MEMORANDUM

TO: SFP

FROM: Jane M. Simon

RE: Duties of Underwriters, Underwriters' Counsel and Bond Counsel in Connection with Bond Offerings under Arkansas law

ISSUES PRESENTED

I. What are the duties of underwriters in connection with bond offerings and for which types of negligent activities may they be held liable?

II. What are the duties of underwriters' counsel in connection with bond offerings and for which types of negligent activities may they be held liable?

III. What are the duties of bond counsel in connection with bond offerings and for which types of negligent activities may they be held liable?

BRIEF ANSWERS

I. Underwriters have a duty to thoroughly investigate the transaction and all of the documents and agreements underlying the transaction. Underwriters cannot simply rely upon the representations of the issuer or its agents. Underwriters also have a duty to refrain from marketing the bonds until the details of the transaction are sufficiently complete and finalized.

II. Counsel for underwriters has a duty to exercise due care in performing due diligence review and in investigating the transaction.

III. Bond counsel has a duty to investigate and discover errors contained in the documents underlying the transaction. Bond counsel also has a duty to exercise due care in formulating opinions about the various aspects of the bond issue.

DISCUSSION

This memorandum discusses and analyzes the various duties of underwriters, underwriters' counsel, and bond counsel involved in the issuance of bonds. Since there is no Arkansas law on this subject, this memorandum analyzes cases from various other states as well as federal law.

It should be pointed out that a few of the cases discussed in this memorandum consider federal securities violations and remedies. The same general duties which are applied in such cases can be carried over to cases involving common law remedies, since each party involved in the transaction owes a similar duty to all others in the transaction—the duty to exercise due care under the circumstances—regardless of the violation alleged. At least one commentator has recognized this concept by noting that "state law remedies against attorneys cannot be considered wholly apart from the federal securities statutes." Morgan Shipman, *The Need for SEC Rules to Govern the Duties and Civil Liabilities of Attorneys Under the Federal Securities Statutes,* 34 Ohio St. L.J. 231, 240 (1973).

Although many of the cases cited in this memorandum involve lawsuits brought by bondholders and bond purchasers, the same duties which the underwriters and attorneys owe to the purchasers can be applied to the issuer , assuming that the issuer relied on the opinions in the same manner as the purchasers. In such a situation, the potential for "arguable attorney liability to the issuer if the issuer is found liable for defective disclosure documents and cross-claims against the attorney under a state law negligence theory is obvious." Id.

Many of the cases analyzed in preparing this memorandum never reach the issue of negligence, because they turn on whether a duty is owed by the defendant to a party with whom he was not in privity. Although, this "near-privity" issue appears to be the key issue in examining the duties owed to the issuer by the underwriter, the underwriter's counsel, and bond counsel, such analysis is the subject of another memorandum prepared in this case and is outside the scope of this memorandum.

I. Duties of Underwriters

The City's allegations against the underwriter, [XX], in this case are two-fold. First, [XX] had a duty to refrain from marketing the bonds until the elements of the project were sufficiently established. In this case, a satisfactory site had not been selected and approved, and the state and federal permits for the project had not been obtained. Second, [XX] had a duty to ensure that the project would work and that the contracts underlying the project were sufficiently valid and enforceable.

The duties of an underwriter in a bond issue are many. The underwriter is most heavily relied upon to verify published materials involved in the issue because of his expertise in appraising the securities issue and because of his incentive to do so. Small, *An Attorney's Responsibilities Under Federal and State Securities Laws: Private Counselor or Public Servant?,* 61 Cal. L. Rev. 1189, 1217 (1973). The underwriter is familiar with the process of investigating the business condition of a company and possesses extensive resources for examining the issuer's strengths and weaknesses. Id. at 1217. Many parties to the transaction look to the

underwriter to pass upon the soundness of the bonds and the correctness of the transaction and agreements. Id. at 1218.

