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SEC Further Defines the Scope of Attorney Liability Under the Federal Securities Laws in the Matter of George C. Kern, Jr.

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NOTES

SEC FURTHER DEFINES THE SCOPE OF ATTORNEY LIABILITY UNDER THE FEDERAL SECURITIES LAWS IN THE MATTER OF GEORGE C. KERN, JR.

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I. INTRODUCTION

The Securities & Exchange Commission ("SEC" or "Commission"), through its Division of Enforcement, endeavors to preserve the integrity of securities markets by enforcing the federal securities laws in administrative proceedings and in federal courts. The Commission relies heavily on professionals such as accountants and attorneys to ensure enforcement of and compliance with federal securities laws intended to protect the investing public.

For example, the role of the public accountant is viewed as crucial to the effective functioning of securities laws. Accountants are regulated by professional standards enumerated in Generally Accepted Accounting Principles ("GAAP") and Generally Accepted Auditing Standards ("GAAS"). In addition, the SEC has actively expanded its oversight of the accounting profession by instituting administrative proceedings against accountants practicing before the Commission, and by offering numerous guidelines in accounting and

auditing enforcement releases.¹ Other forms of guidance provided for accountants by the SEC include Financial Reporting Releases, Codification of Financial Reporting Policies, and Staff Accounting Bulletins.²

As the complexity of securities transactions has increased, the importance of ensuring that ethical and competent attorneys practice before the Commission has also increased. Historically, the practice of law has been regulated by the states through codes of ethics³ and model rules,⁴ in accordance with professional standards and disciplinary bodies established by state bar associations. In the absence of a federal regulatory body to discipline lawyers, the SEC, through administrative adjudication and civil actions, has deemed it necessary to address on its own the misconduct or negligence of attorneys who practice federal securities law.⁵

Unlike its approach to the accounting profession, the Commission has not set definitive standards for attorneys in the area of federal securities regulation. The lack of clear guidelines for attorneys practicing securities law has been the cause of much conflict between the legal profession and the regulators. This conflict has sparked a reevaluation of the scope of a securities lawyer's obligation to his client and to the investing public.⁶

¹ See *In re Portney*, Accounting & Auditing Enforcement Release No. 242 [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,711 (Aug. 21, 1989); *In re Moore*, Accounting & Auditing Enforcement Release No. 264 [1987-1991 Transfer Binder] Fed. Sec. L. Rep. ¶ 73,733 (July 17, 1990); *In re Excel Bancorp, Inc.*, Accounting Series Release No. 316 [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,785 (Sept. 11, 1991); *In re Amre, Inc. & Walter W. Richardson*, Accounting & Auditing Enforcement Release No. 356 [1987-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 73,823 (Mar. 2, 1992).

² Special Report on Regulation of Accountants under Federal Securities Laws, Fed. Sec. L. Rep. (CCH) No. 1489, Part II (Mar. 14, 1992).

³ See Model Code of Professional Responsibility (1983).

⁴ See Model Rules of Professional Conduct (1991).

⁵ See *In re Carter and Johnson*, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847 (Feb. 28, 1981) (SEC enumerated its standards for unethical or improper conduct under Rule 2(e)); *Aaron v. SEC*, 446 U.S. 680 (1980) (Supreme Court held that scienter must be shown in an action against attorneys under Section 10(b) of the Exchange Act and Section 17(a)(1) of the Securities Act of 1933); *SEC v. National Student Marketing Corp.*, 457 F. Supp. 682 (D.D.C. 1978) (SEC imposed a "whistle blowing" duty on attorneys whose clients' proposed conduct would violate the securities laws).

⁶ See *Lincoln Savings & Loan Assoc. v. W. Danny Wall*, 743 F. Supp. 901, 919-920 (D.D.C. 1990), where the district judge questioned the professional conduct of accountants and attorneys of an insolvent financial institution.

Despite much criticism from the legal community,⁷ the Commission has attempted to hold attorneys accountable for unethical or improper conduct that results in the violation of a securities law. One of the SEC's most powerful enforcement tools is Section 15(c)(4) of the Securities Exchange Act of 1934 ("Exchange Act").⁸ This provision authorizes the SEC to issue administrative orders requiring compliance with disclosure sections 12, 13, 14, and 15(d) of the Exchange Act. Section 15(c)(4) provides that,

[i]f the Commission finds, after notice and opportunity for a hearing, that any person subject to the provisions of section 12, 13, 14, or subsection (d) of section 15 of this title or any rule or regulation thereunder has failed to comply with any such provision, rule or regulation in any material respect, the Commission may publish its findings and issue an order requiring such person, and any person who was a cause of the failure to comply due to an act or omission the person knew or should have known would contribute to the failure to comply, to comply, or to take steps to effect compliance, with such provision or such rule or regulation thereunder upon such terms and conditions and within such time as the Commission may specify in such order.⁹

Under Section 15(c)(4), an attorney can be cited for being the "cause" of his client's failure to comply with any of the disclosure provisions. The scope of Section 15(c)(4) was addressed in the Commission's administrative proceeding against Wall Street attorney George Kern, who was found to have "caused" his client, Allied Stores Corporation, to violate disclosure requirements pertaining to tender offer negotiations.¹⁰ Although the *Kern* decision has been viewed by legal professionals as an SEC failure, the fact that it

⁷ Report of the ABA's Section of Business Law Task Force on SEC Section 15(c)(4) Proceedings, *BUS. LAW.*, Vol. 46, Nov. 1990.

⁸ 15 U.S.C.A. § 78o(c)(4) (West Supp. 1991).

