SECURITIES LAW360

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Changing Standards Of Lawyer Liability

Tuesday, August 15, 2006 --- A recent opinion by the Securities & Exchange Commission (SEC) sanctioning bond counsel for being negligent in providing advice to a school district signals a possible retreat from the long-held position of the Commission that it will not sanction lawyers for providing negligent legal advice to issuers.

A December 2005 opinion by the SEC overturned an opinion by an administrative law judge (ALJ) dismissing the Enforcement Division's charges that bond counsel had violated Section 10(b) of the Securities Exchange Act of 1934 and Section 17(a) of the Securities Act of 1933, with the SEC holding that the lawyer had been negligent in conducting due diligence regarding a bond offering and thus violated subsections (2) and (3) of Section 17(a). In the Matter of Ira Weiss, Securities Act Release No. 8641, Exchange Act Release No. 52875, Admin. Proc. File No. 3-11462 (Dec. 2, 2005).

* The Weiss Decision *

Ira Weiss was bond counsel for a Pennsylvania school district in connection with an offering of municipal securities. The school district contemplated significant renovation of its elementary school as well as construction of a new middle school. To finance these projects, the school determined after consultation with a broker-dealer and Mr. Weiss to issue tax-exempt bonds.

In his role as bond counsel, Mr. Weiss was retained to assure that the bonds contemplated by the school district would be validly issued and tax exempt. In this capacity, Mr. Weiss issued two legal opinions.

He prepared an unqualified opinion to the effect that the school district had determined to undertake projects requiring in excess of $10 million to be funded by the proceeds from the bonds. His opinion also stated that the interest on the bonds would not be subject to federal income taxation. In addition, Mr. Weiss prepared a supplemental opinion affirming that nothing had come to his attention leading him to believe that the school district's disclosure document was materially inaccurate or incomplete.

Mr. Weiss testified that he was aware that the IRS has a complicated three-part test for determining whether a bond issuance is tax exempt. In particular, he knew that the issuer must allocate at least 85% of the net bond proceeds to capital projects within three years and commit at least 5% of the proceeds to the capital projects within six months of the issue date. Further, he knew that the issuer must pursue completion of the capital projects and allocation of the net sale proceeds with appropriate diligence.

If these conditions are met, the securities qualify for tax exemption even if the remaining proceeds are invested in higher yielding, taxable investments for up to three years. The school district, however, did not satisfy these requirements and instead invested the proceeds in taxable instruments and earned the spread between the nontaxable interest rates being paid and the taxable rates yielded by investing the proceeds.

The Enforcement Division filed a cease-and-desist proceeding against Mr. Weiss, alleging that he had been reckless in rendering his opinions and thus that violated the antifraud provisions of the 1933 and 1934 Acts. After a hearing, an ALJ dismissed the charges in their entirety. Initial Decision No. 275 (Feb. 25, 2005).

The Commission reversed, with Commissioner Glassman dissenting. The other four Commissioners held that Mr. Weiss violated Sections 17(a)(2) and 17(a)(3), but not Section 17(a)(1) or Section 10(b). He was thus ordered to cease and desist from committing or causing any violations or future violations of the subsections and to disgorge $9,509.63, the amount he earned in his capacity as bond counsel for the matter.

The Commissioners found that Mr. Weiss had been negligent in his capacity as bond counsel because he failed to make necessary inquiries concerning the reasonable expectations of the school district to spend the note proceeds on capital projects according to a defined timetable.

The Commissioners specifically noted that Weiss "did not make adequate inquiry" to determine whether the school district would take appropriate actions within six months and three years so that the notes would qualify for tax-exempt treatment.

Thus, the Commissioners found that Mr. Weiss "knew or should have known" that the school district did not have an objectively reasonable expectation of satisfying the IRS requirements for tax-exempt treatment of the notes. The Commissioners further found that Weiss had inadequately explained the IRS requirements, particularly those requiring certain expenditures within six months and three years, to the school district representatives.

* Weiss Cannot Easily Be Harmonized with SEC's Longstanding Position Not to Sanction Lawyers for Providing Negligent Legal Advice *

As recently as April 2005, then General Counsel Giovanni Prezioso addressed a group of general counsel and reminded them that the Commission has long held the position that it will not sanction a lawyer, acting in the capacity as a legal adviser, merely for "giving bad advice, even if that advice is negligent and perhaps worse," citing the Commission's decision in William R. Carter & Charles J. Johnson, Jr., 22 SEC Docket 292, Rel. No. 17597 (1981).

The Commission explained in Carter & Johnson, an action brought under the predecessor rule to present Commission Rule 102(e), that securities lawyers must be free to make difficult legal judgments without fear of legal liability or loss of the ability to practice before the SEC.

In the intervening two plus decades, to avoid chilling lawyers from providing frank legal advice, the SEC has steadfastly avoided disciplining lawyers under Rule 102(e) for providing negligent legal advice, and Commissioners such as Norman Johnson have spoken forcefully regarding the importance of adhering to this bright-line test because of the central role that lawyers play as gatekeepers in the disclosure process.

Nowhere in the Weiss decision did the Commission discuss Carter & Johnson or attempt to distinguish it. We are thus left with two possible explanations for the decision in Weiss. The first, which has very little logical underpinning, is that the relief sought was a cease-and-desist order, not an order suspending or barring Mr. Weiss from practicing before the Commission under Rule 102(e).

Because the stigma associated with being ordered by the Commission to cease and desist from violating the Securities Act of 1933 as a result of having been negligent in providing legal advice to an issuer can be the equivalent of a sanction issued under Rule 102(e), it is difficult to imagine that this is the reason Mr. Weiss was sanctioned and Messrs. Carter and Johnson were not.

A more logical explanation is that the Commission has decided that only the pure advice of a lawyer is protected in the event of negligence. This is because the Commission focused on what it characterized as the negligent due diligence conducted by Mr. Weiss before providing his advice and his failure to communicate to the school district all three of the very specific IRS requirements.

The Commission, however, provided no explanation for drawing such a line, and all lawyers realize that a fine line often exists between providing incorrect legal advice and conducting inadequate due diligence concerning the operative facts upon which the advice is premised, particularly where the operative facts are communicated orally by the client.

Moreover, it is not self evident that negligently conducting due diligence is more deserving of punishment than negligently opining on the law, particularly since either can give rise to a malpractice action against the lawyer.

Unfortunately, because it did not attempt to distinguish Carter & Johnson, we do not know precisely why the Commission ultimately decided to sanction Mr. Weiss, whether because of the nature of the relief sought or the type of negligent conduct. Nor has the Commission explained why a single act of negligence by a lawyer is deserving of sanctions when, pursuant to Rule 102(e), accountants are not subject to sanctions unless they engage in a pattern of negligent conduct or in a single act of gross negligence. These important public policy considerations went unaddressed in Weiss and once clear waters are now turbid, leaving lawyers uncertain about the precise contours of the SEC’s current enforcement stance.

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