A. Duty to Investigate

In order to properly carry out his or her duties, the underwriter must undertake a thorough investigation of the issuer and all documents pertaining to the issue. An underwriter who does not make a "reasonable investigation is derelict in his responsibilities" to deal fairly with the investing public and to all concerned with the transaction. In re Richmond Corp., 41 S.E.C. 398, 406 (1963). In order to satisfy his or her duties of investigation, the underwriter has the responsibility to verify that which is reasonably verifiable, and the Securities and Exchange Commission ("SEC") has indicated that the failure to make an appropriate investigation by failing to exercise the appropriate degree of care is not only a basis for civil liability, but also for revocation of the underwriter's registration as a broker/dealer. See Richmond Corp., 41 S.E.C. at 406.

Many cases have considered and interpreted the underwriter's duty to investigate. In Chris-Craft Indust., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir. 1973), for example, the Second Circuit stressed the importance of the role played by the underwriter and set for the underwriter such a high standard that in light of its duty, the court could readily find that the underwriter was reckless. In this regard, the court stated:

> First Boston [the underwriter] is a skilled, experienced and well-respected dealer-manager and underwriter. It had an obligation to . . . reach a careful, independent judgment based upon facts known to it as to the accuracy of the registration statement. Moreover, if it was aware of facts that strongly suggested, even though they did

> not conclusively show, that the registration materials were deceptive, it was duty-bound to make a reasonable further investigation.

Id. at 371.

Since the underwriter in Chris-Craft, in exercising its due diligence functions, had examined the records of the corporation which disclosed a possible sale to another buyer, the underwriter was held to be aware of facts which imposed upon it a duty to explore further. Id. at 372. The court found that the underwriter did not make a careful search of the corporation's records, nor did it talk to officials at the company of the potential buyer. Id. Under these circumstances, the underwriter's conduct amounted to an almost complete abdication of its responsibility to potential investors and possibly to others who relied upon it to detect misrepresentations. Id. at 373. The court concluded that the underwriter possessed enough information to reasonably deduce that the corporation's registration statement was materially inaccurate and therefore held the underwriter liable for federal securities violations to the investors. Id. at 373.

In a similar case, Richmond Corporation, 41 S.E.C. 398, the SEC considered the role of the underwriter in a case brought by the SEC to determine whether a stop order should issue suspending a registration statement. The court noted that it is a well-established practice and a standard of the business for underwriters to exercise diligence and care in examining an issuer's business and the accuracy and adequacy of the information contained in the registration statement. Id. at 406. See also United States v. Morgan, 118 F. Supp. 621 (S.D.N.Y. 1953). By associating himself with a proposed offering, an underwriter impliedly represents that he had

made such an investigation in accordance with professional standards. Richmond Corp., 41 S.E.C. at 406.

In Richmond Corporation, the underwriter's investigation of the registrant's business consisted merely of visiting two of the registrant's three tracts of land, examining the registrant's list of stockholders and obtaining a credit report on the corporation. Id. at 405. As to all other matters in connection with the registration statement, the underwriter relied solely upon representations made by the registrant's management. The SEC concluded that "it seems clear that such a limited investigation by an underwriter does not measure up to the degree of care, reasonable under these circumstances, necessary for and required of an underwriter to satisfy himself as to the accuracy and adequacy of the representations in the prospectus." Id. at 405.

B. Duty to Ensure Details are Complete

Regarding the underwriter's duty to refrain from marketing the bonds until the elements of the project are sufficiently established, the SEC has noted the importance of the due diligence process and the fact that the underwriter can delay the offering until it has completed its due diligence review. 3A Harold S. Bloomenthal, Securities and Federal Corporate Law, § 7.25 (1988). Therefore, [XX] should have refrained from marketing the bonds when it knew, or should have known, that the selection of the [XX] site had not been finalized and that the permits necessary to operate the project had not been granted.

