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UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

No. 78-1048

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellant,

v.

ANDREW J. HASWELL, JR.,

Defendant-Appellee.

Appeal from the United States District Court
for the Western District of Oklahoma

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLANT

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PRELIMINARY STATEMENT

This injunctive action brought by the Securities and Exchange Commission presents legal issues with respect to the responsibilities of a securities lawyer, Andrew J. Haswell, Jr. ("Haswell"), in the context of several public offerings of industrial development revenue bonds. Haswell served as counsel to the quasi-governmental authority which was the issuer of the three bond issues involved in this case. In connection with each of the three issues, Haswell failed to meet responsibilities imposed upon him by law—responsibilities arising from duties essentially defined and undertaken by Haswell himself. In connection with each issue, Haswell either saw red flags—warning signals—strongly indicating violations of the law, or deliberately closed his eyes to the presence of such indications.

In the district court's view, Haswell did not assume any responsibilities "other than to act as a bond counsel in issuing his opinion * * * and as a lawyer merely placing in legal form the agreements of other parties" involved in the issuance of the securities in issue in this case (R 448). The court concluded that an attorney in Haswell's position would not have known that a fraud, and massive resultant financial losses, were being inflicted on public investors. As the Commission will demonstrate in this brief, however, the incorrect standards applied by the district court to Haswell's conduct will, if accepted as the norm, fail to provide investors with the measure of protection intended by the federal securities laws. The overwhelming evidence in this case indicated that Haswell did not satisfy the duty he owed to public investors, and that, had he done so, the three offerings involved in this case could never have taken place, since his legal opinions, and other legal services, were critical to the success of these securities offerings.

STATEMENT OF THE ISSUES PRESENTED

1. Did the district court err in concluding that the defendant, a lawyer, had not violated the antifraud provisions of the federal securities laws and in denying injunctive relief in an action brought by the Securities and Exchange Commission, in which the evidence indicated that the lawyer:

— reviewed disclosure documents prepared by the underwriter for two of the three bond offerings in issue, documents which presented a grossly distorted picture of the companies for which the bonds were issued and, despite knowledge that the facts were not as represented in the documents, failed to take adequate action to amend them, or to cause others to do so;

— drafted and compiled a disclosure document for a third company, from which he omitted material facts regarding the company, the intended use of the proceeds of the offering, and the company's financial condition and capabilities, and in which he included patently unreasonable production and sales projections, despite the fact that he had made absolutely no inquiry as to the source or basis of these figures;

— issued unqualified tax opinions regarding the purported tax-exempt nature of each of the three bond issues, without having any factual or legal basis for his opinions and while on notice of facts indicating that statutory requirements regarding the use of the proceeds of the offerings could not possibly be satisfied?

2. Did the district court apply an incorrect legal standard in holding that the Commission had to demonstrate scienter, which it defined as an "extreme fraudulent departure" from proper standards of conduct, in an action brought under the antifraud provisions of Section 17(a) of the Securities Act, as well as under Section 10(b) of the Securities Exchange Act, and Rule 10b-5 thereunder?

3. Did the district court err in failing to find that the defendant violated, and aided and abetted violations of, the securities registration provisions of the federal securities laws, where the defendant failed to produce any evidence as to the availability of an exemption from the registration requirements?

4. Did the district court err in stating that even if there were violations on Haswell's part, it would not enjoin him, where the court's findings and conclusions, and the legal standards it applied, were erroneous

in significant respects, and where the record is barren of any showing by Haswell of circumstances that courts have held may indicate that injunctive relief is not needed?

STATEMENT OF THE CASE

1. The Order Under Review

This is an appeal by the Securities and Exchange Commission ("Commission") from an order (R 442) 1/ of the United States District Court for the Western District of Oklahoma (Judge Bohanon), entered on October 19, 1977, after trial in an action for injunctive relief brought by the Commission. In that order, the court found that Haswell had not violated the federal securities laws as alleged in the complaint, and denied all requested relief as to Haswell.

In its action, the Commission charged violations of registration 2/ and antifraud 3/ provisions of the federal securities laws (R 9-41), in connection with the offer and sale of industrial development revenue bonds ("IDR bonds") issued by the Midwestern Oklahoma Development Authority ("MODA") on behalf of three companies, Western States Plastics, Inc. ("WSP"), Lee and Hodges, Inc. ("L&H"), and Harper Industries, Inc. ("HII") (R 1-3). The

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1/ In this page-proof brief, pages in the record on appeal are cited as "R __;" pages in the transcript of the trial held on September 8 and 9, 1977, are cited as "Tr. __;" plaintiff's exhibits are cited "P. Ex. __." The Commission has sought leave to file a deferred Appendix in this case, and if its motion is granted, the Commission will file a definitive version of its brief, citing to pages of the Appendix, when filed.

2/ Sections 5(a) and 5(c) of the Securities Act of 1933, 15 U.S.C. 77e(a) and 77e(c). See p. 1a, infra.

3/ Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), and Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 promulgated thereunder, 17 CFR 240.10b-5. See pp. 1a-3a, infra.

Commission filed its complaint on May 3, 1977, seeking preliminary and permanent injunctions against nine persons or entities, including Haswell. 4/

The case was originally assigned to District Judge Dougherty, but on May 20, 1977, the court entered an order, sue sponte, transferring the case to the Honorable Luther Bohanon (R 106). Judge Bohanon had presided over two earlier private actions brought against Haswell and others under the federal securities laws, and had dismissed the charges against Haswell in each of those actions. 5/ On August 15, 1977, Haswell made a motion for severance and separate trial (R 373), which was granted by the court two days later (R 383), over the strong objection of the Commission (R 385). The district court also denied the Commission's pending requests for discovery (R 385), and directed the Commission to proceed to trial hastily. Indeed, the trial was held three weeks later, on September 8 and 9, 1977, although certain important witnesses could not be located by that date. 6/

4/ The other named defendants are (1) WSP, (2) L&H, and (3) HII, defunct corporations which leased property from MODA, which issued bonds on their behalf; (4) William K. Capper, a consultant to WSP; (5) Dennis R. Cowell, doing business as United City Corporation, an unincorporated entity which acted as underwriter for the WSP, L&H and HII bond issues; (6) Stephen A. Lancaster, a finder and underwriter for the WSP, L&H and HII bond issues; (7) Harold T. Pehr, president of WSP; and (8) Fred W. Rausch, Jr., bond counsel involved in the HII Series A bond issue (R 2-3). The Commission's action remains pending with respect to all of these other defendants.

5/ In response to a motion by Haswell, Judge Bohanon dismissed these two actions on February 18, 1977, and October 8, 1976, respectively. These two cases are currently on appeal before this Court; Cronin v. Midwestern Oklahoma Development Authority et al., C.A. 10, Nos. 77-1640, 77-1641, 77-1642, 77-1643 and 77-1644, which involves the HII bond issue; and Franke v. Midwestern Oklahoma Development Authority et al., C.A. 10, Nos. 77-1645 and 77-1640, which involves the Chill Can Industries, Inc. bond issue.

6/ These included Messrs. Cowell, Capper and Lancaster. See, infra, p. 12 n. 22.

After trial, the court received post-trial briefs and scheduled final argument. After the Commission filed its brief, however, the court entered an order requiring the five Commission attorneys (in the Commission's Fort Worth Regional Office and its Division of Enforcement) who had signed the brief to show cause within twenty days why they should not be held in contempt of court (R 434). The court's order was unexplained, but the object of the court's displeasure was apparently the fact that the Commission had attached, as an exhibit to its post-trial brief, a letter from the Internal Revenue Service Commissioner to the Chairman of the Commission, and had referred to this letter in connection with its legal argument on the tax law issue involved in this action. 7/ Other Commission attorneys filed a response to the court's order to show cause (R 452), arguing that the order should be vacated. Final argument on the merits of the case against Haswell was held with the threat of contempt hanging over the five Commission attorneys; the district court did not vacate its order to show cause until January 27, 1978, after it had already dismissed the Commission's action. In its order dismissing the Commission's action, the court charged that Haswell had been "gravely damaged by the Commission's wrongful actions in this case" (R 451).

2. The Nature of the Securities Involved in this Case

IDR bonds are interest-bearing obligations of a company, issued under the aegis of a governmental or quasi-governmental authority such as MODA. 8/

7/ The Commission acknowledged in its brief that the letter was not in evidence, but stated that it was being cited solely for its value in explicating the legal issue involved. The letter had been filed with the court earlier in connection with the Commission's motion for preliminary injunctive relief (R 43).

8/ The lower court's opinion states that

> "MODA is a development authority organized in November, 1969, under the laws of the State of Oklahoma. MODA was

(footnote continued)

Interest paid on these obligations is afforded tax exempt treatment by the Internal Revenue Code if these issues meet certain specified requirements. Generally, financing through the sale of IDR bonds provides a method of raising money for a private company, often a company that is in a developmental stage and, presumably, would have difficulty raising capital on its own. If these obligations are adequately secured, their tax exempt status makes them attractive to investors; a lower rate of interest can therefore be paid and still attract sufficient interest from public investors.

The issuing company, as in the instant case, generally leases land or property from the authority. The proceeds from this lease are calculated to provide sufficient revenue so that the authority, or a trustee bank acting on its behalf, can make interest payments and repay the bonds within the designated period of time. This is the authority's principal financial obligation to the IDR bond purchasers. Thus, this ability of the issuing company to achieve sufficient income to pay its obligations to the governmental authority is of vital concern to the investor who purchases IDR bonds. 9/

8/ (continued)

> organized after the United States Department of the Air Force closed its Air Force base near Clinton and Burns Flats, Oklahoma. MODA was organized for the purpose of attracting industry to use the facilities at the closed Air Force base in an effort to buoy the local economy, which suffered as a result of the loss of the Air Force facilities and anticities [sic]. MODA was organized at the specific recommendation of the Department of Defense, Office of Economic Adjustment, which recommendation pointed out that an organization such as MODA could offer financing through the issuance of tax exempt industrial revenue bonds" (R 443).

9/ Tr. 163. Material information with respect to the company's financial condition and expectations is therefore of interest to shareholders. IDR bonds may be contrasted, in this respect, to general obligation bonds which are issued by a governmental authority, with the investors to be paid interest from the authority's tax revenues. The financial condition or prospects of the company on whose behalf general obligation bonds are issued may not be as material to investors. Tr. 162.

One of the principal requirements for tax exempt status for IDR bonds is that "substantially all of the proceeds" from the sale of those bonds must be used to purchase land or depreciable property. 10/ This property, in turn, serves as the collateral for the debt owed to bond purchasers. 11/ Thus, public investors can expect that, in the event of a default on the bonds, the land or depreciable property purchased by the issuing company will be sold and all or substantially all of the proceeds will be applied to the payment of the bonds. In order to protect the interests of the bondholders, and ensure that the proceeds from the sale of the bonds are, in fact, used to purchase land or depreciable property to secure the bondholders' interests, the funds are often escrowed in a "construction fund," with expenditures reviewed to ensure compliance with the terms of the offering, and with the law. 12/ The lawyer who drafts the collateral security documents

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10/ 26 U.S.C. 103(b)(6).

