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RELIANCE ON ADVICE OF COUNSEL AS A DEFENSE TO SECURITIES LAW VIOLATIONS

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Reliance on Advice of Counsel as a Defense to Securities Law Violations

Today I want to share with you my views on the difficult question whether, and to what extent, reliance on advice of counsel is, or should be, a relevant factor in defending against a securities law violation?

Despite years of case law development, law review articles and panel discussions among learned observers and practitioners, clear rules remain elusive.

I became interested in this subject shortly after starting with the Commission in July of this year. The Office of the General Counsel was seeking authorization from the Commission to file an amicus brief in a case on appeal before the Third Circuit. I want to briefly describe a hypothetical set of facts, derived from the issues in that case but much simplified, to pose the question that attracted my interest.

Imagine yourself as counsel to the issuer of convertible debentures publicly traded on the New York Stock Exchange. Debentureholders are entitled to convert into the issuer's common stock, which is privately held. The issuer, a railroad with non-rail assets, seeks to spin off those assets into a corporation not subject to ICC regulation. It transfers the assets to a wholly-owned subsidiary and proposes to pass ownership of the subsidiary to the issuer's common stockholders by means of a dividend payable in the stock of the subsidiary.

You are asked whether, under applicable law, including, of course, the terms of the debentures and the indenture under which they were issued, it is necessary to notify the debentureholders of the proposed dividend, and thereby afford them an opportunity to convert. Management is aware that, if a significant number of the public debentureholders convert, a registration statement will have to be filed, involving delay and extra cost. Management also recognizes that, if there are no conversions, ownership of the non-rail assets will pass to the issuer's stockholders, without dilution.

The issuer's ability to repay the debentures will in no sense be impaired by the spin off. While not all debentureholders will necessarily convert, some -- perhaps many -- will. Notice of the plan is clearly material to the debentureholders. Management is willing to notify the debentureholders and file an S-1 if a legal duty requires it to do so. You are asked whether such a duty exists.

You research the indenture, the issuer's listing agreement and the applicable rules of the New York Stock Exchange and of the Commission. After careful research, you conclude that no such duty exists and so advise your client. Acting in reliance upon that opinion, the dividend is paid. Later, in defending a 10b-5 action brought by debentureholders, the issuer asks you why its reliance on your professional judgment as to the question of duty isn't enough to dispose of the case by motion for summary judgment. Since Hochfelder, hasn't Rule 10b-5 required scienter, which the Supreme Court defined as "a mental state embracing intent to deceive, manipulate or defraud", or in the context of Section 10(b), "knowing or intentional misconduct?" How, management asks, could we have engaged in misconduct, knowing or intentional, when we came to you -- the best securities lawyer in the land -- precisely to avoid doing anything wrong -- even accidentally?

Before answering, you had best look carefully at the law and think through the possible implications. You might be surprised at what you find. For example:

-- Were you to defend on the ground of good faith reliance on counsel's opinion, expect to have SEC v. Savoy, a D.C. Circuit case, decided in September, thrown at you. Here, the court made the unexceptional point that "[c]ompliance with the federal securities laws cannot be avoided simply by retaining outside counsel to prepare required documents," but then went on to suggest, in dicta, that reliance on advice of counsel is not a defense to liability under 10b-5 but only one factor to be considered in fashioning the appropriate remedy. Other cases, perhaps rooted in the notion that "ignorance of the law is no excuse," would be added to lend support for the D.C. Circuit Court's dicta.

There are two other implications, which I will just note because they are worth remembering, but without further discussion today.

-- In asserting the reliance defense, you should be prepared to bow out of the case as counsel for the defendant issuer. One consequence of asserting the reliance defense may be an implied waiver of the attorney-client privilege. Cases have so held, forcing counsel for the party asserting the defense to submit to discovery on that subject. Under §5-102 of the Disciplinary Rules of the Code of Professional Responsibility, this situation might even call for your withdrawal as counsel, due to the likelihood of your becoming a witness, either for your client or for the plaintiff.

-- If reliance on your opinion turns out to be irrelevant to the question of 10b-5 liability, be prepared for your client to complain, perhaps even sue, over your failure to advise, in advance, as to:

(a) whether your opinion was qualified or unqualified,

(b) whether reliance on the opinion would be relevant at all to defending against a 10b-5 suit, and

(c) if relevant, whether the requisites for a reliance defense were fully satisfied in this case. Commentators have suggested that a lawyer has a duty to give his client advice on these matters.