⁹ Section 15(c)(4), 15 U.S.C.A. § 78o(c)(4) (West Supp. 1991).

¹⁰ *In re George C. Kern, Jr.*, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,815 (June 21, 1991), *aff'd*, [1988-1989] Fed. Sec. L. Rep. (CCH) ¶ 84,342 (Nov. 14 1988).

highlights the Commission's current focus on the ethical conduct of the legal profession has been overlooked.

II. LEGISLATIVE HISTORY OF SECTION 15(c)(4)

Section 15(c)(4) was enacted for the limited purpose of correcting false filings. This section was designed to "establish an administrative procedure . . . for apprising investors of materially misleading filings and for the resolution of accounting and other complex and technical questions involving the disclosure provisions of the [Exchange Act]." ¹¹ The statute was adopted by Congress in the Securities Acts Amendments of 1964 ¹² to improve investor protection and solidify standards and controls over brokerage firms and their associated persons. ¹³

In 1984, Section 15(c)(4) was amended in a provision of the Insider Trading Sanctions Act of 1984 ("ITSA"). ¹⁴ Specifically, the amendment added Section 14 of the Exchange Act (proxy and tender offer regulations) to the provisions that could be enforced through Section 15(c)(4) administrative proceedings. Moreover, the 1984 amendment added new language permitting proceedings to be brought against a person who was a "cause" of one of the enumerated violations. As amended, Section 15(c)(4) allows the Commission to proceed against an individual who has contributed to a regulated entity's reporting violation, even though that individual has no direct compliance responsibilities pursuant to the Exchange Act.

III. ENFORCEMENT OF SECTION 15(c)(4): THE KERN CASE

In cases where the SEC has instituted proceedings against non-regulated individuals for causing a violation pursuant to Section 15(c)(4), the individuals named have been directors, officers, or em-

¹¹ S. Rep. No. 379, 88th Cong., 1st Sess. 1 (1963). (Report of the Senate Committee on Banking and Currency to Accompany S. 1642).

¹² Pub. L. No. 88-467, § 6, 78 Stat. 565, 573 (1964).

¹³ *Id.*

¹⁴ Pub. L. No. 98-376, § 4, 98 Stat. 1265 (1984).

ployees of the regulated entity.¹⁵ In the *Kern* case, the lawyer was also a director of the regulated entity.¹⁶ *Kern* represents the first time the SEC has suggested that attorneys may also be targeted under Section 15(c)(4).¹⁷

A. Facts

George C. Kern, Jr. ("Kern"), a reputable partner at Sullivan & Cromwell who headed the mergers and acquisitions division of the law firm, served as outside counsel to Allied Stores Corporation ("Allied"), a publicly traded corporation subject to the reporting requirements of the Exchange Act.¹⁸ On September 12, 1986, Allied became the target of a hostile tender offer by Campeau Corporation ("Campeau").¹⁹ Allied's board of directors (including Kern) met on September 23 to consider Campeau's offer. They resolved to explore alternatives through an investment banking firm.²⁰ The next day, Allied made the following disclosure on Item 7(a) of its Schedule 14D-9, filed with the SEC on September 25, 1986:

At its September 23, 1986 meeting, the Board considered and reviewed the feasibility and desirability of exploring and investigating certain types of possible transactions, including without limitation, a change in the present capitalization of the Company, the public or private sale of Shares or other securities of the Company to another company or person, the acquisition by the Company of Shares by tender offer or otherwise, the acquisition by the Com-

¹⁵ Report of the ABA's Section of Business Law Task Force on SEC Section 15(c)(4) Proceedings, BUS. LAW., Vol. 46, November 1990.

¹⁶ *In re George C. Kern, Jr.* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342, at 89,580.

¹⁷ See *In re George C. Kern, Jr.* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342 (initial decision), and *In re George C. Kern, Jr.* [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,815 (the Commission's subsequent review), where Kern's professional conduct in his role as outside counsel to Allied, not as director, was the focus of the proceedings.

¹⁸ *In re George C. Kern, Jr.* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342, at 89,580.

¹⁹ *Id.* at 89,581.

²⁰ *Id.*

pany of all or part of the business of another company or person, and the acquisition of the Company or of one or more of its significant business segments or of certain of its assets or a portion of its Shares by another company or person. After considerable discussion, the Board resolved that it was desirable and in the best interests of the Company and its stockholders to continue to explore and investigate, with the assistance and advice of Goldman Sachs, such transactions, although the Board noted that the initiation or continuation of such activities may be dependent upon future actions with respect to the Offer. There can be no assurance that these activities will result in any transaction being recommended to the Board or that any transaction which may be recommended will be authorized or consummated. The proposal or consummation of any transaction of the type referred to in this Item 7 may have an impact on the Offer. At its September 23, 1986 meeting, the Board also adopted a resolution with respect to the need for confidentiality with respect to the parties to, and possible terms of, any transactions or proposals of the type referred to in the preceding portion of this Item 7 during negotiations with respect to any such transactions.²¹

Allied, along with Kern, opened negotiations on September 26 with Edward J. DeBartolo Corporation ("DeBartolo") for the sale of six shopping centers owned by Allied.²² At the end of the day, the parties agreed on a price of \$405 million for the malls, subject to a report on their quality.²³ During the course of the negotiations, Allied's CEO understood that Kern, without consulting any of the officers of Allied, would make all decisions regarding any disclosures required by federal securities laws.²⁴

At this stage of the negotiations, Kern thought the agreement reached with DeBartolo did not require disclosure because he believed it did not represent an agreement as to both the price and

²¹ *Id.* (Item 7(a), Schedule 14D-9, Solicitation/ Recommendation Statement Pursuant to Section 14(d)(4) of the Securities Exchange Act of 1934, cited in the initial decision).