11/ Security provisions to accomplish this were included in the opinions written by Haswell. P. Ex. 25, 26, 27, R 510-512.

12/ Tr. 27, 113-114. A construction fund was used for two of the three issues involved in this action, the WSP and HII Series B issues. Tr. 28, R 512, Indenture p. 20. The function of the construction fund is, as Haswell knew, to protect the bondholders by insuring that sufficient land and equipment to secure the investors' interest is actually purchased. In connection with the WSP issue, Haswell had originally acceded to the request of the underwriters that no construction fund be established, but that the net proceeds be placed at the company's disposal. P. Ex. 5, R 490. This decision was altered since, as Haswell informed the trustee bank, "It has been determined to be advisable for the protection of the Bondholders that a Construction Fund be established and that the funds be invested and disbursed upon presentation of Payment Requisitions approved by Company and Authority representatives." P. Ex. 3, p. 2, R 488 (emphasis added). Nevertheless, as indicated, infra, p. 26 n.47, no construction fund was provided by Haswell for L&H bondholders, with disastrous results for those investors.

generally performs this function. 13/

In addition to the presence of sufficient collateral, another key to the successful marketing of IDR bonds is an opinion of counsel that the bonds are legally issued and that income to investors in the form of interest on the bonds is, in fact, tax exempt (Tr. 128, 172, 173). Aside from preparing and issuing such a tax opinion, an attorney may also perform a role in the preparation or review of disclosure documents (sometimes referred to in the testimony at trial as "official statements") which, inter alia, inform investors about the bond issues, the issuers, and the risks involved in such an investment. 14/ The attorney also prepares other significant documents, such as the leases and indentures pertaining to the collateral, and should assure himself that these bond issues are adequately secured under the terms of the indenture (Tr. 172).

The bonds are sold by the issuer to an underwriter, normally at a small discount of between one to seven percent, which represents payments made to the underwriter and the brokers for their services in marketing the bonds, and are then sold to the public at or near their face (par) value (Tr. 158-161). Because these bonds are normally sold to the public at or near their face value, the level of risk associated with a particular issue is reflected in the rate of interest payable on the bonds (Tr. 24, 159-160).

If the bonds qualify for tax exempt status under the Internal Revenue Code, they are also exempt from the securities registration provisions

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13/ Tr. 114. Haswell did so with respect to the WSP issue. Id.

14/ Tr. 158. Haswell reviewed and amended the disclosure documents for the WSP and L&H issues, which had been prepared by the underwriter; and Haswell himself drafted and compiled the disclosure document used in connection with the HII offering. Tr. 32, 83-84, 105.

of the Securities Act of 1933, pursuant to Section 3(a)(2) of that Act, 15 U.S.C. 77c(a)(2). 15/ The antifraud provisions of the federal securities laws, however, apply whether or not the securities are exempt from registration. 16/

3. Haswell's Involvement with MODA's Bond Issues

The essential facts in this case are not in dispute. 17/ Haswell is an attorney in Oklahoma City, Oklahoma, who served as counsel to MODA from January, 1970, to the time of the trial. Haswell practices primarily as a securities attorney, specializing in the area of municipal securities (R 114, 117). On January 20, 1970, Haswell entered into an employment agreement with MODA (Pl. Ex. 23, R 508), whereby he agreed to serve as legal counsel to MODA in connection with its bond issues. The agreement provided that Haswell was to

> "render professional and legal services in the nature of advice and counsel relating to the development of the Clinton-Sherman Air Force Base * * * into an industrial park and related facilities, including but not limited to; negotiation relating to and preparation of documents incidental to the passing of title and transferring of possession of the Base from the United States Government and the City of Clinton, Oklahoma; preparation of various instruments related to the leasing of lands and residences thereon; preparation of instruments and documents related to and negotiations concerning a vocational technical school to be established on the base; prepar-

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15/ See, infra, p. 1a.

16/ See Section 17(c) of the Securities Act of 1933, 15 U.S.C. 77q(c); Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b). See, infra, pp. 2a-3a.

17/ See Haswell's Response to opposition of Securities and Exchange Commission to Appellee's motion to affirm, filed in this Court on April 17, 1978, p. 1.

> ation of and negotiations related to sale and leasing of real and personal property; negotiations with prospective industrial tenants; preparation of lease agreements, contracts and other instruments related to industrial tenants; preparation of instruments and documents related to creation of corporations, both profit and non-profit, related to and necessary to the development of the base; preparation and negotiation of construction contracts, insurance policies, bonds and other legal instruments related to construction; preparation of documents related to issuance of tax-exempt municipal bonds and other forms of indebtedness; and any other professional and legal services related to the operations of [MODA]."

(R 508, emphasis supplied). With respect to Haswell's fees, this agreement specified (id., emphasis supplied):

> "For legal services related to the issuance of Bonds or other evidences of indebtedness and the preparation of legal instruments related thereto, the legal fee shall be established by mutual agreement, which can be based on a percentage of the amount of indebtedness, or other mutually acceptable basis." 18/

As a result of the pervasive nature of Haswell's legal services to MODA, his duties, responsibilities, and influence with respect to MODA's issuance of IDR bonds were wide-ranging. 19/ Pursuant to his agreement with MODA, Haswell represented MODA in connection with the offer and sale of six IDR bond issues (Tr. 16), including the three particular issues which were the subject of the Commision's complaint. These latter three issues, sold

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18/ Haswell testified that, pursuant to his agreement with MODA, he "set [his] own fees" for services rendered in connection with MODA issues (Tr. 105), and that those fees were contingent on the successful closing of the bond issues (Tr. 128).

19/ MODA is governed by a board of five outside Trustees who do not devote full time to the affairs of MODA. Haswell frequently attended meetings of the board; Haswell has also personally represented the Chairman of MODA, Frank G. Kliewer, Jr., who is also president of the Cordell National Bank (Tr. 39). He has also represented this bank in connection with litigation (Tr. 39, 40).

to the public for a total of $2.2 million, included WSP, a $700,000 issue dated April 1, 1972 (R 510); L&H, a $200,000 issue dated May 1, 1972 (R 511); and HII, a $1.3 million issue dated July 11, 1972 (R 512). For each of these issues, Haswell prepared relevant documentation, which he assembled into a "transcript of proceedings," 20/ and he issued an opinion with respect to the purported tax exempt status of these issues (R 511-513). He reviewed the disclosure documents prepared by the underwriter, United City Corporation, for the WSP and L&H issues, suggesting certain amendments that he deemed appropriate (Tr. 25, 84). In addition, for the HII issue, Haswell prepared the disclosure document in connection with the sale of HII bonds to public investors (Tr. 105-106; R 513).

Ultimately, each of these three issues defaulted, and investors recouped, respectively, only 30 cents, 8 cents, and 10 cents, for each dollar they had invested (R 4, 18, 27 and 36, admitted R 121). 21/

a. The Western States Plastics, Inc. IDR Bond Issue

Haswell first heard of WSP in early February, 1972 (Tr. 17), when he discussed with defendant Dennis R. Cowell ("Cowell"), doing business as an underwriter under the name of United City Corporation (Tr. 19), the possibility of having MODA issue IDR bonds for WSP. 22/ The information obtained by

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20/ Tr. 25, 83, 105. Haswell stipulated that before he issued his opinion in connection with the WSP, L&H and HII issues, he reviewed the full "transcripts of proceedings" he had compiled. R 401.

21/ In addition to these three companies, Haswell served as counsel in connection with three other MODA bond issues, which are not directly involved in this action, Circuit Technology of Oklahoma, Inc., Crestwood of Oklahoma, Inc. and Chill Can Industries, Inc. Each of these three issues also defaulted. R 4, 123.

22/ The underwriter has since become defunct and the United States Marshall has not been able to locate Cowell for service of the complaint in this action (Transcript of hearing on motion for preliminary injunction, p. 6).

(footnote continued)

Haswell in his discussions with Cowell was recorded by Haswell in handwritten notes (R 509). These notes indicate, inter alia, that WSP was a new entity incorporated under the laws of Nevada, with the minimum capitalization permitted by state law, and that, when the bonds were issued, they would be sold to the underwriter, United City Corporation, at a 30 percent discount from the face amount, for net proceeds of $490,000 from a total offering of $700,000 (R 509).

In his answer (R 121), Haswell admited that, at a meeting with the MODA trustees, he had told them that the WSP bonds were "junk bonds" that involved a "high risk" and that they were a "speculative" security that would have to be sold at a 30 percent discount. 23/ Yet, these material facts were not disclosed in the preliminary disclosure document for WSP (R 514), which Haswell examined at his early February meeting with Cowell (Tr. 32), nor was disclosure of these facts made in the final document actually distributed to purchasers of the bonds.

22/ (continued)

Concerning the underwriter, Haswell testified that he did not inquire: whether United City Corporation was incorporated; who the directors were; who constituted its management; the number of its employees; how long they were in business; how many payments to underwriters had been made; whether it sold bonds retail or only wholesale; whether it acted as a fiscal agent; as to any officers; as to its financial condition; or as to Cowell's background and experience as an underwriter (Tr. 20-21). One of the few things Haswell admitted knowing about the underwriter was that it was willing to sell bonds that involved a high degree of risk at a 30 percent discount (Tr. 36).

23/ See R 10. Generally, the only reason bonds are sold at a high initial discount, such as 30 percent, is to reflect a high degree of risk. This risk was, in the case of the three issues involved in this case, disguised when the bonds were sold by the underwriter to the public, since the bonds bore a "normal" coupon rate and were sold at or near their face value (Tr. 24, 160).

As reflected in his notes of his meeting with Cowell, Haswell thus knew that the preliminary material falsely stated that the discount was $69,000, rather than the actual $210,000 discount. He also knew that it falsely stated that $467,000 would be used to purchase machinery; in fact, Haswell himself had compiled documents, which he assembled into the "transcript of proceedings" regarding the WSP offering, which indicated that the actual expenditure planned by the company was only $339,187 (R 514). 24/ Haswell did not indicate that he ever received any financial statements, actual or pro forma, for WSP, and none were included with the preliminary offering circular (R 514). 25/ Further, there was no disclosure in the preliminary

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24/ Tr. 25. In addition to preparing the "transcript of proceedings" for the WSP issue (R 510), Haswell also prepared the "principal security documents" for the WSP issue, which he described as

> "[1] the indenture which would secure the bonds, and pursuant to which bonds would be issued, a document between MODA and the Trustee Bank selected by the Underwriter, [2] the lease agreement between * * * Western States Plastics and MODA, leasing the project to the Company, [3] the related financing statements, [4] the recording materials, [5] closing, delivery, and authentication documents, [6] the corporate board of directors Resolution for enactment by the Company, [and 7] accompanying signature identifying documents with respect to the Company." (Tr. 25).