Should reliance on advice of counsel ever be a factor relevant in establishing a defense to securities law violations? At the outset I should stress that the "reliance defense," as justifiable reliance on advice of counsel is sometimes referred to, is not really a defense at all but simply some evidence tending to support a defense based on due care or good faith.

Now, as suggested in Savoy, there are those who believe that reliance on advice of counsel is irrelevant to any of those violations. I am not among that group. Nor, indeed, is the Commission. In a recently filed amicus brief involving

Rule 10b-5, it expressed the view that under appropriate circumstances, defendant's reliance on advice of counsel is a relevant factor in determining whether the requisite scienter exists.

There are a few cases, the most recent of which is Savoy, suggesting that the reliance defense is irrelevant to substantive violations. However, a close reading of those cases will establish that they do not, in fact, stand for that proposition at all -- in the earlier cases because they simply don't make that suggestion, and in the later ones because they rely on a misreading of the earlier ones.

Of course, viewed as a question of policy, some have argued that there are sound reasons for permitting a defense based upon reliance on advice of counsel. The existence of this defense should serve to encourage the use of competent counsel on difficult questions of law, thereby fostering improved disclosure to investors. As the Commission stated in its recent decision, In re Carter:

> Significant public benefits flow from the effective performance of the securities lawyers' role. The exercise of independent, careful, and informed legal judgment on difficult issues is critical to the flow of material information to the securities markets.

And as the Second Circuit recognized in SEC v. Spectrum, Ltd.:

> The legal professional plays a unique and pivitol role in the effective implementation of the securities laws. Questions of compliance with the intricate provisions of these statutes are ever present, and the smooth functioning of the securities markets will be seriously disturbed if the public cannot rely on the expertise proffered by an attorney when he renders an opinion on such matters.

On the other hand, there are legitimate and even powerful policy arguments against the defense. It is clear the defense could serve to foster abuses. There is, understandably, a fear that the reliance defense might encourage unscrupulous

clients to buy immunity from securities law violations by opinion-shopping. Accommodating lawyers will spring up, eager to provide the protection afforded by reliance on a formal, yet clearly erroneous opinion. Critics of the defense often ask why those injured by a defendant should bear the risk of his counsel's mistakes. Here one must recognize that the lawyer has seldom been held liable for the consequences of his erroneous opinion. Some see the reliance defense as giving to the lawyer a judge-like power to declare what the law is. And, finally, one may argue that we foster the development of better lawyers by putting a higher premium on their being correct. Why add value to their role when they perform it inadequately?

It is these concerns that in the past have made the Commission and others uneasy about the reliance defense. The fact is, however, that we are not writing new laws, but interpreting old ones, many of which involve questions of due care and state of mind. The reliance defense can be relevant to these questions. The trick is to determine when it ought to be available, keeping in mind the concerns just voiced and seeking to deal with them through careful limitations on the use of the defense.

Now, let us turn to this difficult question of when. Perhaps the best way to get one's arms around this subject is to start with what we can say with some certainty and then move on to the less certain, and correspondingly more difficult, areas. There are three discrete questions that must be considered:

First, what is the nature of the reliance? Was counsel carefully selected? Were all the relevant facts given to him? Did the client act in accordance with counsel's advice? Over all, was the reliance reasonable under the circumstances?

Second, what is the nature of the securities law violation? Does it involve a provision such as Sections 5, 11(a) and 12(1) of the Securities Act of 1933 or Section 16(b) of the Securities Exchange Act of 1934, where strict liability is imposed? Is it a provision such as Section 11(b) of the '33 Act or Rule 14a-9 under the '34 Act, where a due care defense is permitted? Is it a provision such as Rule 10b-5, where scienter is a necessary element of the violation? Or is a criminal violation alleged, requiring willfulness?

Third, what is the nature of the advice of counsel to be relied upon? It could relate to the facts. For example, it could be a determination as to whether a statement in a proxy or prospectus is false, or misleading due to omissions. It could relate to the issue of materiality. Are the facts in question material to investors? Finally, it could relate to the existence of a legal duty which is an essential element to a violation. Thus, in 10b-5 cases involving non-disclosure, an essential element to the violation is a finding that the defendant had a legal duty to disclose.