²² *Id.* at 89,581-89,582.

²³ *Id.* at 89,582.

²⁴ *Id.*

structure of the sale.²⁵ On September 29, Allied's sale of the malls to DeBartolo was cancelled when Campeau increased his offering bid.²⁶ Allied, represented by Kern, immediately commenced an aggressive search for a "white knight." Allied approached DeBartolo and began negotiations with that suitor on September 30.²⁷ After several meetings, on October 3 Allied and DeBartolo reached an agreement in principle as to the price and structure of a merger.²⁸ That afternoon, Allied's Board of Directors adopted a resolution approving and recommending the merger, contingent on DeBartolo obtaining the necessary financing.²⁹ Kern did not file an amendment to Allied's Schedule 14D-9 until October 8, 1986,³⁰ because he believed the transaction was uncertain until DeBartolo had secured the financing for the purchase.³¹

On June 29, 1987, the Commission instituted administrative proceedings under Section 15(c)(4) of the Securities Exchange Act of 1934 against Allied and Kern, ordering the initiation of public proceedings to determine whether Allied failed to comply with Section 14(d)(4) of the Exchange Act and Rule 14d-9 thereunder, and whether Kern was a cause of Allied's failures to comply with said provisions of the Exchange Act.³² The SEC's Division of Enforcement ("Division") alleged in the Order Instituting Proceedings ("Order") that Allied failed to promptly amend its September 24, 1986 Schedule 14D-9 to disclose the negotiations Allied engaged in as a result of Campeau's tender offer.³³ Additionally, the Order alleged that Kern made the decisions which resulted in Allied's failures to comply and was a cause of Allied's failures to comply with the disclosure provisions of the Exchange Act.³⁴

²⁵ *Id.*

²⁶ *Id.* at 89,584.

²⁷ *Id.*

²⁸ *Id.* at 89,586.

²⁹ *Id.* at 89,586-89,587.

³⁰ *Id.* at 89,587.

³¹ *Id.*

³² Proceedings Instituted Against Allied Stores Corporation and George C. Kern, Jr., Exchange Act Release No. 34-24648, Administrative Proceeding File No. 3-6869, 38 SEC Docket 987 (June 29, 1987).

³³ *Id.*

³⁴ *Id.*

On July 22, 1987 the Commission accepted Allied's Offer of Settlement, in which Allied consented to the Commission's Findings and Order without admitting or denying the initial Order's allegations.³⁶ Allied was found to have violated Section 14(d)(4)³⁶ of the Exchange Act and Rule 14d-9 thereunder by failing to promptly amend their Schedule 14D-9, and was directed to comply in all respects with the Exchange Act.³⁷ Simultaneously, the Commission terminated the administrative proceeding with respect to Allied.³⁸

B. *The Initial Decision*

Chief Administrative Law Judge Warren E. Blair held that Kern was a "cause" of Allied's failure to comply with the disclosures provisions of the Exchange Act. He concluded that Kern "neglected to give due care and consideration to the need for amendment of Allied's Schedule 14D-9 as material changes occurred" since its original filing.³⁹ In substance, Judge Blair found that Allied failed to promptly amend its Schedule 14D-9,⁴⁰ and that Kern knew or should have known that he was contributing to Allied's failure to comply with Section 14 of the Exchange Act in three different instances:

- 1) Allied's negotiations regarding the sale of its shopping centers;
- 2) Allied's merger negotiations with DeBartolo; and

³⁶ *In re Allied Stores Corporation and George C. Kern, Jr.*, Exchange Act Release No. 24727, 38 SEC Docket 1174 (July 22, 1987).

³⁶ 15 U.S.C.A. § 78n (West Supp. 1991). Section 14(d)(4) of the Exchange Act and Rule 14d-9 thereunder, requires that no solicitation or recommendation to holders of a security shall be made with respect to a tender offer for such securities unless as soon as practicable on the date of the solicitation or recommendation is first published or sent or given to holders of a security, a Schedule 14D-9 (17 C.F.R. § 240.14d-101) is filed.

³⁷ *Id.*

³⁸ *Id.*

³⁹ *In re George C. Kern, Jr.* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342, at 89,593.

⁴⁰ Pursuant to Rule 14d-9(b), if any material change occurs in the information set forth in Schedule 14D-9, an amendment on Schedule 14D-9 must be filed with the Commission disclosing such change promptly.

3) Allied's agreement in principle with DeBartolo and board resolution of October 3, 1986.⁴¹

In the initial decision, Allied's original disclosure in Schedule 14D-9 that its Board had "resolved that it was desirable and in the best interest of the Company and its stockholders to continue to explore and investigate" certain recapitalization transactions, was found to be deficient as to the disclosure of the September 25 negotiations for the sale of the shopping malls.⁴² Kern's counsel argued that Kern exercised reasonable professional judgment in determining that these negotiations did not prompt further disclosures, since there was no agreement on price and terms of the sale on that date, and that no material change had transpired from the time of the initial filing.⁴³ Judge Blair acknowledged that no agreement in principle as to the price and terms of the sale had been reached as of September 25, but disagreed as to the materiality of the events.⁴⁴

In determining whether this event was material and would require disclosure thereof, the court cited the seminal case of *Basic Incorporated v. Levinson*.⁴⁵ In that case, the Supreme Court ratified the use of the probability/magnitude balancing test enunciated in *SEC v. Texas Gulf Sulphur Co.*,⁴⁶ and affirmed its prior decision in *TSC Industries, Inc. v. Northway, Inc.*⁴⁷ It held that materiality was determined by balancing the indicated probability that an event will occur with the anticipated magnitude of the event in light of the totality of the circumstances.⁴⁸ Kern argued that the probability of the sale of the shopping centers was too remote on September 25, since the deal was subject to DeBartolo's review of the malls' quality reports.⁴⁹ Nevertheless, Judge Blair weighed the probability that the sale would be consummated with the magnitude of that event

⁴¹ *Id.* at 89,581-89,588.