25/ Financial statements, actual or pro forma, can reveal significant facts in situations such as those involving the WSP, L&H and HII issues, where a start-up company, or a thinly capitalized company, issues bonds at a large discount. For example, immediately after the issuance of a $700,000 offering at a discount of $210,000, the company's assets and liabilities are increased by $490,000. The liability is increased to $700,000 proportionately over the life of the bonds by amortizing the discount to the statement of income as additional interest expense. See Accounting Principles Board Opinion 21, October 1, 1977. This recognition of the asset and the liability reduced by the discount could cause a corporation to appear to be in unsound financial condition. The ability of a corporation to defer the recognition of such a discount is conditional on the continued viability of the corporation.

offering materials of the high degree of risk involved in investing in these bonds.

Despite Haswell's knowledge of these material facts, he did not insist, as counsel for MODA, that these matters be disclosed in the material provided to investors, and Haswell knew nothing about United City Corporation (see, pages 12-13, n. 22 supra; Tr. 20-21) which would allow him to rely upon the underwriter to include these material facts. In these circumstances, Haswell nevertheless issued his bond opinion (R 510) on the tax aspects of the WSP issue and delivered it to the underwriter (Tr. 31), a critical step in offering the securities of WSP to the public.

The proceeds of the WSP bond issue were to be disbursed from a construction fund which was monitored by Haswell. In late 1972, it came to Haswell's attention that WSP officials had been systematically inflating the invoices for equipment purchases forwarded to Haswell for payment, and that, as a result, WSP had paid $104,065 for goods and services worth only about $50,000. 26/ On December 20, 1972, Haswell summarized his knowledge of this matter in a letter to Frank Kliewer, Jr., the Chairman of MODA (P. Ex. 22, R 507). The trustee bank instituted suit 27/ and recovered over $30,000 in the form of disgorgement from a bank account controlled jointly by defendants Capper, Cowell and Lancaster (R 17, 121; Tr. 115).

26/ These WSP officials included Cowell, the underwriter, and his associate, Lancaster who, shortly after the completion of the WSP offering, had acquired control of the company (R 5, 123). The overbillings were made through Capco Plastics Consultant Co., controlled by defendant Capper (R 16, 127).

27/ Guarantee Trust Co. v. Western States Plastics, Inc., et al. (D. Ct. Wahita County, Cordell, Oklahoma, C-73-7).

b. The Lee and Hodges, Inc. IDR Bond Issue

Haswell first performed legal services for L&H in late 1970. He incorporated the company in January, 1971 (Tr. 37, R 486 p. 3), and, in the following month, he participated in MODA's issuance of $25,000 of First Mortgage Industrial Development notes for L&H (Tr. 37) for the purpose of acquiring upholstery manufacturing equipment. In March, 1971, L&H needed additional financing, and a $15,000 line of credit was established with the Cordell National Bank (Tr. 39). In late 1971, L&H needed additional working capital, and Haswell represented the company in an unsuccessful attempt to borrow $65,000 from the United States Small Business Administration ("SBA") (Tr. 41). 28/

In order to provide the additional capital needed by L&H, arrangements were begun, at a meeting held on or about May 1, 1972 (Tr. 84), for an offering of MODA bonds. 29/ Ultimately, bonds having a face amount of $200,000 were offered and sold (R 486) at an effective discount of 35 percent, producing proceeds for the company of $130,000 (Tr. 51). 30/ In order to provide for the payment of the interest due to investors during the first year after the offering,

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28/ This loan application was denied after a meeting attended by Haswell, an SBA loan officer, and others on February 22, 1972 (R 505).

29/ Haswell testified that he may have initially suggested to L&H that it attempt to get the additional financing it needed through the issuance of MODA bonds. Tr. 46.

30/ The L&H offering was sold with an underwriter's discount of $60,000, or 30 percent of the total offering, to which was added a "fiscal fee" of $10,000, also payable to the underwriter, for an effective 35 percent discount. Of the net proceeds of $130,000, $14,000 was used to provide a reserve fund from which to pay interest on the offering for the next 12 months (Tr. 51); $7850 for the payment of legal fees and other expenses of the issue (Tr. 51); and $13,318 to repay the balance of the first MODA issue in 1971 (Tr. 65, see also R 487). The preliminary offering circular (R 486) did not disclose these specific uses of the proceeds, or include any financial statements, actual or pro forma, for L&H.

$14,000 of the proceeds was placed in escrow (Tr. 51).

After arranging for United City Corporation to underwrite this offering, Haswell prepared a letter to MODA (R 491), outlining the agreement with the underwriter, and MODA then approved it (Tr. 54). In that letter from Haswell to Frank Kliewer, Jr., Chairman of MODA, dated May 1, 1972, Haswell stated that United City Corporation would purchase the L&H bonds "at 65 cents on the dollar," indicating his awareness of the size of the discount to the underwriter. Haswell further stated that he was meeting with United City Corporation to "finalize the circular," that is, the disclosure document to be used in connection with sales of the bonds to the public (P. Ex. 6, R 491, p. 2).

Haswell testified that at or shortly after the May 1, 1972, meeting, United City Corporation provided Haswell with a disclosure document in the form of a four-page "preliminary official statement" (R 486) which United City had prepared for use in connection with the sale of L&H bonds (Tr. 83-84). Haswell reviewed portions of this document and amended certain statements therein (Tr. 84). This document, however, misrepresented certain information and did not contain other information known by Haswell, as a result of his extensive prior representation of L&H, and which he knew or should have known was of material significance to investors. Specifically, the offering material failed to disclose that the SBA had declined to loan $65,000 to L&H for working capital and payment of bills (Tr. 40-41); that a significant portion of the proceeds from these bonds would be used to pay past due obligations, including federal taxes (Tr. 52-53); 31/ that the bonds would be sold at a 35 percent

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31/ In connection with his representation of L&H before the SBA, Haswell testified (Tr. 72) that he may have seen an unaudited balance sheet for L&H dated November 19, 1971. That balance sheet (R 487) showed

(footnote continued)

discount (Tr. 55; see R. 491); and that L&H would use only about $13,000 of the proceeds of the entire issue to purchase land or depreciable property, in reliance on Haswell's opinion that L&H could spend the proceeds for other purposes, so long as it intended to purchase land or depreciable property within three years of the offering (Tr. 55). 32/ There was little likelihood that L&H would be able to obtain the funds necessary to make such purchases. 33/

When Haswell reviewed the L&H preliminary offering circular (R 486, Tr. 84), the principal change he made was in the description of the "purpose" of the offering, which read: "Bonds are being issued to add equipment to an existing plant for the manufacturing of upholstered furniture." In fact, however, less than seven percent of the proceeds of the offering was to be used to acquire equipment. Haswell attempted to deal with this

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31/ (continued)

that L&H had total capital of only $17,806.40 and that if it increased its liabilities by issuing $200,000 worth of bond while receiving proceeds (assets) of only $94,831.64, its balance sheet would immediately indicate an unsound financial condition. See, supra, p. 14 n. 25.

In addition, the aging of accounts payable attached to the November 19, 1971, balance sheet indicated that the accounts payable were overdue to the extent that L&H was also likely insolvent in that it appears that L&H was not meeting its obligations as they became due and payable.

32/ The $13,000 L&H spent for depreciable equipment by L&H was used to retire an outstanding debt on used machinery already being used by the company. For purposes of computing the amount the company had spent to acquire depreciable property, Haswell permitted this used equipment to be valued at "replacement value," which was said to be $50,000 (Tr. 67), rather than the amount actually paid to retire the debt (Tr. 55-56, 59; R 487).

33/ Haswell prepared the "transcript of proceedings" for the L&H bond issue (R 401, stipulations 3 and 4), which included the documents setting forth the company's obligations under the terms of this $200,000 issue (R 511). Thus, through his structuring of this securities offering, Haswell was intimately aware of the effect the offering would have on the company's finances (Tr. 51).

deficiency in the proposed disclosure by adding the following language: "and to refund the authority's outstanding indebtedness secured by equipment used by the tenant, and to acquire the tenant's interest in existing equipment and leasehold improvements." 34/ The effect of this amendment, however, was not to clarify, but to obfuscate, the crucial fact that little of the net proceeds would be used to purchase equipment that would be available as security for investors in these bonds.

The purchase of these bonds involved a high degree of risk, in view of the fact that there was little or no collateral to protect investors (R 516). MODA had not been provided any actual or pro forma financial statements for L&H to be used in connection with the offering (Tr. 68), and Haswell, who knew from his past experience in representing L&H how difficult it was to obtain financing for this company, did not require that L&H provide public investors with any economic evaluation of the company, or any accurate data regarding the ability of L&H to repay the $200,000 bond issue (Tr. 67). Nor did Haswell insist that material facts known to him be disclosed, and he knew nothing about United City Corporation (see page 12 note 22, supra) which would allow him to believe that the underwriter would include these material facts in any final disclosure document. 35/ Haswell nevertheless issued his bond opinion (R 511) on the tax aspects of the L&H issue, and delivered it to the underwriter (Tr. 83), which was a critical step in offering the securities of L&H to the public.

34/ Haswell stipulated that this correction appears in P. Ex. 1, R 486, in his own handwriting. R 402.

35/ Haswell had not received from the underwriter the final disclosure document used in connection with the earlier WSP offering, and, on May 8, 1972, he wrote a letter to Cowell, requesting him to send a copy of the preliminary L&H material and a copy of the final WSP material (P. Ex. 7, R 492).

c. The Harper Industries, Inc. IDR Bond Issue

In late May 1972, Haswell received a proposal that MODA issue bonds for HII, a company about which Haswell had not previously known (Tr. 103), that proposed to manufacture and distribute disposable plastic salt and pepper shaker units. In connection with this offering, Haswell, as MODA's counsel, was to obtain MODA's approval for this $1.3 million issue, to write a tax opinion with respect to the HII "Series B" issue 36/ and to prepare the relevant documentation for the issue. 37/ Significantly, Haswell also undertook, in connection with the HII issue, to draft or assemble the disclosure document to be used in connection with the sale of HII bonds to the public (R 513), a document that was to contain "statements and information" that are "true and correct in all material respects," and which "do not * * * omit any statement or information that is necessary to make the statements and information therein not misleading in any material aspect or which should be included therein." 38/ Thus, Haswell's

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36/ The total $1.3 million HII issue was separated into Series A ($695,000) and Series B ($605,000) offerings (R 513), so that the two parts of this offering could be the subject of legal opinions from separate counsel. The entire project was first presented to Haswell as one package (Tr. 104). Apparently, however, Haswell did not want to render an opinion on the use of proceeds for Series A property. Series B property, as to which Haswell did opine, consisted primarily of leasehold improvements to be made to MODA property in Oklahoma (R 513).