Before tackling these three areas, I should emphasize that the cluster of questions to be addressed here concern reliance on advice of counsel as a defense to liability, not as a mitigating factor for a court to consider in imposing sanctions. With respect to relief, courts have uniformly held that good faith reliance on advice of counsel is a relevant factor in determining whether to impose a sanction after a securities law violation has been established. Thus, in a case brought by the Commission seeking injunctive relief, the Commission is required to show that "there is a reasonable likelihood that the wrong will be repeated." Good faith reliance on advice of counsel would generally be relevant to this question. Such reliance may be a strong indication that the defendant is not likely to violate the securities laws. However, despite one district court's suggestion to the contrary, reliance would not seem relevant to an assessment of damages once a violation has been established.

I return, now, to the three questions concerning (1) the nature of the reliance, (2) the nature of the violation, and (3) the nature of the advice.

1. The Nature of the Reliance. What violations reliance on advice of counsel may be used as a defense to remains uncertain. I will address that uncertainty later in the talk. In thinking about the nature of the reliance, however, it will be helpful to appreciate that we are talking about a defense chiefly useful in cases where a lack of good faith or due care is necessary to establish the violation.

There is general agreement as to the nature of the reliance that must exist for the defense to be asserted at all. The elements of the defense rest upon good faith and due care. These elements must be found in the defendant's:

(a) selection of counsel;

(b) disclosure of facts to counsel;

(c) receipt of advice from counsel; and

(d) action taken in accordance with that advice.

Even here, however, some unresolved questions remain. Good faith and due care would require that the defendant reasonably believe that the counsel selected was both competent to render the advice sought, and sufficiently unbiased to make that advice reliable. But suppose counsel, in fact, isn't competent. Here, it is helpful to recall that the reliance defense issue only arises when counsel's advice is wrong. Even competent counsel can be wrong occasionally, but to require competence in fact, regardless of the defendant's good faith and due care in selecting him, would sharply reduce the usefulness of the defense, if not eliminate it entirely. Due care in the selection ought to suffice. What that standard means in particular cases will turn on many factors, not the least of which are the novelty or complexity of the legal issue in question, the amount of experience that the defendant has had with counsel, and whether counsel is representing the defendant or someone else. The question should be what is reasonable under all the circumstances. One doesn't go to an eye doctor for appendicitis, but one might reasonably accept his advice in treating a mild headache.

On the matter of bias, again it seems appropriate only to require of the defendant an honest judgment based upon a reasonable investigation. If the lawyer is, in fact, biased, and his advice self-serving, but the defendant, after due inquiry, is unaware of these defects, the defense should, nonetheless, be available. Of course, a "head in the sand" approach won't do. The defendant must investigate enough to have a reasonable basis for believing in the unbiased quality of counsel's advice. Some might argue that Canon 5 of the Code of Professional Responsibility, which exhorts lawyers to exercise independent professional judgment on behalf of a client, creates a sufficient basis for belief. I do not think Canon 5 alone should suffice, although it may create a rebuttable presumption that the advice is unbiased.

Obviously, questions might arise if counsel is paid by someone other than the defendant. Further questions arise if counsel does not represent the defendant. Neither situation, however, should automatically preclude a reliance defense. Institutional investors and underwriters often require the issuer to pay their counsel's fees and disbursements, and even retain counsel on the basis that it look solely to the issuer for payment. If a transaction fails to close, counsel knows

it may have trouble getting paid by the issuer. Indeed, sometimes it is understood that counsel will only be paid if the transaction is consummated. Do these facts put counsel in a position from which he cannot give "wholly disinterested advice" -- that being the criterion required for a reliance defense under the circumstances found in Arthur Lipper Corp. v. SEC, a 1976 Second Circuit decision? Although counsel realistically must be seen as having a monetary interest in concluding the transaction, normally that interest alone should not be viewed as creating an unacceptable bias. Reputable counsel can, and do, exercise independent judgment on behalf of their clients, despite a monetary stake of the nature described. Nor should the Lipper case be read to support an opposite conclusion. There, the counsel in question did not represent the broker-dealer seeking to use his advice as a shield to Rule 10b-5 liability in a case involving illegal give-ups. Instead, the counsel represented the investment adviser receiving the illegal payments. With the professional responsibilities that flow from a lawyer-client relationship unavailable to the broker-dealer, and counsel's primary concern directed toward sanctioning an arrangement advantageous to his client, the court understandably held that counsel was not in a position to give the broker-dealer wholly disinterested advice, and it could not have reasonably thought he was.

The Lipper case does suggest, however, the need for a high degree of care when one proposes to rely on the advice of counsel other than one's own, particularly where that counsel, or the person to whom its loyalties run, stands to benefit from one's reliance on that advice.