C. Duty to the Issuer

A case in which the issuer sued the underwriter for negligence, is the unpublished opinion of Ted Glasrud Associates, Inc. v. Piper, Jaffray and Hopwood, Inc., No. C7-88-1275, 1989 WL 5631 (Minn. Ct. App. 1989). In that case the plaintiff, Glasrud, contacted Piper, Jaffray and Hopwood ("PJH") about underwriting a municipal bond offering. PJH sent a letter of understanding to Glasrud wherein PJH offered investment banking services in obtaining a secure source of mortgage funds through a municipal home ownership revenue bond issue. Id. at *1. PJH represented that it would structure the financing so that the mortgage interest rate could be brought down at the time a mortgage was originated. However, this mortgage buy-down provision was poorly worded and when Glasrud began to place the mortgage funds and to originate the mortgages, the buy-down provision was far more expensive than had been represented by PJH. Id. at *2.

Glasrud brought suit claiming that PJH was negligent because the mortgage buy-down provision was inadequate and poorly worded. The appellate court determined that in order to establish negligence, it was essential for Glasrud to have expert testimony to establish the standard of care of an underwriter. Id. at *4. The court reasoned that where the acts or omissions complained of are not within the general knowledge and experience of laypersons, it would be speculative for the fact finder to decide the issue of negligence without having the benefit of expert testimony. Id. Accordingly, Glasrud failed to present a fact issue as to PJH's duty, or breach of that duty, and the trial court correctly granted summary judgment. Id. Even though the underwriter was successful, this case seems to imply that if the

appropriate expert testimony concerning the underwriter's duty in this situation had been produced, the issuer would have succeeded on his negligence claim against the underwriter.

Based upon the foregoing analysis, [XX] had a duty to undertake a thorough investigation of the Authority and all documents and agreements pertaining to the issue. It could not merely rely upon the representations made by the City and the Authority. Based upon its experience in the field, [XX] knew, or should have known, that the guarantee made by the City was unenforceable and that the site and permits were not sufficiently finalized to permit the deal to go forward. Moreover, based upon the Glasrud case, it appears as though the City probably has a cause of action against [XX] for negligence in this case.

II. Duties of Underwriters' Counsel

The City has sued the underwriter's counsel, [XX] for failing to exercise due care in performing the due diligence review of the transaction, which includes examination of the agreements underlying the transaction. Specifically, [XX] failed to discover that the guarantee made by the City was unconstitutional and also allowed the deal to go forward when the site selection was not yet finalized and the requisite permits had not yet been granted.

Counsel for underwriters have often been held liable in similar situations. In In re Flight Transportation Corporation Securities Litigation, 593 F. Supp. 612 (D. Minn. 1984), for example, the purchasers of securities brought an action alleging securities violations, common law fraud and negligent misrepresentation against the law firm which represented the underwriter in a public offering of securities.

Plaintiffs alleged that there were omissions and false and misleading information regarding the revenues, businesses, operations and financial condition of the corporation in the prospectus. Id. at 614. They asserted that the law firm assisted in the preparation of the prospectus and failed to exercise its duty of conducting a "due diligence" investigation of the information contained in the prospectus. Id. The plaintiffs also claimed that the law firm knew of, or recklessly disregarded, facts of a fraudulent scheme and failed to disclose those facts in the prospectus. The court concluded that these allegations stated a cause of action for fraud and negligent misrepresentation against the underwriter's counsel, and accordingly denied the defendant's motion to dismiss. Id. at 619.

Although the Flight Transportation case involved allegations of fraud, it also contained a cause of action for negligent misrepresentation, which is very similar to the allegations against the underwriter's counsel in the instant case. In this case, [XX] had a duty to exercise ordinary care in performing its due diligence review of the transaction, agreements comprising the Project and the remarketing of the bonds. [XX] failed to exercise its duty to conduct a proper due diligence investigation, as did the underwriter's counsel in Flight Transportation. [XX] knew, or in the exercise of ordinary care should have known, of the uncertainty regarding the [XX] site, that the necessary government permits had not issued, and that the [XX] Agreement was unenforceable. Based upon the Flight Transportation case, such allegations are probably sufficient to state a cause of action for negligence against the underwriter's counsel.