Bond counsel with respect to the HII Series A offering is Fred W. Rausch, Jr. an attorney in Topeka, Kansas, who is also named as a defendant in this action.

37/ These documents included a lease agreement, indenture (Tr. 106) and other documents contained in the "transcript of proceedings" prepared by Haswell (R 512).

38/ P. Ex. 11, R 496, §4.01. An event of default occurred if any statement in the disclosure document was, or became, untrue or incorrect in any material respect. Id., §5.07(B).

(footnote continued)

responsibilities in connection with the HII offering explicitly included sole responsibility for the preparation of the disclosure document he knew would be disseminated to bond purchasers, rather than the responsibility of reviewing and amending material prepared by the underwriter, as Haswell had done in connection with both the WSP and L&H offerings.

When Haswell prepared the disclosure document relating to the HII offering, he knew that the underwriter was to be United City Corporation, which would purchase the bonds at a 30 percent discount. He also knew that HII intended to use $250,000 of the proceeds to purchase a patent which was owned by Harold T. Pehr, the chairman, president and treasurer of HII, although the true value of the patent was not reliably determinable. These material facts were not adequately disclosed in the offering statement prepared by Haswell (see R 513, p. 5).

Haswell also knew that HII had not, as yet, produced any salt and pepper shakers for sale; 39/ but the company nevertheless cited projections for annual production and sales of disposable salt and pepper shakers which ranged from 300 million units in the following year, 1973, to over 3 billion units

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38/ (continued)

Haswell stated at trial that, pursuant to his employment agreement with MODA, he "also prepared, as part of [his] responsibility, an official statement and security document for the entire [HII] issue" (Tr. 105). Haswell stipulated that he drafted pages 1 through 20 of the disclosure document, and assembled the remaining materials, which were drafted by others, into the final document (R 401).

39/ At trial, Cleetus T. Groner, the engineer for HII, testified that the HII assembly line for salt and pepper shakers was never operational (Tr. 141). When he was hired, more than a month after the HII bond offering, he was given "sketchy outlines" for an assembly line and, other than a few machines, the establishment of the assembly line "was pretty much from scratch * * *. We had to design * * * right from the beginning" (Tr. 142 and 143).

in 1982. 40/ To fulfill these projections for production and sales of disposable salt and pepper shakers, it would have been necessary for every person in the United States to buy approximately 13 salt and pepper shaker units annually by 1982—a most unrealistic assumption, in light of the fact that the company had never produced any units for sale and had no capability of doing so (Tr. 141, 143). Nevertheless, Haswell incorporated these projections into the disclosure document he prepared, without making any investigation at all as to the identity or competence of the person who prepared the projections, or as to the basis for these figures, or their accuracy. 41/ As a result, notwithstanding the fact that Haswell knew that the company's production capacity was nonexistent, the disclosure document prepared by Haswell (R 513) falsely stated that "[t]he management team of Harper Industries has the capability to do all its own engineering and design work, and start material sales distribution immediately" (R 513).

Haswell prepared the disclosure document used for the HII offering without having received or reviewed any actual or pro forma financial statements for HII to be used in connection with this offering, even though the HII bond purchase agreement among MODA, the underwriter, and HII specifically required the delivery of financial statements to Haswell by HII (P. Ex. 11, R 496, Section 2.05, see Tr. 104). Haswell therefore did not make any determination as to whether HII would be a viable company after selling $1.3 million of bonds at a 30 percent discount, and spending $250,000 to purchase a patent from a company insider; but it was clear that these bonds involved a high degree of risk, since there would be only equipment worth $434,880, and a patent of unknown, and somewhat dubious, value to collateralize this $1.3

40/ R 513.

41/ Tr. 107. When asked why he had failed to make such an inquiry, Haswell responded: "Nobody ever asked me to." Id.

million issue. Haswell did not disclose these facts, and he knew that neither the underwriter, United City Corporation, nor anyone else intended to revise the disclosure document to make adequate disclosure of these material facts when he delivered the offering materials he had prepared, and issued his tax opinion in connection with the $605,000 HII Series B bond issue (P. Ex. 27, R 512).

4. Haswell's tax opinions.

Haswell's tax opinions stated that MODA was issuing bonds on behalf of, respectively, WSP, L&H and HII, under Section 103(b)(6) of the Internal Revenue Code, which provides for the exclusion from gross income of interest on industrial development bonds if "substantially all of the proceeds" of the offering are used for the acquisition, construction or improvement of land or property of a character subject to a depreciation allowance, or to redeem part or all of a prior bond offering which was issued for such purposes. 42/ The three bond issues for which Haswell rendered bond opinions did not qualify for this exemption, nor did it reasonably appear that they could qualify, because "substantially all of the proceeds" were not used and were not, in any

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42/ 26 U.S.C. 103(b)(6)(A). This section provides:

> "(6) Exemption for certain small issues—
>
> (A) In general.—Paragraph (1) shall not apply to any obligation issued as part of an issue the aggregate authorized face amount of which is $1,000,000 or less and substantially all of the proceeds of which are to be used (i) for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the allowance for depreciation, or (ii) to redeem part or all of a prior issue which was issued for purposes described in clause (i) or this clause" (emphasis supplied).

In certain instances, a $5,000,000 limit is authorized if bonds are offered in accordance with 26 U.S.C. 103(a)(6)(D).

case, intended by the company to be used, for the statutorily prescribed purposes. Indeed, for the $700,000 WSP bond issue, less than half of the face amount ($339,187) was to be used to purchase equipment; 43/ for the $200,000 L&H bond issue, slightly more than six percent ($13,318) was used to repay an existing MODA obligation secured by equipment previously purchased and in use by L&H; 44/ and, for the $605,000 HII Series B bond issue, only $384,600 was used for equipment subject to depreciation. 45/

43/ (R 510). Of the remaining $360,813 from the WSP issue, $12,459 was used to pay Haswell's fee (see P. Ex. 18, R 503), $1,400 was used for the trustee's fee; $1,930 was used for trustee's counsel fee; $49,000 was used by WSP for purposes other than the purchase of depreciable property; $86,025 was escrowed, but not capitalized, to be paid to investors in WSP bonds as "interest" during the first two years after the issuance of the bonds, and $210,000 was the discount from the face amount which represented the profit of the underwriter, United City, after deduction of its expenses. As we have seen (p. 13, supra), investors were told that only $69,000 would be used for this purpose (R 514).

44/ (R 511). Of the remaining $186,682 from the L&H issue, $6,750 was used to pay Haswell's fee; $700 was used to pay the trustee's fee; $400 was used to pay the trustee's counsel fee; $14,000 was escrowed to provide "interest" payments during the first year after the issuance of the bonds; $60,000 was the discount from the face amount which went to the underwriter; $10,000 was used to pay an additional "fiscal fee" to the underwriter; and the remaining $94,831 was turned over to L&H (R 511), which, for the most part, used it to pay back taxes and other overdue obligations and to provide desperately needed working capital (R 516).

45/ (R 512, 513, p. 6). Of the remaining $220,400, $26,000 was used to pay the trustee's fee; $181,500 was a bond discount, which included undisclosed legal fees to Haswell of approximately $12,000, see Tr. 105-106, and $36,300 was for interest on Series B Bonds. The lease agreement between MODA and HII (R 512) did not require that this interest be capitalized as part of the basis for any particular equipment.

The $695,000 HII Series A bond issue, with respect to which another attorney, defendant Fred Rausch, had rendered the tax opinion, also did not qualify for the exemption because only $50,280 (appraised value of replacement cost) was used to purchase equipment; of the remaining $644,720, $250,000 was used to purchase a patent from an insider; $208,500 was used as a bond discount, and $186,220 was set aside to pay

(footnote continued)

Despite Haswell's protestations in the court below that the law relating to IDR bonds was "undeveloped" in 1972 (Haswell Affidavit, R 115), the evidence indicated that Haswell was well aware that, as a general rule, a company should spend at least 90 percent of the proceeds of an IDR issue on land or equipment, and that the expenditure of proceeds for equipment in the proportions involved in these three issues did not satisfy the statutory requirements (R 507, p. 3; R 494, p. 1; R 510, lease agreement, p. 9). When Haswell discovered the misappropriation of funds in connection with the WSP issue, see supra, page 15, he became concerned that the issue would lose its tax-exempt status because the overcharges could not be credited as equipment purchases. As Haswell explained in a letter he wrote to the trustee bank (R 507, p. 3)

> "* * * this jeopardized the tax exemption of the Bonds since the Bonds cannot remain as qualified tax exempt Bonds if more than an insubstantial portion (10%) of the proceeds are used for working capital. It appears to me that restoration of money to the Construction Fund may be necessary to preserve the tax exempt status of the Bonds * * * [t]he manner of determining this obligation and enforcement thereof is the responsibility of the Trustee Bank and Counsel to the Trustee Bank since they represent the Bondholders whose funds have been used and the tax exemption of whose Bonds may be jeopardized."

Accordingly, Haswell wrote to WSP, giving them formal notice of the occurrence of various "events of default," including:

> "Violation of the terms of Section 5 of the Lease Agreement the Lessee through its officers and stockholders through participation in a scheme and plan to circumvent the limitation on expenditure of Bond proceeds not in

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45/ (continued)

the first two years' interest on Series A and Series B bonds. This interest was not capitalized, as part of MODA's basis in its newly acquired equipment according to the terms of the MODA lease (R 512). Accordingly, it was not subject to depreciation, and did not qualify as the purchase of "land or depreciable property."

> excess of ten percent (10%) of the purchase price of the Revenue Bonds through inflation of invoice prices for equipment purchases in an attempt to either improperly and illegally increase the amount of working capital for the Lessee, or for the personal profit and benefit of the officers, agents and stockholders of the Lessee." 46/

With respect to the L&H issue, despite the statutory provision which requires "substantially all of the proceeds" of an IDR issue to be used to purchase land or depreciable property, Haswell rendered a tax opinion, and drafted leases, which permitted L&H to use all of the proceeds for other purposes (Tr. 55-56). 47/ The only requirement imposed by Haswell to comply with the statute, and "secure" the interests of the investors, was his inclusion of a lease provision which required L&H to acquire suitable property "within a period of three years" after the offering. 48/ The money to be used to make

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46/ The relevant section of Section 5 of the WSP lease agreement is set forth at page 9 of P. Ex. 25, R 510.

47/ The Commission alleged in its Complaint (R 26), that Haswell drafted a lease and indenture for L&H that

> "Failed to utilize a construction account into which the proceeds of the issue would be deposited, but provided for the payment of the proceeds directly to [L&H] in a lump sum which permitted it to use the proceeds for purposes other than the purchase of land or depreciable property."

Haswell admitted this in his answer (R 121).