⁴² *Id.* at 89,582.

⁴³ Respondent's Brief at 51-52, *Kern* (No. 1174).

⁴⁴ *In re George C. Kern, Jr.* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342, at 89,582.

⁴⁵ *Basic Incorporated v. Levinson*, 485 U.S. 224, 108 S.Ct. 978 (1988).

⁴⁶ *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

⁴⁷ *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

⁴⁸ *In re George C. Kern, Jr.* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342, at 89,583.

⁴⁹ *Id.*

(\$405 million), and concluded that the "balance [lay] heavily on the side of a finding of materiality and a need to disclose the negotiations that transpired on September 25."⁵⁰

Kern had also decided that no amendment to Schedule 14D-9 was necessary as to the merger negotiations with DeBartolo between September 29 and October 3.⁵¹ It appears from the record that various meetings took place during this period, in which significant events occurred in Kern's presence which solidified DeBartolo's tender offer.⁵²

At the hearing, Kern argued that his decision not to disclose the merger negotiations as of October 3 was premised on the fact that DeBartolo's obtaining financing for the deal was a condition precedent to the merger.⁵³ He contended that no agreement existed that would prompt further disclosures since DeBartolo did not have a firm financing commitment at this point.⁵⁴

Judge Blair opined that "by the close of October 2, 1986 a material change in the information previously disclosed had occurred and that the new developments would have been of significant interest to Allied shareholders."⁵⁵ Given the fact that as of October 2 the parties had a draft of the proposed merger reflecting their agreement as to both the price and structure of the merger, the SEC's Division of Enforcement ("Division") argued that there was a strong probability that the merger would be consummated.⁵⁶

Applying the materiality test set forth in *Basic*, Judge Blair concurred with the Division's position and concluded that "the probable effect of the negotiations was close to being of the first magnitude."⁵⁷ Kern was criticized for relying too heavily on the absence of a firm financing commitment as a determining factor in the filing of

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.* at 89,584. During the relevant period, the parties discussed the price structure of the deal, conducted reviews of confidential financial information, and directed their outside counsel to prepare a merger agreement outlining the structure and timing of the offer.

⁵³ Respondent's Brief at 53-54, *Kern* (No. 1174).

⁵⁴ *In re George C. Kern, Jr.* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342, at 89,585.

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.*

an Amendment to Schedule 14D-9, as if an amendment was not required until there was certainty that a merger would occur.⁵⁸ The initial decision emphasized that the standard for determining the materiality of an event is the degree of probability, not certainty, balanced against the anticipated magnitude of the event.⁵⁹ Although, Allied's original Schedule 14D-9 disclosed that the Board had agreed "to continue to explore and investigate" alternatives to the Campeau offer, this disclosure did not encompass the specific negotiations that culminated in DeBartolo's all-cash offer of \$67 million for all of Allied's shares.⁶⁰

On October 3, 1986, Allied and DeBartolo had reached an agreement in principle as a result of the ongoing merger negotiations, with the contingency that DeBartolo obtain the requisite financing.⁶¹ On that same day, the Allied Board of Directors convened and Kern presented the proposed merger.⁶² The minutes of the meeting reveal that the Board adopted a resolution approving the merger offer and recommending its ratification to Allied's shareholders.⁶³

As mentioned before, the initial decision held that Allied's filing of Amendment No. 1 was days late in violation of Section 14(d)(4) of the Exchange Act.⁶⁴ Since Kern had sole responsibility for determining when to file an amendment to Schedule 14D-9, he was found to be the cause of Allied's noncompliance.⁶⁵ Kern argued that an amendment was unnecessary prior to October 8, in that there was no agreement in principle until this date.⁶⁶ In addition, the board's resolution merely authorized Allied's officers to take action when the financing condition had been met.⁶⁷

To determine whether an "agreement in principle" had been attained, the standard pronounced in *Greenfield v. Heublein, Inc.*

⁵⁸ *Id.*

⁵⁹ *Id.* at 89,585-89,586.

⁶⁰ *Id.* at 89,586.

⁶¹ *Id.*

⁶² *Id.*

⁶³ *Id.* at 89,586-89,587.

⁶⁴ *Id.* at 89,587.

⁶⁵ *Id.*

⁶⁶ Respondent's Brief at 56, *Kern* (No. 1174).

⁶⁷ *In re George C. Kern, Jr.* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342, at 89,587.

was applied.⁶⁸ The Third Circuit in *Greenfield* held that an "agreement in principle" is reached when would-be merger partners have agreed on the price and structure of the transaction.⁶⁹ It was Judge Blair's opinion that the officers of both Allied and DeBartolo had agreed as to the price and structure of the proposed merger as of October 3.⁷⁰ Kern's insistence that an agreement which would raise a disclosure obligation had not been reached due to the absence of the required financing was unpersuasive.⁷¹ The court reasoned that to hold otherwise would permit parties to evade the disclosure requirements of Section 14 by including a condition precedent into their agreement, alleging that an agreement does not exist until such condition is met.⁷² Disclosure would not occur until the "agreement in principle became a *fait accompli* merger agreement."⁷³

C. Standard of Culpability Under Section 15(c)(4)

The Commission may institute proceedings pursuant to Section 15(c)(4) against "any person who was a cause of the failure to comply due to an act or omission the person *knew or should have known would contribute to the failure to comply . . . with such provision or such rule or regulation thereunder.*"⁷⁴ The Division argued that the appropriate standard of care in this case was negligence, defined as "the failure to exercise the standard of care required of a reasonable, similarly situated person under the same facts and circumstances."⁷⁵ On the other hand, counsel for Kern argued that the phrase "knew or should have known" in Section 15(c)(4) required that liability be imposed upon a showing of scienter, a higher level of culpability.⁷⁶

Judge Blair agreed with the Division, finding that "a showing of negligence by a person contributing to a failure to comply is suffi-

⁶⁸ *Id.*

⁶⁹ *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 757 (3d Cir. 1984).