The second element in the defense -- disclosure of facts -- requires that the defendant disclose all facts believed by him to be relevant or requested by counsel. Since disclosure will be filtered through the good faith/due care screen, in theory the defense should not automatically fail just because all facts material to counsel's judgment are not conveyed to him. However, it is hard to imagine a case where a material fact is neither requested by counsel nor, in the good faith exercise of due care, disclosed by the defendant in the give-and-take of the lawyer-client relationship.

The third element -- receipt of advice, involves questions of form and certainty. May the advice be oral, or must it be in writing? Must it be unqualified, or may counsel give a reasoned opinion or one suggesting odds such as "it is more likely than not", or "it is probable", or use the formulation of "a court, if properly briefed, should hold."

No hard and fast rules emerge from the few cases that have addressed these questions. As a matter of policy, no such rules need be, or should be, prescribed. The test of reasonableness will suffice. Obviously, a carefully developed written opinion will support more reliance than an oral one to the same effect. But circumstances may not always allow time for the written word to be set and delivered.

On the matter of certainty, there are, again, few cases to guide one. Here, it would seem desirable to require either an unqualified opinion or one in which counsel has a fairly high level of confidence, particularly in situations where a contrary position has been taken by a court, or even by the Commission. Counsel should express and reasonably support a level of confidence significantly higher than the "more likely than not" formulation.

Finally, the defendant must be able to show that he actually acted in reliance upon the advice given. This element requires that the defendant's actions follow the advice in all material respects.

2. The Nature of the Violation. It is clear that reliance on advice of counsel is ineffective as a defense to violations involving strict liability. Since the strict liability sections of the securities laws impose liability regardless of a defendant's due care or lack of scienter, reliance on advice of counsel, however well placed, is simply irrelevant. Thus, for example, in SEC v. Harwyn Industries Corp., the district court held that the defendants had violated Section 5 of the '33 Act by distributing the stock of subsidiaries to the parent's stockholders without registration, despite a further finding that there had been a good faith reliance on counsel's opinion that registration was unnecessary. Similar results would occur in the case of an erroneous opinion that an offering was exempt under Section 4(2) or complied with the safe harbor found in Rule 144 or 146. And a director who bought and sold his company's stock within a six-month period would likewise be required to disgorge all profits under Section 16(b) of the '34 Act, regardless of his good faith reliance on counsel's advice that the purchase and sale were permitted.

In cases involving violations which permit a defense of due care or lack of scienter, reliance on advice of counsel has been treated as a factor to be considered under certain circumstances. Thus, depending on the nature of the advice, reliance on advice of counsel may be an important factor in the due diligence defense for directors and underwriters under Section 11(b) of the '33 Act, relating to registration

statements, in the due care defense under Section 12(2) of the '33 Act, relating to the offer and sale of securities, and under Rule 14a-9 of the '34 Act, relating to proxy statements. Similarly, the reliance defense may play an important role in establishing the absence of scienter under Rule 10b-5. And, of course, the defense is sometimes relevant in determining whether one has the state of mind necessary to meet the willfulness standard for a criminal violation under Section 24 of the '33 Act or Section 32 of the '34 Act.

3. Nature of the Advice. One may rely on advice of counsel as to questions of fact (is the statement accurate and complete?), mixed questions of fact and law (is the statement material?), or questions of law (is there a duty to disclose?).

Questions of Fact. Since Escott v. BarChris Construction Corp., decided in 1968, it has been reasonably clear that neither a director nor an underwriter can escape liability under Section 11(b) of the '33 Act for misstatements in a prospectus simply by relying on counsel to verify that document's accuracy. As you know, Section 11(b) establishes the "due diligence" defense, requiring, in the case of statements not expertised by another, that the defendant have made a reasonable investigation and have reasonable grounds to believe, and in fact believe, that those statements are true. If a person subject to Section 11 liability delegates the investigation to counsel, that person must bear the consequences of counsel's failure to conduct a reasonable investigation. This result seems fair, at least in cases where advice as to facts, rather than law, is involved. It would be within the competence of a director or underwriter to conduct an investigation of this sort himself.

Similar results have been reached in cases arising under Rule 14a-9 of the Proxy Rules. Thus, one may draw the conclusion that the reliance defense may be used only where advice of counsel is given as to matters of law. From the policy standpoint, of course, it makes sense to allow reliance on others to serve as evidence of due care or lack of scienter where the acts relied upon require professional skills or facilities not possessed by the person seeking to assert the defense. Indeed, the weight to be accorded the reliance defense should increase as an increasingly specialized expertise is required of the adviser.