48/ Tr. 55. There is a discrepancy between Haswell's explanation of this legal theory at trial, and the manner in which he represented it in a letter to the bank that was to serve as trustee for the L&H issue. Haswell explained to the bank that the lease and indenture had been amended to require L&H, within three years, "to furnish a Certificate of Completion showing that the Net Proceeds of the bonds received by the Company * * * has been invested in capital improvements" (emphasis added). This, Haswell further explained, "makes it possible for me to revise my legal opinion and give an opinion that interest on the Bonds is not subject to Federal income taxation under existing statutes and decisions." P. Ex. 12, R 497. At trial, however, Haswell explained

(footnote continued)

such purchases, however, would not be the "proceeds" of the issue; and indeed, as Haswell knew, there was little likelihood that L&H, after spending most of the actual proceeds to pay past due obligations and to provide the company with some working capital, would be able to purchase, within three years, the substantial amount of equipment it was required to purchase under the terms of the lease drafted by Haswell.

Haswell knew the facts concerning the intended use of the proceeds of each of the three offerings; indeed, as counsel responsible for the preparation of a tax opinion, he had the responsibility to determine how the corporation intended to use the proceeds, since he could not opine that favorable tax treatment could be obtained unless he could establish that "substantially all of the proceeds" were to be used as prescribed by the statute. 49/ But he issued false opinions despite his knowledge.

48/ (continued)

that, in fact, he knew that the actual "proceeds" of the offering were not to be used to purchase equipment; L&H merely promised to "acquire property * * * equal in value, or cost * * * to a formula set out in the lease agreement which roughly was the net proceeds of the bonds," with certain adjustments. Tr. 55-56.

49/ The following is a summary of these bond issues:

Bond Issue, Date	Face Amount	Discount	Percent	Equipment Purchased	% of Net Proceeds	% of Face Amount
WSP 4/1/72	$ 700,000	$210,000	30%	$339,187	71%	49%
L&H 5/1/72	200,000	70,000	35	13,318	10%	7%
HII 7/11/72	1,300,000	390,000	30	434,880	41%	34%
Total/Average	$2,200,000	$670,000	—	$787,385	52%	36%

5. The District Court's Decision

Despite the foregoing, undisputed, evidence, the district court concluded that an attorney in Haswell's position would not have been put on notice that a fraud was being perpetrated on public investors. With respect to the WSP and L&H issues, the court stated that the alleged violations were "not dependent upon the imposition of an affirmative duty on his part to inquire and discover fraud," but were "based upon the premise that he has an obligation not to assist, knowingly or recklessly in the perpetration of a fraud" (R 446). Applying this standard to Haswell's conduct in connection with the WSP & L&H issues, the court noted that the preliminary disclosure documents reviewed by Haswell in connection with these issues were "not only misleading with respect to the facts, but were obviously full of omissions of material fact" (R 446). But, the court felt that these documents were only "negotiating documents" prepared at a preliminary stage. Haswell prepared documents and delivered them to the underwriter, whose responsibility it was to prepare a "proper circular" (R 448). In the court's view, Haswell did not assume any of these responsibilities, "other than to act as bond counsel in issuing his opinion * * * and as a lawyer merely placing in legal form the agreements of other parties to the transaction." Id. The court found that, at the closing on these bond issues, "Haswell did not insist upon viewing the underwriter's final form of the offering circular," although "[i]t may be that a more careful attorney would have insisted upon this." Id. But, the court, applying an erroneous standard in an action by the Commission for injunctive relief, concluded that Haswell's conduct did not amount

> "to either fraudulent conduct or conduct so reckless that it was an extreme fraudulent departure from the standards of ordinary care, conduct which presented

> a danger of misleading buyers that was either known to Haswell or was so obvious that he must have been aware of it" (R 447).

With respect to the HII offering, as noted, supra, pages 20-23, Haswell not only prepared the "transcript of proceedings," but he actually drafted and compiled the disclosure document which was delivered to the underwriter for use in the sale of HII bonds to the public. The court found, with respect to this document, that "[a]dmittedly, it does not contain the omitted matters deemed by the Commission to have been necessary to have been included" (R 448). But, the court held that it was not necessary for it to make a determination as to the materiality of the omitted matters, because, again, it did not believe that the omission of these matters was the result of any fraudulent or extremely reckless behavior on the part of Haswell (Id.).

Despite the overwhelming evidence advanced by the Commission that Haswell, at the least, had no adequate factual and statutory basis for the bond opinions that he issued, and that these three issues did not comply with the applicable law with respect to their purported tax exempt status (see supra pages 23-27), and that Haswell knew this was the case, the court cryptically stated that it "is not inclined to find that Haswell's bond opinions [with respect to the purported tax-exempt nature of the bond issues] were erroneous and incorrect" (R 448). In this regard, the court merely pointed out that neither the Treasury Department nor any other governmental agency, except the Commission, has challenged Haswell's opinions (R 445, 449).

The court concluded that Haswell had not violated the federal securities laws and denied the Commission's application for an injunction (R 451). Moreover, even if Haswell had been found to have violated the law, the court indicated that it would deny an injunction (R 450). In this regard, the court pointed

out that Haswell has more recently been employed by "many prestigious underwriters, issuers and public authorities," and has issued many other opinions similar to the opinions rendered in connection with the MODA bond issues (R 450-451).

STATUTES AND RULES INVOLVED

The relevant parts of the statutes and rules involved in this case are:

— the securities registation provisions, Sections 5(a) and 5(c) of the Securities Act, 15 U.S.C. 77e(a) and 77e(c);

— the antifraud provisions, Section 17(a) of the Securities Act, 15 U.S.C. 77q(a), and Section 10(b) of the Securities Exchange Act, 15 U.S.C. 78j(b), and Rule 10b-5, 17 CFR 240.10b-5;

— the exemption from the registration provisions for IDR issues satisfying the requirements of the Internal Revenue Code, Section 3(a)(2) of the Securities Act, 15 U.S.C. 77c(a)(2);

— the provision of the Internal Revenue Code prescribing the use of proceeds of IDR issues, 26 U.S.C. 103(b)(6)(A).

These provisions are set forth in the Statutory Appendix, infra, p. 1a.

SUMMARY OF ARGUMENT

The evidence presented by the Commission in the district court establishes that Haswell violated the antifraud provisions of the federal securities laws by

(1) preparing for distribution to investors a disclosure document for the HII offering which he knew contained false, misleading and incomplete information;

(2) participating as legal counsel to MODA, the co-issuer of the WSP and L&H bonds, when he was aware of facts which unmistakably indicated that adequate disclosure to investors concerning these issues would not be made to investors;

(3) making false statements in tax opinions concerning the purported tax exempt status of interest paid to investors in WSP, L&H and HII bonds, when Haswell had no adequate factual or legal basis

> for these opinions, and when he knew these opinions could not be accurate because he was well aware that "substantially all" of the proceeds of these issues would not be used to purchase land or depreciable property.

The district court concluded that, despite Haswell's conduct as described above, he did not violate the antifraud provisions with respect to any of these matters. These legal conclusions are erroneous, and clearly so.

With respect to the HII issue, the district court sought to avoid the necessity of determining whether the omitted matters "deemed by the Commission" to be material were in fact material because it concluded that Haswell did not act with scienter in omitting these matters from the document he prepared for HII. But, there can be little doubt that the false information provided to purchasers of the HII bonds was material. And, as we show infra, page __, even if scienter were a necessary element of a Commission injunctive action (which it is not), Haswell did act with scienter in connection with the preparation of the HII materials. We respectfully submit that, based on the record compiled in the court below, this Court should conclude that Haswell did violate the antifraud provisions in connection with his preparation of the HII disclosure document, and that Haswell's violation was a gross dereliction of the statutory duty he owed to investors, warranting the imposition of injunctive relief.

With respect to the disclosure documents prepared for WSP and L&H, the district court correctly found that the preliminary versions of these documents, which Haswell reviewed and amended, were "obviously full of omissions of material fact" (R 446), a finding that Haswell apparently does not contest. But, the court excused Haswell's utter failure to take any steps to rectify the "obviously" inadequate disclosure he knew would be made to investors by these companies, and by MODA, Haswell's client, by ruling that Haswell "merely

place[d] in legal form the agreements of other parties to the transaction" (R 448), and that Haswell's conduct was not "an extreme fraudulent departure from the standards of ordinary care * * *" (R. 447). In so holding, the district court applied incorrect legal standards. A securities lawyer engaged in connection with the public offer of securities has a duty to the investing public and does not act, as the court supposed, as a mere scrivener of legal documents. At a minimum, when faced with facts which blaringly reveal that a fraud is being practiced on the investing public, as Haswell was faced with in this case, counsel has a duty to take appropriate action. The court imposed upon the Commission, and on the public interest it represents, an inappropriate standard of proof in requiring a showing of an "extreme fraudulent departure" from the proper standards (emphasis supplied), a showing which would not be required of a plaintiff even in a private suit for damages.

The district court avoided ruling on the Commission's assertion that Haswell issued tax opinions which he knew to be false, in obliquely holding that it was "not inclined" to find these tax opinions erroneous. The district court did not base this conclusion, or non-conclusion, upon an examination of the relevant provisons of the Internal Revenue Code, or findings with respect to the facts known to Haswell or reasonably ascertainable by him concerning the use of the proceeds of the three bond issues involved in this case by the three companies. Rather, its stated ground for this ruling was merely that no governmental agency other than the Commission has challenged Haswell's tax opinions. We submit that the court erred and that, as a matter of law, Haswell's tax opinions were erroneous. In publishing these false statements in connection with the offer and sale of securities, Haswell violated the antifraud provisions of the federal securities laws, and acted with a degree

of culpability that fairly commands the entry of injunctive relief.

In addition to violations of the antifraud provisions of the federal securities laws, Haswell violated, and aided and abetted violations of, the securities registration provisions. The bonds issued by WSP, L&H and HII were not registered with the Commission, and Haswell did not establish, in the district court, the availability of any applicable exemption. Haswell's legal services, and in particular his tax opinions, were a sine qua non to the public offer and sale of these bonds, which could not have been marketed in the absence of an opinion that interest paid to investors would be tax free. The district court failed to make any findings of fact regarding the Commission's allegations that Haswell violated the registration provisions in denying the Commission the injunctive relief it had requested.

Finally, little weight should be accorded the district court's statement that, even if it had concluded that Haswell had violated the law, it would deny the Commission any relief, since the district court's discretion must be exercised in the light of correct and complete findings of fact and pursuant to correct legal standards. 50/ As noted, the district court did not even address all

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50/ "Although a grant or denial of a preliminary injunction is within the discretion of the court to which it is addressed, where it is plain that the disposition was in substantial measure a result of the lower court's view of the law, which is inextricably bound up in the controversy, the appellate court can and should review such conclusions."