In a similar case, Abel v. Potomac Insurance Co., 858 F.2d 1104 (5th Cir. 1988), a group of bondholders sought to hold the underwriter's counsel, Wright, Lindsey & Jennings, liable for malpractice. Although the Fifth Circuit ultimately held that the bondholders failed to state a malpractice claim against the law firm, it noted that under Louisiana law, the bondholders could maintain such an action if the underwriter's counsel had prepared the opinion for the benefit of the non-client bondholders and the underwriter's counsel knew that such third party bondholders would rely upon that opinion. Id. at 1132 Therefore, if the City in the instant case can show that [XX] opinion was prepared in part for the benefit of the City and that [XX] knew the City would rely on its opinion, the City probably will have a cause of action against [XX].

III. Duties of Bond Counsel

The City's allegations against the bond counsel, [XX], are two-fold. First, [XX] had a duty to refrain from marketing the bonds until the elements of the project were sufficiently established. In this case, a satisfactory site for the Project had not been finalized, and the permits necessary to operate the Project had not yet been obtained. Second, [XX] had a duty to ensure that the project would work and that the contracts underlying the transaction were valid. The City claims that [XX] was negligent in failing to perform the above-listed duties with due care.

A. Duty to Investigate

When bond counsel has not made an investigation sufficient to permit the good faith rendition of an opinion, or when he is on notice of facts which, if inquired into, would disclose that he could not render the opinion as such, he may be "guilty

of such recklessness that his activities should be proscribed even if he was not a conscious or knowing participant in a violation of law." Small, *An Attorney's Responsibilities Under Federal and State Securities Laws: Private Counselor or Public Servant?*, 61 Cal. L. Rev. 1189, 1196 (1973). Such a result finds support in recent authority. See, e.g., Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir. 1973).

Many courts have held bond counsel liable for their negligence in failing to investigate and discover errors in the issuer's financial statements. For example, in Security Bank & Trust v. Fabricating, Inc., 673 S.W.2d 860 (Tenn. 1983), a municipality employed an attorney to serve as special bond counsel for the town to pass upon the legality and non-taxability of the proposed bond issue, and to prepare the offering circular. Two individuals had personally guaranteed the bond issue, and they submitted statements of their financial condin which were attached to the offering circular. The bond coupons defaulted, and it was discovered that the guarantors did not have the assets reflected in their financial statements. Id. at 861-62.

A trustee bank brought suit against the bondholders for reimbursement, and the bondholders filed a third-party complaint against the bond counsel alleging various acts of negligence. The primary allegations were that the attorney should have discovered the falsity of the financial statements of the guarantor and that the attorney's failure to discover and disclose this and other deficiencies was a direct and proximate cause of the loss suffered by the bondholders. Id. at 863.

While the lower court awarded damages in favor of the bondholders and against the bond counsel for negligence, the Tennessee Supreme Court ultimately held that this malpractice action was barred by the statute of limitations. Id. at 865. The court, however, at least impliedly recognized a cause of action for malpractice or negligence against bond counsel in failing to discover the fraudulent nature of the financial statements of the guarantors which were attached to the offering circular.

B. Opinions about Legality of Issues

Numerous cases have held bond counsel liable for giving a negligent opinion about certain aspects of a bond issue. In Bradford Securities Processing Services, Inc. v. Plaza Bank & Trust, 653 P.2d 188 (Okla. 1982), the plaintiff had advanced money to its customers securing the advances by bonds received on the customers' behalf. The plaintiff became a forced purchaser of the bonds when its customers defaulted in repayment. Id. at 189. When the bonds ultimately proved to be worthless, the plaintiff brought this action against the bond counsel involved in the issue. The plaintiff's claim against the bond counsel was based on a negligence theory asserted under state law for representing in his bond opinion "either expressly or by necessary implication from the language used that the entire consideration for the bond issue had been paid, that said bonds were legally issued, and that the interest would be excludable from gross income." Id. at 190.

