Securities Law Developments

SEC Settles Enforcement Case Against Orange County Bond Counsel

The Securities and Exchange Commission recently announced an Order instituting and settling a cease-and-desist proceeding brought against Jean Costanza, a lawyer who served as bond counsel to Orange County in 1994.[1/] The SEC alleged that Costanza violated Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933 when she negligently participated in drafting offering documents for Orange County notes that omitted material information about the risks of those securities, and when she negligently opined that the notes were exempt from federal taxation without disclosing the risks that the notes might lose their tax-exempt status. The settlement is noteworthy for its resort to negligence-based sections of the 1933 Act in an enforcement proceeding against a lawyer. The SEC's action makes clear that counsel to securities issuers need to be concerned about their potential exposure for negligent conduct under these sections of the 1933 Act, in addition the well known potential liabilities under Section 10(b) of the Exchange Act of 1934.

Omissions in Official Statements and Tax Opinions

Costanza served as bond counsel to Orange County and other local government issuers in eight municipal securities offerings in the summer of 1994 related to the now infamous Orange County investment pools. The Orange County Treasurer managed the pools as an investment fund, in which the County and other local government districts deposited public funds. The SEC's Order states that Official Statements for eight offerings failed to disclose several material facts regarding the pools and that these facts were material because the pools affected the issuers' ability to repay the notes.

Specifically, the Order alleges that the Statements improperly failed to disclose adequately the pools' investment strategy, the risks of that strategy, the degree to which the pools were leveraged, and the pools' investment losses. In three offerings, the Official Statements failed to disclose that the variable interest rate paid on the notes was subject to a 12% interest rate cap. Finally, the Statements on four of the offerings represented that the interest on the notes was tax-exempt, but did not disclose that the issuer had jeopardized the tax-exempt status by taking certain actions to increase the size of the offering. On each of the four tax-exempt offerings, Costanza also issued an opinion that the interest on the notes was exempt from federal income tax, but her opinions did not disclose the risk to the offerings' tax-exempt status.

1/ In the Matter of Jean Costanza, Securities Act Release No. 7621 (Jan. 6, 1999).

Costanza's Knowledge

The Order states that Costanza knew or reasonably should have known about these omissions because, as bond counsel, she participated in drafting seven of the Official Statements for the offerings (including the disclosure about the pools) and prepared the tax opinions. Costanza also prepared resolutions authorizing the issuance of the notes and coordinated the documents for closing the transaction. The Commission pointed to meetings, media reports, and other circumstances to show that Costanza received the information that should have been disclosed in the Offering Statements.

Costanza attended a meeting in March 1994 with potential investors and rating agencies, at which a County official discussed the pools' investment strategy. Similarly, in May 1994, Costanza participated in a conference call with a rating agency, at which a County official discussed the risks of the pools' investment strategy and the collateral calls (in the hundreds of millions of dollars) the pools had suffered in the first four months of 1994. Costanza's own notes from this meeting explicitly recorded the primary risk facing the pools, stating that "if i[nterest] rates go up by 300 [basis points] DISASTER." The Commission further observed that through the first half of 1994, articles appeared in the media describing the pools' investment strategy, the risks of that strategy, the pools' declining value due to rising interest rates, and the resulting collateral calls; the Commission's Order asserts that Costanza knew about such articles. Finally, the Commission observed that in June 1994, County officials and Costanza decided to revise the Statement disclosures to replicate the disclosures made in the Official Statement from a 1993 note offering by another Southern California local government, which had been obtained in response to the media coverage and rating agency questions about the pools discussed above. Although the Orange County officials and Costanza copied much of the disclosure directly from this prior offering Statement, they made changes that downplayed the investment pools' risky investment strategy: for example, unlike the model offering documents, the Orange County Statement did not disclose the dollar amount of derivative securities held by the pool.

The Commission stated that Costanza should have known that the notes had an interest-rate cap because the cap was mentioned in the issuers' certifications that the offering amount complied with state law, in resolutions of the Boards of Supervisors of the issuers authorizing the notes, and in sample notes. Costanza received copies of all three documents, and she helped prepare the last two.

With respect to the risk to the notes' tax-exempt status, the SEC asserted that Costanza advised the issuers to take certain actions that improperly increased the size of the offerings and thereby created a risk that the IRS would declare that the investors were liable for taxes on the note interest. The SEC asserted that "Costanza had notice" that these actions did not comply with the relevant tax laws, jeopardizing the notes' tax-exempt status, but did not explain the factual basis of that assertion.