⁷⁰ *In re George C. Kern, Jr.* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342, at 89,586.

⁷¹ *Id.*

⁷² *Id.* at 89,586-89,587.

⁷³ *Id.* at 89,587-89,588.

⁷⁴ Section 15(c)(4), 15 U.S.C.A. § 78o(c)(4) (West Supp. 1991).

⁷⁵ Memorandum of Law at 49, *Kern* (No. 1174).

⁷⁶ Reply Brief of Respondent at 21, *Kern* (No. 1174).

cient to satisfy the phrase 'should have known' in Section 15(c)(4)."⁷⁷ His conclusion was based on a review of the legislative history of Section 15(c)(4), the intent and purpose of which was to provide a method of addressing in an expeditious manner accounting and technical issues involving the disclosure provisions of the Exchange Act.⁷⁸ The court reasoned that adopting a higher level of culpability would contradict the statute's objective of being a quick means of enforcing disclosure rules.⁷⁹ In addition, Judge Blair stated that if Congress intended to impose a higher standard of culpability, it would have employed language similar to statutes like 15(b)(4)(E), which includes the words "willfully aided, abetted, counseled . . . the violation by any other persons."⁸⁰

D. Relief Under Section 15(c)(4)

The Division of Enforcement sought as part of the remedy an "order directing Kern to comply or take steps to effect compliance with Section 14(d)(4) of the Exchange Act and Rule 14d-9."⁸¹ In reply, counsel for Kern argued that the scope of the Commission's authority under Section 15(c)(4) did not authorize the issuance of orders directing future compliance in general terms.⁸²

In the initial decision, the administrative court defined the Commission's authority pursuant to Section 15(c)(4) by reviewing the legislative history of the statute.⁸³ Judge Blair concluded that the Commission did have the authority to issue orders of future direction, where appropriate.⁸⁴ However, the court proceeded to hold

⁷⁷ *In re George C. Kern, Jr.* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342, at 89,591.

⁷⁸ S. Rep. No. 379, 88th Cong., 1st Sess. 23-26 (1963).

⁷⁹ *In re George C. Kern, Jr.* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342, at 89,590. Under a higher standard, the Division would be required to prove that Kern acted with knowledge of the illegality.

⁸⁰ *Id.* at 89,592.

⁸¹ Post Hearing Memorandum at 69, *Kern* (No.1174).

⁸² Brief of Respondent at 16-18, *Kern* (No. 1174).

⁸³ *In re George C. Kern, Jr.* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342, at 89,593.

⁸⁴ *Id.* at 89,595.

that there was no authority for the Commission to issue orders of general compliance.⁸⁵

Based on the facts of this case, the court reasoned it would be an abuse of the Commission's authority to direct Kern to generally ensure that any other regulated entity that Kern may represent in the future would comply with the disclosure provisions of the Exchange Act.⁸⁶ In addition, since Kern was no longer associated with Allied and Allied had ceased to be a publicly traded corporation subject to the disclosure provisions, an order directed at Kern as to Allied's future compliance was inappropriate.⁸⁷ In closing, Judge Blair ordered that the proceedings as to Kern be discontinued.⁸⁸

E. Commission's Review of the Initial Decision

On January 5, 1989, the Commission ordered on its own initiative a review of all issues of fact and law that were advanced in the administrative court's initial decision in *Kern* pursuant to Rule 17(c) of its Rules of Practice.⁸⁹ Thereafter, Kern also appealed the lower court's decision.⁹⁰ The opinion of the Commission addressed the sole issue of whether the scope of Section 15(c)(4) of the Exchange Act should be construed as providing for the issuance of general future compliance orders.⁹¹ The Commission began its analysis by recognizing that the issuance of these types of orders under Section 15(c)(4) was "a matter of first impression in an adjudicated proceeding."⁹² Finding that the language of the statute did not provide for the issuance of future compliance orders in general, the

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ *Id.* at 89,596.

⁸⁹ SEC Digest 89-3-01, 1989 WL 227217 (S.E.C.). Rule 17(c), 17 C.F.R. § 201.17(c) (1990), provides that ". . . [t]he Commission may on its own initiative order review of any initial decision by a hearing officer within 30 days after the initial decision has been served on all parties. . . ."

⁹⁰ *In re George C. Kern, Jr.*, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,815 (June 21, 1991).

⁹¹ *Id.* at 82,004-82,005.