The court first considered whether there could be any liability on behalf of the bond counsel because the plaintiff was not the bond counsel's client. The court noted that privity had no applicability under Oklahoma tort law and that the bond counsel's liability depended upon whether the harm to this particular plaintiff was

foreseeable. Id. at 190-91. The court then examined foreseeability and concluded that:

> The formula that should govern the jury in determining the issue of negligence is, *is the conduct of an ordinarily prudent man based upon the dangers he should reasonably foresee* TO THE PLAINTIFF OR ONE IN HIS POSITION *in view of all the circumstances of the case* such as to bring the plaintiff within the orbit of defendant's liability . . . and if the defendant fails to exercise the care that an ordinarily prudent person should have exercised under the circumstances, he is liable for the injuries plaintiff suffered as a result of such negligence.

Id. at 191.

The Bradford court noted that the bond counsel allegedly knew or should have know that his legal opinion would appear on the bond certificates and be relied upon by the purchasers of the bonds. Id. at 189. The court also noted that plaintiff relied upon the opinion. The court thus concluded that the plaintiff had stated a cause of action against the bond counsel for negligence in preparing his opinion, which made representations on the payment of consideration, the legality of the bond issue, and the tax-exempt status of the bonds. Id. at 191. See also Lubin v. Sybedon Corp., 688 F. Supp. 1425 (S.D. Cal. 1988) (investor stated claim for malpractice against attorneys who assisted in preparing offering documents).

In a similar case, Koehler v. Pulvers, 614 F. Supp. 829 (D.C. Cal. 1985), a group of limited partners who had invested in a partnership brought suit alleging legal malpractice and securities violations against the attorney who was hired as counsel by developers in the offer and sale of the partnership. The counsel had written an opinion letter advising that the securities issue was an exempt transaction. He also permitted the opinions to be disclosed to the underwriter and

investors without independently investigating the information supplied by the developer defendants for incorporation into the offering materials he prepared. Id. at 838-39.

The Koehler court found that the attorney should have known of the misrepresentations and omissions contained in the offering materials and that the attorney proximately caused the investors' injuries since he provided the necessary services to promote and facilitate the sale. Id. at 849. Therefore, the court concluded that the attorney was liable for legal malpractice to the limited partners whose investment interests were issued as purported exempt securities following the attorney's negligent opinion. Id. In reaching its holding, the court noted that "the duty of the lawyer includes the obligation to exercise due diligence including a reasonable inquiry, in connection with responsibilities he has voluntarily undertaken. A lawyer has no privilege to assist the issuer to circulate statements which he knows or should know to be false." Id. at 845.

Based upon the foregoing analysis, a court could find [XX] liable for its negligence for failing to investigate and discover the error contained in the City's guarantee. [XX] should have also discovered that the details of the site and the permits had not been finalized and should have refrained from issuing the bonds. Moreover, the fact that [XX] gave an inaccurate opinion as to the legality of the issue is probably enough to hold it liable, based upon the holdings of Bradford and Koehler. Since it probably can be established that the City relied upon the advice of [XX] and it was foreseeable that it would do so (see near-privity memorandum), the City has stated a valid cause of action against [XX] for its negligence.

CONCLUSION

For the foregoing reasons, this memorandum concludes that the City probably has a cause of action against the underwriter [XX] for its negligence in connection with the bond offering. The City also may be able to recover against the underwriter's counsel [XX] if the City can show that counsel's opinion was prepared for the benefit of the City and that counsel knew the City would rely upon its opinion. Finally, the City will probably be able to recover against the bond counsel [XX] for its negligence in connection with the bond offering.