Lawyers' Potential Exposure

The Commission's action against Costanza demonstrates that lawyers who assist in the preparation of offering documents are at risk if the offering documents contain deficiencies of which the lawyers should be aware. In addition to potential liability to private litigants under Section 10(b) of the Exchange Act if they are the "author" of offering documents, lawyers must be mindful of their potential exposure, under Section 17(a) of the Securities Act, for negligent participation in offering

documents that omit material facts. Unlike Section 10(b) of the Exchange Act, Sections 17(a)(2) or (3) of the Securities Act do not require proof of scienter.[2/]

In Central Bank of Denver,[3/] the Supreme Court made clear that although there was no private right of action under Section 10(b) of the Exchange Act for secondary actors who aid and abet primary securities law violations, such actors could still be held liable as primary violators:

> The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts. Any person or entity, *including a lawyer*, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all the requirements for primary liability under Rule 10b-5 are met.[4/]

In other cases, the federal courts have recognized the possibility of lawyer liability for omissions in securities offering disclosure documents. In Klein v. Boyd,[5/] the Third Circuit reversed a District Court decision granting summary judgment dismissing the securities fraud claims brought against the Philadelphia law firm of Drinker, Biddle & Reath ("Drinker") for its role in allegedly preparing misleading disclosure documents on behalf of a limited partnership venture. The District Court had concluded that Drinker could not be liable because its role in the transaction had not been identified to investors. The Third Circuit reversed, holding that a lawyer who can fairly be characterized as an author or co-author of a client's fraudulent document may be held primarily liable to investors under the federal securities laws for the misstatements or omissions contained in the disclosure documents, even though the investor is unaware of the lawyer's role in the fraud.

The Third Circuit's opinion built on other cases that have recognized the potential liability of lawyers advising securities issuers. In Kline v. First Western Government Securities,[6/] the Third Circuit also reversed a District Court's grant of summary judgment to a law firm that wrote opinion letters advising its client regarding the tax consequences of an investment in forward contracts through the client. The plaintiffs alleged that the opinion letters, upon which they relied in deciding to invest, omitted material facts regarding the transactions. The Third Circuit reversed the District Court's holding that the lawyers had no duty to the investors, explaining that the lawyers had a "general"

[2/] Aaron v. SEC, 446 U.S. 680, 697 (1980); SEC v. Hughes Capital Corp., 124 F.3d 449, 453-454 (3d Cir. 1997); SEC v. Steadman, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992).

[3/] Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994).

[4/] Id. at 191 (emphasis added).

[5/] Nos. 97-1143, 97-1261, 1998 WL 55245 (3d Cir. Feb. 12, 1998), opinion vacated on grant of reh'g en banc (Mar. 9, 1998). After the panel issued its opinion, the Third Circuit voted to hear Klein en banc. The SEC has filed an amicus brief, arguing that a secondary actor in a securities transaction, such as a lawyer, may be held liable as a primary violator under Section 10(b) whenever the actor, either alone or with others, "creates" a misrepresentation. The en banc court has not yet issued its opinion.

[6/] 24 F.3d 480 (3d Cir. 1994), cert. denied, 513 U.S. 1032.

duty to speak truthfully once they had undertaken the "affirmative act of communicating or disseminating information."[7/] And in Ackerman v. Schwartz,[8/] the Seventh Circuit similarly held that a lawyer who wrote an opinion letter allegedly containing untrue facts could be held liable as a primary violator of the securities laws if the lawyer authorized the release of the opinion to investors.[9/]

The Costanza case reveals that the Commission remains eager to police the conduct of lawyers and other professionals who participate in the process of offering securities to the public and will hold counsel to issuers accountable for disclosure deficiencies that the lawyers were in a position to prevent. The SEC has shown that, at the very least, it will bring cease-and-desist actions to sanction lawyers for negligent conduct even if it is not prepared to allege that the lawyer acted with scienter. In light of the Costanza settlement and the Klein line of cases, lawyers assisting in the preparation of securities disclosure documents need to be aware of their potential exposure and need to assure that all potentially material information of which they are or should be aware has been carefully evaluated and, if appropriate, included in the disclosure documents they participate in drafting.

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7/ Id. at 491 (internal quotations omitted), quoting Rose v. Arkansas Valley Envtl. & Util. Auth., 562 F. Supp. 1180, 1206-08 (W.D. Mo. 1983).

8/ Ackerman v. Schwartz, 947 F.2d 841 (7th Cir. 1991).

9/ Id. at 846.