⁹² *Id.* at 82,005. In footnote four, the Commission stated that most of the Section 15(c)(4) proceedings have been settled by consent.

court turned to the statute's legislative history for guidance.⁹³ While the Congressional hearings surrounding the amendments to Section 15(c)(4) in 1984 may have been indicative of Congress' intent to broaden the scope of the statute, the Commission also examined the effect of Congress' action in the passage of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 ("SERPSRA").⁹⁴

In SERPSRA, Congress granted the Commission the authority to issue orders against a violator or a cause of a violation "to cease and desist from committing or causing such violation and any *future violation of the same provision*, rule or regulation."⁹⁵ Nevertheless, SERPSRA did not settle the issue in the case at hand, since this legislation was enacted subsequent to the Commission's initial proceedings against Kern in 1987.⁹⁶

The Commission's review of the nearly 100 proceedings instituted under Section 15(c)(4) evidenced a steady trend toward the issuance of general future compliance orders as an administrative remedy.⁹⁷ The first orders issued pursuant to a Section 15(c)(4) violation were of a corrective nature, followed by orders directed at implementing procedures to prevent a recurring violation.⁹⁸ Subsequently, orders requiring future compliance with the Exchange Act, and orders directed at general future compliance emerged.⁹⁹

Referring to a summary of the use of Section 15(c)(4) outlined in the legislative proposals to amend the statute in 1984, the court recognized that Section 15(c)(4) was "primarily a means of compelling issuers to correct false or inaccurate periodic reports."¹⁰⁰ The Commission proceeded to hold that:

⁹³ *Id.*

⁹⁴ Pub. L. No. 101-429, 104 Stat 931 (1990).

⁹⁵ *In re George C. Kern, Jr.*, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,815 (June 21, 1991) at 82,007.

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ *Id.*

¹⁰⁰ *Id.* Citing SEC Oversight and Technical Amendments: Hearings on H.R. 4574 Before the Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce, 98th Cong., 2d Sess. 344 (1984).

[i]n light of all the foregoing factors, we now believe that the better view of the proper exercise of our authority, in the context of the Commission's performance of its adjudicative function in contested administrative proceedings, is that we are and ought to be constrained from imposing orders of general future compliance under Section 15(c)(4).¹⁰¹

The Commission concluded its opinion by affirming only the administrative law judge's order to discontinue the proceedings against Kern.¹⁰² None of the other issues raised in the initial decision were reviewed by the Commission.¹⁰³

IV. ANALYSIS

Who won? The appellate decision in *Kern* has received much criticism from both sides represented in the debate. On the one hand, legal practitioners in the securities industry contend that the negligence standard of culpability applied by the administrative court was erroneous, and that a higher standard like scienter should have been employed. Moreover, since the Commission did not specifically affirm the lower court's findings as to this particular issue, some securities attorneys may argue that the appropriate standard for finding someone to be the "cause" of a violation pursuant to Section 15(c)(4) is still an open question.¹⁰⁴

On the other hand, the Division of Enforcement of the SEC was left with no suitable remedy or sanction to apply against Kern. In affirming Judge Blair's position as to the narrow scope of Section

¹⁰¹ *Id.* at 82,008.

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *But see* the Commission's standard of review in such proceedings outlined in Rule 17(d) of the Commission's Rules of Practice, 17 C.F.R. § 201.17(d) (1990), providing that ". . . the Commission may decline to review the initial decision except that it will order review where . . . (2) [t]he petition for review makes reasonable showing that . . . (ii) [t]he initial decision embodies (a) [a] finding or conclusion of material fact which is clearly erroneous; or (b) [a] legal conclusion which is erroneous . . ." Thus, the Commission's failure to review Judge Blair's conclusion that Kern was the cause of Allied's disclosure violation, implies that the lower court's findings of facts were not erroneous.

15(c)(4), the Commission may have rendered this statute useless as an enforcement tool.¹⁰⁵

Nevertheless, the *Kern* decision provides attorneys, and other professionals, with a valuable guide as to the scope of their obligations in complying with the disclosure provisions of the Exchange Act. In determining whether a particular event requires disclosure, *Basic's* probability/magnitude balancing test is applied, where the large magnitude of an event may warrant disclosure in spite of a small probability of its occurrence.¹⁰⁶ Attorneys for Kern vigorously argued that the Commission was attacking Kern's good faith legal judgment, an area outside of the Commission's authority, in his decisions to postpone disclosure.¹⁰⁷ Both Judge Blair and the Commission were unpersuaded by these arguments, emphasizing Kern "knew or should have known" that the omission would result in a violation of the securities laws,¹⁰⁸ a primary area of concern in the Commission's oversight functions.

Notably, the fact that Kern was also a director of Allied was not a decisive factor in assessing Kern's culpability. More emphasis was placed on Kern's discretionary authority to make all disclosure decisions on behalf of his client.¹⁰⁹ Perhaps a narrow reading of the SEC's ruling in *Kern* would find an attorney to be a "cause" of his client's failure to comply with the disclosure provisions of the Exchange Act only where the attorney has discretionary authority for such compliance. A broader construction of the initial decision would apply the same standard of culpability to an attorney giving legal advice to his client, where the client retains responsibility of making the disclosure decisions.

¹⁰⁵ ABA Committee Discusses Kern Ruling, International-ization, SEC Amicus Briefs, 20 SEC. REG. & L. REP. (BNA) 46 at 1786.

¹⁰⁶ *In re George C. Kern, Jr.* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342, at 89,583.

¹⁰⁷ See Reply Brief of Respondent at 20, *Kern* (No. 1174), advocating a higher standard of culpability than negligence, where a good faith error would be free from liability. See also Memorandum of *Amicus Curiae*, Association of the Bar of the City of New York, arguing that such standard setting and regulation of the legal practice by the Commission would have a "chilling effect on the necessary independence of counsel."

¹⁰⁸ *In re George C. Kern, Jr.* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342, at 89,591.

¹⁰⁹ *Id.* at 89,592.