Societe Comptroir DeL'Indus v. Alexander's Department Stores, 299 F.2d 33, 36 (C.A. 2, 1962). See also, e.g., Securities and Exchange Commission v. First American Bank & Trust Co., 481 F.2d 673, 682 (C.A. 8, 1973); Douglas v. Beneficial Finance Co. of Anchorage, 469 F.2d 453, 454 (C.A. 9, 1972); Milsen Co. v. The Southland Corp., 454 F.2d 363, 369 (C.A. 7, 1971); Securities and Exchange Commission v. Capital Gains Research Bureau Inc., 306 F.2d 606, 613 (C.A. 2, 1962) (en banc) (dissent), reversed, 375 U.S. 180 (1963); Ring v. Spina, 148 F.2d 647, 650 (C.A. 2, 1945).

the relevant facts, it erred in significant respects to the extent it did find the facts, and it applied erroneous legal standards in several significant respects. Moreover, there are not present in this case any of the factors which courts have recognized may warrant the denial of injunctive relief in the exercise of a district court's discretion, and the district court did not cite any valid factors which would justify the exercise of its discretion in this fashion.

ARGUMENT

I. THE DISTRICT COURT ERRED IN HOLDING THAT HASWELL DID NOT VIOLATE, AND DID NOT AID AND ABET VIOLATIONS OF, THE ANTIFRAUD PROVISIONS OF THE FEDERAL SECURITIES LAWS.

A. Haswell's review and preparation of disclosure documents relating to the MODA offerings, and his issuance of tax opinions when he knew or should have known of the fraud being practiced on public investors, demonstrates that he violated the antifraud provisions and that he acted with scienter.

An attorney performing legal services in connection with the offer and sale of speculative new securities to the public is not, as the district court indicated, a mere legal technician or draftsman, but a professional whose decisions, as exemplified by this case, can have far-reaching and dramatic effects. As Judge Friendly has stated for the Court of Appeals for the Second Circuit:

> "In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crow-bar."

United States v. Benjamin, 328 F.2d 854, 863 (C.A. 2), certiorari denied sub nom. Howard v. United States, 377 U.S. 953 (1964). As the same court more recently noted in Securities and Exchange Commission v. Spectrum, Ltd., 489 F.2d 535, 541-2 (C.A. 2, 1973):

> "The legal profession plays a unique and pivotal role in the effective implementation of the securities laws.

> Questions of compliance with the inticate provisions of these statutes are ever present and the smooth functioning of the securities markets will be seriously disturbed if the public cannot rely on the expertise proffered by an attorney when he renders an opinion on such matters."

In this case, as indicated, supra, pp. 10-27, the evidence demonstrated that—

— Haswell, knowing that WSP was a thinly-capitalized, start-up company and that MODA proposed to sell bonds to the underwriter at a 30 percent discount to be marketed to the public, failed to see to it that these facts were reflected in the disclosure document prepared for this issue, when he had an opportunity to inspect and amend a preliminary draft of this document which was plainly deficient;

— Haswell, who was fully aware of the financial condition of L&H as a result of his having represented this company for a substantial period of time before MODA issued bonds on its behalf to the public, participated in the issuance of these bonds despite the fact that he knew that the disclosure document which he had reviewed and amended failed to indicate that these bonds were being sold to the underwriter at a 35 percent discount, that L&H had been unsuccessful in obtaining financing from the Small Business Administration, that only an insignificant portion of the net proceeds of the offering would be used to purchase land or depreciable property, and that the company had meager prospects for success;

-- Haswell, knowing that MODA was to issue bonds in behalf of HII at a 30 percent discount to the underwriter, and that HII was to use $250,000 of the proceeds of the issue to purchase, from a company insider, a patent whose value was not readily determinable, prepared a disclosure document to be distributed to potential investors that failed adequately to disclose these and other material facts;

-- Haswell, knowing that HII had not produced any salt and pepper shakers for sale, prepared a disclosure document which incorporated HII's groundless and patently unrealistic projections for annual production and sales of disposable salt and pepper shakers, and falsely assured investors that HII had the capacity to do its own engineering and begin sales distribution "immediately;"

-- Haswell issued an opinion that interest paid to investors on $200,000 of MODA bonds issued on behalf of L&H would be exempt from federal income tax when he knew that only $13,318 of the proceeds of this offering would be used to repay a prior MODA offering and there would be no restrictions on the use of the proceeds of the issue;

— Haswell issued an opinion that interest paid to investors on $700,000 of MODA bonds issued on behalf of WSP would be exempt from federal income taxation when he knew that only $339,187 of the proceeds would be used to purchase equipment; and

— Haswell issued an opinion that interest paid to investors on the $605,000 HII Series B issue would be exempt from federal income tax when he knew that only $284,600 of the proceeds of this offering would be used to purchase equipment subject to depreciation.

The district court's finding (R 446, 448) that neither Haswell nor "a reasonable person" would be sufficiently put on notice that a fraud was to be perpetrated, is, in light of this evidence, clearly erroneous, and must be reversed. As the court found, the underwriter showed Haswell preliminary circulars for the WSP and L&H issues which "were not only misleading with respect to the facts but were obviously full of omissions of material facts" (R 446, emphasis added). Nevertheless, the district court erroneously concluded that Haswell had no duty to see that these glaring deficiencies were corrected before he issued his tax opinions, because Haswell merely "prepared most of the underlying documents and delivered copies of the documents to the underwriter in order that the underwriter could prepare its own proper circular" (R 446). Haswell also issued the tax opinions which permitted these offers to go forward, without taking any steps to correct these deficiencies, and without even receiving or reviewing the underwriter's final form of the offering circular, despite the fact that "a more careful attorney would have insisted upon this" (R 447). The Commission submits that, based upon the undisputed evidence and the limited findings contained in the lower court's opinion, Haswell should be held, as a matter of law, to knowledge of the fraud about to be perpetrated by the issuers of the bonds and the underwriter.

As the Court of Appeals for the Second Circuit held in affirming an injunction entered against an attorney who was "careless" in falsely advising that unregistered shares could be issued without a restrictive legend, such an attorney cannot "cloak himself in a professional ignorance." Securities and Exchange Commission v. Management Dynamics, Inc., 515 F.2d 801 at 809 (C.A. 2, 1975). 51/ Indeed, a claim of ignorance, far from serving to exonerate one who was in a position to be well-informed, may serve to sustain even a criminal conviction premised on reckless irresponsibility. See United States v. Henderson, 446 F.2d 960, 966 (C.A. 8, 1971): "It is well-established that ignorance of inculpatory facts due to a reckless disregard is no more a defense than ignorance of inculpatory law." See also United States v. Benjamin, supra, 328 F.2d at 863.

51/ The similarities between the role of the attorney, Levy, in Management Dynamics and that of Haswell are plain:

> "* * * the record clearly discloses the existence of misleading statements of material matters. The many obstacles to successful development of the * * * project were not mentioned and * * * the release gave the impression that the project was virtually certain to be completed * * *. Levy's responsibility for these statements is clear, for he reviewed them and even suggested changes in language * * *. As an experienced securities lawyer, Levy surely should have known that contingencies cloud the horizon of almost every business venture, and he should have asked * * * about potential obstacles to the planned developments. Moreover, and particularly because of his expertise, he should have insisted that these possible impediments be identified in any communication which described the projects."

515 F.2d at 809. Similarly, Haswell, as an experienced securities lawyer, should have taken steps to see that shareholders were told the truth about the various MODA companies, and about the serious obstacles that stood in the way of their success.

As the only securities lawyer involved in the offering of the WSP, L&H and HII Series B bond issues, Haswell could not reasonably suppose that someone other than himself would assume the responsibility for reviewing the disclosure documents from a legal perspective to see that these documents adequately reflected the true facts. If Haswell felt that additional documentation or review was necessary, as counsel to MODA, the co-issuer of the bonds, he was obliged to assure himself that the necessary steps would be taken. Because of the wide range of his duties and responsibilities to MODA, the fact that he was in a position to obtain the information he needed to apprise himself of the facts, and the actual knowledge that he had obtained concerning these issues, Haswell acted while knowing that he was participating in and aiding and abetting a scheme which victimized bond purchasers.

As we have pointed out, even the limited findings of fact made by the lower court in exonerating Haswell establish that Haswell's actions were knowing, not merely negligent or inadvertant. 52/ In Herzfeld v. Laventhol, Kerkstein,

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52/ The evidence indicates that Haswell, and those with whom he was associated in connection with the issuance of MODA bonds, were acquainted with both the undisclosed risk an investment on these bonds entailed, and the questionable backgrounds of the underwriter and brokers who were, undoubtedly, the principal architects of this fraud on the public. In August 1972, Guaranty Trust Company expressed to Haswell its reluctance to accept more trusteeships similar to those it had entered into in connection with WSP, L&H and HII. In that letter, the treasurer of the bank explained:

> "* * * our Board of Directors has expressed some concern for accepting additional responsibilities similar to those we have now. Their concern lies in the area of having more than one of these deals go sour, and they would prefer that we look carefully at the realistic potential of any company with which we become involved. In other words, they do not want us to get into the business of handling only those revenue bond issues that are apt to go into default. These, of course, are the same thoughts and concerns that I expressed to you in Oklahoma City * * *."

(footnote continued)

Horwath & Horwath, 540 F.2d 27 (C.A. 2, 1976), a private action for damages under Section 10(b) of the Securities Exchange Act and Rule 10b-5, the court distinguished the conduct of the accountants involved in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), 53/ on grounds equally applicable here:

> "The accountants here are not being cast in damages for negligent nonfeasance or misfeasance, but because of their active participation in the preparation and issuance of false and materially misleading accounting reports on which Herzfeld relied to his damage." 54/

Similarly, Haswell, with knowledge of the facts, did nothing to correct disclosure documents for WSP and L&H which were "full of omissions of material

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52/ (continued)

P. Ex. 19, R 504 (emphasis added). Earlier, in May 1976, counsel to Guaranty Trust Co., Charles Johnson, had written to Haswell to express, in a cynical vein, his appreciation to Haswell for involving him in "these wonderful, wonderful bond issues." Johnson continued:

> "Each one is a new expenience [sic] and I look forward to having a piece of this excellent business in the future. * * * The underground from Memphis always poses a new challenge. I wonder what sewer they are in now."

P. Ex. 17, R 502. The last two sentences are apparently a reference to the fact that the MODA bonds were marketed through the efforts of brokers, a number of which were located in Memphis, Tennessee. See R 14, 26. Haswell made no reply to Johnson's rather revealing comments. Tr. 138-139.

53/ The Supreme Court in Hochfelder considered the issue of whether, in a private action, an accountant could be held liable for virtually unlimited money damages for fraud that he did not know about. The scienter standard applied by the Court in that case does not apply to an action brought by the Commission, where the defendant is not subject to personal liability for large damage claims. See infra, pp. 48-58.

