute and sophisticated members of the legal professional such as the two respondents. Their own testimony reveals a gradually dawning awareness of Hart's intent not to comply with securities regulations. 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 participation 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.

The appropriate remedial action as to a particular respondent depends on the facts and circumstances applicable to him and cannot be measured precisely on the basis of action taken against other respondents. 31/

While both respondents have been found to have violated the securities laws and to have behaved in an unethical and unprofessional manner, it is apparent in assessing their individual participation that Carter, as the senior of the two, was more closely concerned with the client. He was responsible for the credit agreement, the amendatory agreement, the 8-K, and the press release of December 20, 1974. In addition, he attended the meetings with the Banks, received the original call from White & Case and was aware that the Banks and their counsel were looking to him to do something about disclosure.

Johnson, as secretary of National, was present at four board meetings and was aware of what the board was or was not being told by Hart concerning the true financial picture of National. He also knew that no meetings were held from February until May 24, 1975, and that then it was only pressure from

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31/ Dlugash v. Securities and Exchange Commission, 373 F.2d 107, 110 (2d Cir., 1967).

the board that resulted in that meeting and eventual disclosure of National's financial condition. Johnson knew of Lurie's false representation concerning his approval of material sent to shareholders and that Hart was flagrantly disregarding his advice, even to the point of asking for an opinion that disclosure was not necessary after Johnson had told him that it was.

In determining an appropriate sanction, consideration has been given to mitigating factors. In this connection both respondents were advising Hart that disclosure be made but then doing nothing when their advice was ignored. Johnson refused Hart's request for a favorable opinion that disclosure was not necessary. Carter appears to have indicated on several occasions that he would like to be rid of National as a client. Socha testified, "I think it's fair to say that Mr. Carter was generally exasperated with the client. . . . Yes, I do recall Mr. Carter at least saying numerous times that he would like to retire from this account."

Four attorneys testified as character witnesses, two for each respondent. All four testified as to the excellent professional reputations of the respective respondents. Nevertheless, one character witness said, "you can't be a good lawyer if you simply know the rules and ignore their application in real-life situations."

Both respondents are long-standing members of the bar with no previous violation or blemish on their records. However, consideration must be given to the necessity of protecting the investing public from future situations of the type which occurred here. As the court has said:

> In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar. 32/

Upon careful consideration of all of the facts and circumstances, it is concluded that adequate protection of the public interest requires that Carter be suspended from appearing and practicing before the Commission for a period of one year and that Johnson be suspended from appearing and practicing before the Commission for a period of nine months.

ORDER

Accordingly, IT IS ORDERED, pursuant to Rule 2(e) of the Rules of Practice, that respondents William R. Carter and Charles J. Johnson, Jr. be denied the privilege of appearing and practicing before the Commission for the periods of one year and nine months, respectively, from the effective date of this order.

32/ United States v. Benjamin, 328 F.2d 854, 863, cert. denied, 377 U.S. 953 (1964).

FURTHER, IT IS ORDERED that the charge concerning respondents' responsibility for National's 1974 annual report be dismissed.

This order shall become effective in accordance with and subject to the provisions of Rule 17(f) of the Commission's Rules of Practice.

Pursuant to that Rule, this initial decision shall become the final decision of the Commission as to each party who has not filed a petition for review pursuant to Rule 17(b) within fifteen days after service of the initial decision upon him, unless the Commission, pursuant to Rule 17(c), determines on its own initiative to review this initial decision as to him. If a party timely files a petition for review, or the Commission takes action to review as to a party, the initial decision shall not become final with respect to that party.[33/]

Ralph Hunter Tracy
Administrative Law Judge

Washington, D.C.
March 7, 1979

33/ All proposed findings and conclusions and contentions have been considered. They are accepted to the extent they are consistent with this decision.