The Commission clearly refused to adopt a "two-tiered standard for enforcement of Section 15(c)(4), one for the 'cause,' who happens to be a lawyer, the other for a non-lawyer 'cause.' Such distinction would be at odds with the statutory language of Section 15(c)(4) which calls to account any person, not just a non-lawyer, who is a 'cause'."¹¹⁰

In addition, the Commission stressed the importance of having attorneys follow precedent established in prior administrative proceedings such as the *Revlon*¹¹¹ case.¹¹² In *Revlon*, the Commission held that disclosure is required upon the commencement of substantive discussions concerning a possible merger, irrespective of the fact that negotiations are in preliminary stages.¹¹³ Although the *Revlon* decision was issued in a consent settlement action pursuant to Section 15(c)(4) as opposed to a litigative proceeding like *Kern*, Judge Blair opined that the decision "should have alerted Kern to the disclosure philosophy of the Commission."¹¹⁴

Kern's counsel was satisfied with the outcome of the case,¹¹⁵ since proceedings against Kern were discontinued due to the Commission's lack of authority in issuing prospective orders of compliance.¹¹⁶ However, securities attorneys should be cautious before relying on a broad application of this ruling in *Kern*. The Commission's reluctance to issue a general compliance order was primarily due to the facts of this case.¹¹⁷ By the time the Commission addressed the relief requested by the Division of Enforcement,

¹¹⁰ *Id.* at 89,592-89,593.

¹¹¹ *In re Revlon Inc.*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,006 (June 16, 1986).

¹¹² *In re George C. Kern, Jr.* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342, at 89,593.

¹¹³ *In re Revlon Inc.*, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,006 (June 16, 1986).

¹¹⁴ *In re George C. Kern, Jr.* [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342, at 89,593.

¹¹⁵ Barbara Franklin, "No Authority Found For Order in Kern Case," N.Y.L.J., June 24, 1991, at 1.

¹¹⁶ *In re George C. Kern, Jr.*, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,815 (June 21, 1991) at 82,008.

¹¹⁷ See the initial decision [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342, at 89,595, and the Commission's subsequent review [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,815, at 82,008.

Kern had no existing legal relationship with Allied,¹¹⁸ which had become a nonreporting company. Under these circumstances, there would have been no purpose in requiring Kern to ensure that Allied comply with the disclosure provisions of the Exchange Act in the future.

Moreover, the Commission recognized that the new enforcement remedies enacted in SERPSRA would authorize the Commission to issue general prospective cease and desist orders.¹¹⁹ Had the *Kern* case arisen after the SERPSRA legislation was effective, the Commission would have issued an order against Kern "to cease and desist from committing or causing such violation and any future violation of the same provision, rule or regulation."¹²⁰ Consequently, the Commission may replace the use of Section 15(c)(4) as an enforcement tool against attorneys with the use of the cease and desist provisions of SERPSRA.

V. SCRUTINY OF ATTORNEY CONDUCT IN THE WAKE OF *KERN*

Highly publicized alleged abuses by professionals have stimulated action against accountants and lawyers by other regulatory bodies. For instance, the Office of Thrift Supervision ("OTS") and the Department of Justice recently sued the prominent law firm of Kaye, Scholer, Fierman, Hays & Handler ("Kaye, Scholer") and its former managing partner for \$275 million, freezing the firm's assets for their role in representing a convicted savings and loan executive.¹²¹ The OTS' temporary cease-and-desist order had never been enforced against a law firm.¹²²

In the Notice of Charges, the OTS alleged that Kaye, Scholer's actions constituted "reckless, unethical and improper professional

¹¹⁸ The merger was approved on October 8, 1986, and the initial decision in *Kern* is issued on November 14, 1988.

¹¹⁹ *In re George C. Kern, Jr.*, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,815 (June 21, 1991) at 82,007 (Commission states that "for the future, the passage of SERPSRA renders moot the issue of the Commission's general power").

¹²⁰ *Id.*

¹²¹ Stephen Labaton, *U.S. Moves to Freeze Assets Of Law Firm for S. & L. Role*, THE NEW YORK TIMES, Mar. 2, 1992, at A1.

¹²² Stephanie B. Goldberg, *Welcome to the New Uncertainty*, A.B.A.J. 51, July, 1992.

conduct, reckless breaches of [the firm's] duty of loyalty and duty to provide competent advice with due care, and demonstrated a lack of the professional character and integrity necessary for an attorney to practice before the OTS."¹²³ Specifically, the law firm was charged with violating its duty to disclose material information about its client's activities while responding to regulatory examinations of its client.¹²⁴ Kaye, Scholer was also charged with breaching its fiduciary duty to its client by failing to advise the board of directors that the owners of the financial institution were not acting in the bank's best interest.¹²⁵

In response, Kaye, Scholer agreed to settle the lawsuit for \$41 million, and two former partners of the firm were permanently barred from representing federally insured lending institutions, while another former partner agreed not to make material omissions in future dealings with the OTS.¹²⁶ By issuing this cease-and-desist order against one of the most prestigious law firms in New York, the OTS sent a clear message to members of the legal and financial community: lawyers will be treated like everyone else when it comes to bank crimes. A lawyer's duty of vigorous advocacy does not supersede his duty of care.

Another case that has had a major impact on attorney liability in the securities industry is *Lincoln Savings and Loan Association v. Wall*.¹²⁷ In *Lincoln*, District Court Judge Stanley Sporkin raised the following questions regarding professionals who advised officers and directors of the bank on improper financial transactions leading to the bank's insolvency:

Where were these professionals . . . when these clearly improper transactions were being consummated? Why didn't any of them speak up or disassociate themselves from the transactions? Where also were the outside accountants and attorneys when these transactions were effectuated? What is difficult to understand is that with all the professional

¹²³ James Podgers, *Changing the Rules*, A.B.A.J. 53, 54 July, 1992.