54/ 540 F.2d at 37. In this case, the accountants misrepresented, in financial statements they had examined, that certain transactions had been consummated, and profit realized, when in fact the transactions were contingent in nature. Id. at 36-37.

fact" (R 446). Although Haswell demonstrated his awareness of his responsibility to review these documents for accuracy when he supplied minor amendments for the WSP and L&H materials, the amendments he supplied did not cure the deficiencies. Indeed, in the case of an amendment supplied for the L&H documents, see, supra, pages 18-19, Haswell attempted to achieve artful concealment, rather than disclosure, of the facts regarding the use of the proceeds of the offering. 55/ And, there is no dispute that Haswell assumed complete responsibility for the drafting and assembly of the disclosure document for HII; yet the document he produced misrepresented essential facts to public investors and put forth patently false projections as to which he admitted making not even a minimal inquiry, since "no one asked me to" (Tr. 107).

Finally, the evidence demonstrated that Haswell, undoubtedly with knowledge of the relevant facts, issued three separate tax opinions which were false. This intentional conduct is sufficient to establish liability, even under a standard of liability that requires proof of intentional fraud. 56/

55/ Haswell's efforts with respect to his description of the use of proceeds of the L&H issue can most charitably be described as resting on the assumption that his "task has been adequately performed if [he] can avoid blatant fraud and still keep the stockholder from discovering which shell the pea is under." Gould v. American Hawaiian Steamship Co., 319 F. Supp. 795, 810 (D. Del., 1970).

56/ Even with respect to criminal cases, "the intent necessary * * * is merely that of intending to do the act prohibited, rather than intending to violate the statute." United States v. Charnay, 537 F.2d 341 (C.A. 9), certiorari denied, 429 U.S. 1000 (1976). The Court of Appeals for the Second Circuit stated in Arthur Lipper Corp. v. Securities and Exchange Commission, 547 F.2d 171, 181 187 (C.A. 2, 1976):

> "Indeed, even in the criminal context neither knowledge of the law violated nor the intention to act in viola-

(footnote continued)

The Supreme Court, in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), while stating that scienter under Section 10(b) "refers to a mental state embracing intent to deceive, manipulate or defraud," 57/ allowed that "in certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act," thus implying that "in some circumstances, reckless behavior is sufficient for civil liability under Section 10(b) and Rule 10b-5." 58/ Other courts have recognized that an injunction may be needed to prevent future violations of the law in cases where a securities attorney acted negligently or carelessly.

56/ (continued)

> tion of the law is generally necessary for conviction. The first proposition seems implied by the rule ignorantia juris non execusat. Hall, Criminal Law 288 (2d ed., 1969). See ALI, Model Penal Code §§1.13(12), 2.02(a) & (b); Ellis v. United States, 206 U.S. 246, 257, 27 S. Ct. 600, 602, 51 L. Ed. 1047 (1907), where, in rejecting a claim that knowledge of the law was required for conviction under a statute that included the word 'intentionally,' Justice Holmes said, 'If a man intentionally adopts certain conduct in certain circumstances known to him, and that conduct is forbidden by the law under those circumstances, he intentionally breaks the law in the only sense in which the law ever considers intent'" (emphasis supplied).

See also, United States v. Benjamin, supra, 328 F.2d at 862.

57/ 425 U.S. at 193. When the Supreme Court's definition is compared to the standard applied by the district court—conduct which is "an extreme fraudulent departure from the standards of ordinary care" (R 447)—it is plain that the court below required more of the Commission than would be required in a private action for damages.

58/ Id. at 193-194, n. 12. Numerous courts have interpreted Hochfelder to mean that reckless conduct is a sufficient predicate for civil damage liability in private actions under Section 10(b) and Rule 10b-5. See, e.g., Securities and Exchange Commission v. Universal Major Industries, Corp., 546 F.2d 1044, 1047 (C.A. 2, 1976), certiorari denied sub nom. Homans v. Securities and Exchange Commission, 434 U.S. 834 (1977); Sunstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033, 1045 (C.A. 7, 1977), certiorari denied, 434 U.S. 875 (1977); Bailey v. Meister Brau, Inc., 535 F.2d 982, 993 (C.A. 7, 1976). Rolf v. Blyth, Eastman, Dillon & Co., Inc., 570 F.2d 58 (C.A. 2, 1978); Securities and Exchange Commission v. Coven, [Current] CCH Fed. Sec. L. Rep. ¶96,462 (C.A. 2, June 2, 1978).

In Securities and Exchange Commission v. Spectrum, Ltd., 489 F.2d 535 (C.A. 2, 1973), the court held an attorney charged with aiding and abetting securities fraud should be enjoined if he was negligent in issuing, without having made a sufficient investigation of the facts, an opinion letter needed to sell securities--even if he had no actual knowledge of the improper scheme. See also Securities and Exchange Commission v. Management Dynamics, supra, 515 F.2d at 808-809; Securities and Exchange Commission v. Century Investment Transfer Corp., CCH Fed. Sec L. Rep. ¶ 93,232 (S.D. N.Y., 1971).

This case similarly raises the issue of the extent of the duties of counsel to investors in securities, when counsel prepares documents and issues an opinion in circumstances in which he is on notice that a fraud is being practiced on the investing public. Haswell knew that public investors were relying on his legal opinion that all requirements were met and that interest on the bonds would, in fact, be tax free; he also knew that investors had to rely on the disclosure documents he had examined or prepared for the information they needed to make an informed investment decision. In this case, the district judge recognized that "a more careful attorney" than Haswell would have done more than Haswell did to investigate the suspicious circumstances surrounding the MODA bond offerings (R 447). In finding that Haswell did not violate the law because his conduct did not amount "to either fraudulent conduct or conduct so reckless that it was an extreme departure from the standards of ordinary care," (id., emphasis supplied) the district court failed to provide investors with the measure of protection intended by Congress in enacting the federal securities laws. This holding is, we submit, reversible error.

An attorney in Haswell's position, who should have known of fraud in connection with an offering as to which he had issued or was planning

to issue his opinion, should reasonably be expected to do more than passively "plac[e] in legal form" (R 447) the agreements of other parties to the transaction. The Commission does not claim that an attorney is a guarantor of the accuracy of information disseminated to investors. But, when on notice of circumstances that call into question matters basic to the issuance of a legal opinion, counsel should conduct an investigation of appropriate scope and with sufficient diligence to determine the facts. And, an attorney with knowledge of information material to investors should take reasonable steps to satisfy himself that these material facts are disclosed to the public.

As the District Court for the District of Columbia recently stated with respect to an attorney who, like Haswell, issued a false opinion in connection with the sale of securities:

> "there is ample precedent for regarding an attorney as an aider and abettor based upon the issuance of a false and misleading opinion letter. The defendant's assertion that he has no idea [of the fraud] is belied by his intimate acquaintance with the entire transaction * * *. [The defendant] either actually knew that a fraudulent scheme was envisioned by [the company], or else he recklessly ignored what should have been readily apparent."

Securities and Exchange Commission v. National Student Marketing Corp., 402 F. Supp. 641, 649-650 (D. D.C., 1975). Similarly, in this case, the evidence introduced below "shows substantially more than a marginal involvement and limited knowlege by this attorney." Id. at 646. The court in National Student Marketing was "unwilling to accept" the argument advanced by the attorney involved in that case, and by Haswell in the lower court, that lawyers can "ignore the commerical substance of a transaction" which involves a fraud on public investors. Rather, when an attorney is "fully familiar with the

circumstances" which indicate that a transaction is being undertaken "which could be utilized to mislead third parties," he has an obligation to take steps to prevent that fraud. Id. at 648. That is the case here, where Haswell was familiar with the circumstances in which MODA was proposing to issue its bonds, and was in a position to acquire information concerning the suspicious circumstances known to him and to take appropriate remedial steps.

Nor does the fact that Haswell may not have been the principal perpetrator of the fraud serve to exculpate him. Numerous courts have recognized that in enforcement actions brought by the Commission, as well as in private actions for damages, liability may appropriately be imposed on persons who aid and abet securites law violations. As this Court noted in Securities and Exchange Commission v. Barraco, 438 F.2d 97, 99 (C.A. 10, 1971), those who contribute to the effectuation of a violation of the federal securities laws may be held accountable for their actions. In accord with this principle, the Court of Appeals for the Second Circuit, in Securities and Exchange Commission v. Coven, [Current] CCH Fed. Sec. L. Rep. ¶96,462, affirmed, in part, an injunction entered against an experienced securities attorney who aided a fraudulent distribution of securities by falsely certifying, in a letter to a trustee bank, that the issue was fully subscribed. The court stated, id. at p. 93,679:

> "Inasmuch as those responsible for violations of §17(a) [of the Securities Act] may be liable for negligent misconduct in the context of SEC enforcement actions, we see no reason why scienter of the sort required in Hochfelder should be a necessary element of aiding and abetting. Rather, we adhere to the flexible standard we articulated in SEC v. Management Dynamics, Inc., supra. The test is whether an alleged aider and abettor 'should have been able to conclude that his act was likely to

> be used in furtherance of illegal activity,' in light of all the circumstances, 515 F.2d at 811, including the nature of the defendant's assistance to the primary wrongdoer, his participation in the challenged conduct, his awareness of the illegal scheme, and any duties to investigate or supervise that may be applicable."

Applying this test to Haswell's conduct, it is plain, in light of the critical nature of the assistance he rendered to the issuers and underwriters of MODA bonds, the duty he had to investors, his certain knowledge of various elements of the illegal scheme and, at a minimum, his reckless disregard for investors, that Haswell must be held to have aided and abetted the violations of others. 59/

Particularly when Haswell's entire course of conduct in connection with the three separate offerings involved in this case is examined, the glaring nature of his misconduct is readily apparent. In view of the actual knowledge Haswell had concerning WSP, he may not contend that he lacked sufficient

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59/ In Rolf v. Blyth, Eastman, Dillon & Co Inc., 570 F.2d 38 (C.A. 2, 1978), the court held that, even in a private damage action under Rule 10b-5, where an aider and abetter owes a duty to the defrauded party, recklessness satisfies the scienter requirement enunciated in Hochfelder. The test for "the abettor's responsibility * * * is [whether] the defendant should have been able to conclude that his act was likely to be used in furtherance of illegal activity." Securities and Exchange Commission v. Management Dynamics, Inc., 515 F.2d 801, 811 (C.A. 2, 1975); see also, Securities and Exchanage Commission v. Spectrum, Ltd., 489 F.2d 535, 542 (C.A. 2, 1973).

See also Kerbs v. Fall River Industries, Inc., 502 F.2d 731, 740 (C.A. 10, 1974); Securities and Exchange Commission v. Universal Major Industries Corp, supra, 546 F.2d at 1046-1047; Securities and Exchange Commission v. National Bankers Life Insurance Co., 448 F.2d 652 (C.A. 5, 1971), affirming, 324 F. Supp. 189, 194-195 (N.D. Tex.); Rochez Brothers, Inc. v. Rhoades, 527 F.2d 880, 886 (C.A. 3, 1974) ; Woodward v. Metro Bank of Dallas, 522 F.2d 84, 94-97 (C.A. 7); Hochfelder v. Midwest Stock Exchange, 503 F.2d 364, 374-375 (C.A. 7), certiorari denied, 419 U.S. 875 (1974). Cf. Ernst & Ernst v. Hochfelder, supra, 425 U.S. at 191-192 n. 7.

familiarity with its affairs to permit him to amend the deficiencies contained in the WSP disclosure documents. With respect to the L&H offering, made within months of the WSP offering, Haswell was thoroughly familiar with L&H and its financial condition. He had represented the company since its inception and had represented it in unsuccessful attempts to obtain the financing it needed.