Evidence of this principle is found in the expertising section of Section 11(b). If a particular statement in the prospectus has been "expertised", the defendant is not re-

quired to prove that he made or caused to be made a reasonable investigation, but only that he had no reasonable ground to believe, and did not believe, that the statement was untrue.

Questions of Fact and Law. Advice as to materiality, unlike facts, often involves legal as well as factual judgments. While the businessman ought to be able to judge what is material to investors, and do so more accurately than counsel, in the end judges, not laymen, give meaning to the notion of materiality, and counsel often serve the essential role of framing the business judgment -- interpreting the materiality concept as applied to the facts in question, so that the business judgment is rendered in the proper context.

Thus, it is not surprising to find that reliance on counsel's advice as to the immateriality of facts omitted from disclosure has served to support the due care or lack of scienter defense. I should emphasize, however, that reliance on counsel's view that a particular matter is immaterial will not help where that matter is falsely stated or described in a misleading way in the prospectus or proxy statement, and the defendant knew or recklessly disregarded this fact. It is only in cases of omission where the reliance defense will help when the advice of counsel relates to materiality.

Questions of Law. Advice as to matters of law should provide the strongest case for assertion of the reliance defense. However, somewhat ironically, it is precisely in this area that the reliance defense has experienced the most difficulty. Suppose counsel opines, for whatever reason, that a disclosure document containing misstatements meets the legal requirements of Section 5, the Proxy Rules, or Rule 10b-5. This opinion -- which addresses the legal effect of the matters set forth -- should not shield a defendant who knows or should have known of those misstatements. Good faith is absent, and reliance is no substitute.

If the legal advice relates to the disclosures made, however, and causes the defendant, in the exercise of due care, to believe them to be true, the reliance defense should be available. Thus, for example, an erroneous legal opinion as to the assignability of a major licensing agreement essential to the defendant's business should provide the basis for a reliance defense to a 10b-5 action brought for a false press release describing the assignment. Since Hochfelder, actions under 10b-5 have required a showing of knowing, intentional or reckless misconduct. This showing cannot be made where the misstatement derives from legal advice creating in the defendant's mind a mistaken belief that the disclosure document is accurate.

In the case of omissions, reliance on advice of counsel as to legal matters should provide a basis for defense under the circumstances described above. Going beyond those circumstances, however, should the reliance defense ever extend to omissions based upon advice as to lack of a legal duty to disclose? Here, I return to the case described at the outset. There, as you may recall, counsel advised the defendant that a subsidiary's stock could be dividended up to the common stockholders without notifying the holders of the defendant's convertible debentures. Notice of the plan was clearly material to the debentureholders. Management was eager not to give the notice, both to avoid registration of the subsidiary's stock, and to avoid the dilution that conversions could cause. However, management was willing to give notice if counsel said it was required.

In omission cases, absent a duty to disclose, no violation of Rule 10b-5 occurs. If scienter means knowing, intentional or reckless misconduct, in a case where the rights of the debentureholders to notice are carefully set out in an indenture, it seems the essence of good faith and due care -- quite the opposite of misconduct -- for the defendant to seek expert counsel on whether notice need be given and then reasonably to rely on that advice. If counsel is wrong as to the duty, an action based upon the contract will lie, regardless of counsel's advice and the defendant's good faith reliance on it. But to charge scienter under these circumstances, thereby affording a basis for an action under 10b-5, seems to me misplaced.

Now, it may be argued that the result I am suggesting runs contrary to the fundamental principle that one need not know one's conduct violates the law to incur liability for the violation. SEC v. Falstaff Brewing Corp., a 1980 D.C. Circuit decision, so held in analyzing the concept of scienter under Rule 10b-5. But in that case, the defendant had knowingly sent materially misleading proxy statements and letters to stockholders. Defendant's ignorance of the law obviously was no excuse, both because it was simply ignorance and because defendant committed affirmative acts of deceit -- clearly a form of misconduct.

Omission cases, I submit, are different. Liability turns on the existence of a duty. While ignorance of that duty, I agree, should not excuse the defendant, the exercise of due care to determine whether that duty exists, evidenced by good faith reliance on advice of counsel, ought to be a factor weighing against a finding of scienter.

I recognize this to be a very close question! How one answers it probably depends, as much as anything else, on the subtle and shifting shades of meaning one gives to scienter. One could easily conclude that reliance on advice as to legal duty is not relevant in the case I have been describing. Indeed, debate on these matters exists within, as well as outside the Commission. One purpose in expressing my views here was to join, and carry forward, that important debate.