¹²⁴ *Id.* at 53-54.

¹²⁵ *Id.* at 54.

¹²⁶ Stephanie B. Goldberg, *Welcome to the New Uncertainty*, A.B.A.J. 51, at 51-52, July, 1992.

¹²⁷ *Lincoln Savings and Loan Association v. Wall*, 743 F.Supp. 901 (D.D.C. 1990).

talent involved (both accounting and legal), why at least one professional would not have blown the whistle to stop the overreaching that took place in this case.¹²⁸

Specifically, the court criticized certain actions of private counsel, such as engaging in dilatory practices with the bank's regulators and preparing frivolous lawsuits.¹²⁹ Judge Sporkin's comments may have encouraged potential litigants in the savings and loan industry to seek relief in the private sector.¹³⁰ In line with an expected influx of professional liability lawsuits,¹³¹ the *Lincoln* opinion alerts attorneys and accountants of the increased likelihood of being held accountable to the general public when representing a public company.

Ernst & Young, one of the accounting firms engaged by Lincoln Savings & Loan Association and a named defendant in a federal civil fraud lawsuit, recently agreed to settle for \$63 million.¹³² A settlement of this magnitude may serve to remind accountants of their potential liability in auditing public companies. In the future, accountants may be subjected to a higher standard of care, as suggested by Judge Sporkin's statement in *Lincoln*, that "accountants must be particularly skeptical where a transaction has little or no economic substance. This is so despite the fact that the transaction might technically meet GAAP standards."¹³³

These lawsuits may indicate an emerging trend toward regulation of entities that file professional liability suits as a result of pressures from regulators and the investing public. Administrative agencies will be continuously challenged to maintain a proper balance between their regulatory and enforcement functions.

¹²⁸ *Id.* at 920.

¹²⁹ *Id.* at 921.

¹³⁰ *Id.* at 920.

¹³¹ Mark I. Rosen, Deputy General Counsel for the Federal Depository Insurance Corporation, stated that with regard to suits filed against attorneys and accountants, "[w]hat's been filed now does not even come close to representing what's in the pipeline or what may be happening in the future." Sontag, *Two Twists to S&L Fallout*, NAT'L L.J., Sept. 17, 1990, at 3.

¹³² *Ernst & Young, law firm settle in Keating case*, THE MIAMI HERALD, Mar. 31, 1992, at 3C.

¹³³ *Lincoln Savings and Loan Association v. Wall*, 743 F.Supp. 901, 913 (D.D.C. 1990).

VI. CONCLUSION

The Commission's decision in *Kern* signalled its intention to take a more active role in establishing and enforcing standards applicable to the legal profession. *Kern* not only provides guidance on substantive issues pertaining to the disclosure provisions of the Exchange Act, but also establishes the principle that lawyers will be subjected to the same standards applicable to other persons under the securities laws. Regardless of an attorney's good faith legal judgement, the Commission is going to measure the professional conduct of an attorney by the *same* standard of "any person who was a cause of the failure to comply" with Section 15(c)(4). Given the SEC's expanded rule-making authority in SERPSRA, an increase in litigation is expected.¹³⁴

As the obligations of a securities attorney have increased both in number and complexity, the need for the Commission to define what is expected of attorneys practicing before it has also increased. The SEC should promulgate standards and provide more guidance through no-action letters, special committee reviews, and educational literature, as it has done in the accounting profession. The current method of defining standards through administrative proceedings and civil litigations, which can cause irreparable damage to well meaning professionals, is not efficient.¹³⁵

Administrative agencies such as the SEC and the OTS should prescribe clear standards of conduct of which professionals will have advance notice, and resort to enforcement actions after a violation of such standards has occurred. It would be unfair and ineffective to

¹³⁴ SEC, Budget Estimate Fiscal 1992, at II-i (Feb. 4, 1991) ("it is expected that a significant number of defendants and respondents who previously would have consented in Commission proceedings will contest the Commission's allegations when monetary penalties or other, new, forms of relief are sought").

¹³⁵ Recent actions questioning attorney duties and liability under the federal securities laws include: *Schatz v. Rosenberg*, Docket No. 91-1062, 943 F.2d 485 (1991) (Petition was filed with the U. S. Supreme Court by sellers of companies against law firm that represented the buyer to address attorney liability under the fraud provisions of the Exchange Act). *SEC v. Singer* [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,525 (SD NY) (Action against an attorney for alleged insider trading after attorney's summary judgment motion was denied). *In re Nouskajian*, Securities Act of 1933 Release No. 6923, 50 SEC Docket (Jan. 16, 1992) (Rule 2(e) proceeding was instituted against an attorney selling unregistered securities in the form of investment contracts).

use a “create the rules as we go” approach and pursue disciplinary actions against professionals without guidance on the rules.

An attorney representing a client in a regulated industry must remember that the commitment entails a dual representation: to the client and the government. Zealous representation of the client is not the only focus of the relationship. Adherence to relevant government regulations is also critical. Cases like *Kaye, Scholer* “raise difficult questions about how far a lawyer’s advocacy can go before crossing over the line from zeal to deception.”¹³⁶ This case, as well as other recent actions by the SEC, suggest that the regulators are likely to continually remind lawyers that practicing before the Commission is a privilege, not a right.

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¹³⁶ Stephen Labaton, *U.S. Moves to Freeze Assets Of Law Firm for S. & L. Role*, THE NEW YORK TIMES, Mar. 2, 1992, at A1.