Haswell's conduct in connection with the WSP and L&H offerings was, as we have noted, excused by the district court on the grounds that the underwriter, and not Haswell, had the ultimate responsibility of preparing the disclosure documents that were disseminated to investors. But, this does not relieve Haswell of his responsibility to correct deficiencies in these documents which were, in fact, known to him. And, with respect to the HII issue, even this very tenuous ground is completely undercut by the fact that Haswell himself was responsible for the preparation of the HII disclosure document, a document that was deficient in many significant respects.

Finally, there is no possible justification for the erroneous tax opinions disseminated by Haswell. Haswell knew that the companies involved in these issues could not conceivably comply with the primary statutory requirement, that "substantially all of the proceeds" of the issue be used to purchase land or depreciable property—property that would, in turn, serve as security for the debt owed to purchasers of the MODA bonds. 60/ This is

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60/ The district court dismissed the Commission's contentions regarding the falsity of Haswell's tax opinions with the statement that no government agency other than the Commission had challenged Haswell's opinions (R 445, 449). This is, of course, irrelevant. The salient point is

(footnote continued)

not a case where the issuers concealed from the attorney their intentions regarding their intended use of the proceeds; it is, rather, simply a case where the attorney completely abdicated his responsibility to investors to inquire as to the intended use of proceeds, to establish, at a minimum, that the companies' stated intentions would comply with the law with respect to the use of proceeds, and to take reasonable precautions to put some limitations, through appropriate escrow arrangements, on the ability of the companies to spend money for purposes other than those permitted by the statute.

As Judge Learned Hand stated with respect to the professional conduct of an accountant in United States v. White, 124 F.2d 181, 185 (C.A. 2, 1941),

> "Logically the sum is often greater tha[n] the aggregate of the parts, and the cumulation of instances, each explicable only by extreme credulity or professional inexpertness, may have a probative force immensely greater than any one of them alone."

Here, viewing Haswell's entire course of conduct in the context of the three MODA bond issues involved in this case, there can be no other conclusion except that Haswell must have known that his actions would substantially contribute to the success of a securities fraud, or, at the least, that he was recklessly indifferent to that possibility. We submit that Haswell's conduct was in

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60/ (continued)

that the tax opinions contained misrepresentions that were made in connection with the offer and sale of securities, and that they facilitated the sale of unregistered securities to the public, matters within the jurisdiction of the Commission. That investors were not denied any of the tax advantages they were led to expect does not detract from the fact that investors were led to believe that they were investing in the bonds of companies that, by virtue of the required purchase of land and equipment, would have substantial assets, which was not the case. Moreover, investors were falsely led to believe that there was adequate security to protect their investment—a misrepresentation which directly and adversely affected investors, who received only a fraction of their investment in MODA bonds upon the dissolution of the companies involved in this case. See supra, p. 12.

fact "fraudulent and culpably reckless behavior," which violated the anti-fraud provisions of the securities laws.

B. The district court erred in holding that scienter is a necessary element of a Commission action for equitable relief.

1. The district court erred in holding that scienter is a necessary element of a Commission action for equitable prophylactic relief under Section 10(b) of the Securities Exchange Act and Rule 10b-5.

As the Supreme Court pointed out in Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963), a fundamental purpose of the federal securities laws is to "substitute a philosophy of full disclosure for the philosophy of caveat emptor * * *" (Id. at 186). The Supreme Court also has repeatedly recognized that the federal securities laws, including the antifraud provisions, are to be construed "not technically and restrictively, but flexibly to effectuate [their] remedial purposes." Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 12 (1971); Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., supra, 375 U.S. at 195.

In accord with these principles, this Court has held, in an action brought by the Commission to obtain an injunction against further violations of the registration and antifraud provisons of the federal securities laws, that "proof of scienter or intent to defraud is not required to show violations justifying preliminary injunctive relief under such statutes." Securities and Exchange Commission v. Pearson, 426 F.2d 1339 (C.A. 10, 1970).

The argument that the Supreme Court's narrow holding with respect to private actions for damages in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), should be expanded to require the Commission to establish

scienter in an action brought to obtain equitable relief under Section 10(b) of the Securities Exchange Act and Rule 10b-5 has been rejected by the Court of Appeals for the First Circuit. In Securities and Exchange Commission v. World Radio Mission, Inc., 544 F.2d 535 (C.A. 1, 1976), the court of appeals stated:

> "From the standpoint of an SEC injunction against violations which the court finds are likely to persist, a defendant's state of mind is irrelevant. If proposed conduct is objectively within the Congressional definition of injurious to the public, good faith, however much it may be a defense to a private suit for past actions, see Ernst & Ernst v. Hochfelder * * *, should make no difference. Cf. SEC v. Capital Gains Research Bureau, Inc., ante." 544 F.2d at 540-541.

In addition, the Court of Appeals for the Second Circuit, in Securities and Exchange Commission v. Universal Major Industries, 546 F.2d 1044, 1047 (C.A. 2, 1976), certiorari denied sub nom. Homans v. Securities and Exchange Commission, 434 U.S. 834 (1977), another case decided after Hochfelder, "made it clear" that the law in that circuit is that "in SEC proceedings seeking equitable relief, a cause of action may be predicated on negligence alone, and scienter is not required." 61/ Although Universal Major Industries involved Section 5 of the Securities Act rather than Section 10(b) of the Securities

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61/ As the court noted in World Radio Mission,

> "Even those courts that correctly anticipated the Hochfelder outcome and required proof of scienter in private damage actions under Rule 10b-5, see, e.g., Lanza v. Drexel & Co., 2 Cir., 1973, 479 F.2d 1277, have not considered intent relevant in SEC injunction actions, see, e.g., SEC v. Shapiro, 2 Cir., 1974, 494 F.2d 1301, 1308."

Securities and Exchange Commission v. World Radio Mission, Inc., supra, 544 F.2d at 540-541.

Exchange Act, 62/ that fact does not detract from the court's explicit statement that negligence is a sufficient predicate for a Commission action for injunctive relief. In Universal Major Industries, and more recently, in Securities and Exchange Commission v. Coven, supra, [Current] CCH Fed. Sec. L. Rep. ¶96,462, the court specifically reaffirmed its pre-Hochfelder decision in Securities and Exchange Commission v. Spectrum, Ltd., 489 F.2d 535 (C.A. 2, 1973), a decision in which the court recognized that it had "enunciated the negligence test principally in cases involving the antifraud provisions of the securities laws * * *." 63/ The repeated decisions of the Court of Appeals for the Second Circuit holding that negligence is the proper standard in Commission actions for equitable relief, 64/ also are consistent with pre-Hochfelder decisions

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62/ In Arthur Lipper Corp. v. Securities and Exchange Commission, supra, 547 F.2d at 180-181, n. 6, an appeal from an administrative proceeding in which the Commission had barred the respondent from the securities business for having aided and abetted violations of Section 10(b) and Rule 10b-5, the Court of Appeals for the Second Circuit assumed that the Hochfelder culpability standard did not apply in "injunctive proceedings the objective of which is solely to prevent threatened future harm."

63/ Securities and Exchange Commission v. Universal Major Industries Corp., supra, 546 F.2d at 1046-1047; Securities and Exchange Commisson v. Coven, supra, [Current] CCH Fed. Sec. L. Rep. at 93,679. In Coven, the court reaffirmed the "flexible standard" articulated in Spectrum and in Management Dynamics, a standard which, the court recognized, "may sometimes impose stringent obligations upon attorneys whose actions facilitate wrongdoing." Nevertheless, the court held, "We do not believe * * * that imposition of a negligence standard with respect to the conduct of a secondary participant [an attorney] is overly strict * * *."

64/ See Securities and Exchange Commission v. Management Dynamics, Inc., supra, 515 F.2d 801; Securities and Exchange Commission v. Spectrum,

(footnote continued)

of this Court in Pearson and of numerous other courts of appeals and district courts. 65/

64/ (continued)

Ltd., supra, 489 F.2d 535; Securities and Exchange Commission v. Everest Management Corp., 475 F.2d 1236, 1240 (C.A. 2, 1972); Securities and Exchange Commission v. North American Research & Development Corp., 424 F.2d 63 (C.A. 2, 1972); Securities and Exchange Commission v. Texas Gulf Sulphur Co., 401 F.2d 833 (C.A. 2, 1968) (en banc) certiorari denied sub nom. Coates v. Securities and Exchange Commission, 394 U.S. 976 (1976). Cf. Hanly v. Securities and Exchange Commission, 415 F.2d 589, 596 (C.A. 2, 1969).

65/ See, e.g., Securities and Exchange Commission v. Pearson, 426 F.2d 1339, 1343 (C.A. 10, 1970); Securities and Exchange Commission v. Dolnick, 501 F.2d 1279, 1284 (C.A. 7, 1974); Securities and Exchange Commission v. Van Horn, 371 F.2d 181, 186 (C.A. 7, 1966); Securities and Exchange Commission v. Geotek, 426 F. Supp. 715, 726 (N.D. Cal., 1976); Securities and Exchange Commission v. Trans Jersey Bancorp, [Current] CCH Sec. L. Rep. ¶95,918 (D. N.J., 1976); Securities and Exchange Commission v. E. L. Aaron & Co., [Current] CCH Fed. Sec. L. Rep. ¶96,043 (S.D. N.Y., 1977), appeal by a defendant pending, No. 77-6091 (C.A. 2); Securities and Exchange Commission v. American Beef Packers, Inc., [Current] CCH Fed. Sec. L. Rep. ¶96,186 (C.A. 2, 1977); Securities and Exchange Commission v. Cenco, Inc., [Current] CCH Fed. Sec. L. Rep. ¶96,133 (N.D. Ill., 1977), petition by Commission for rehearing pending. Most recently, the District Court for the District of Columbia, in denying a motion to dismiss a Commission injunctive action on the ground that the Commission had not alleged scienter, held that "In injunctive actions brought by the SEC under Rule 10b-5, however, scienter is not an element that the Commission must prove." Securities and Exchange Commission v. Hart, [Current] CCH Fed. Sec. L Rep. ¶96,454 at 93,645 (citations omitted).

See also S. Rep. N. 94-75, 94th Cong., 1st Sess. 76 (1975), where the Senate Committee on Housing Banking and Urban Affairs noted:

> "Private actions frequently will involve more parties and more issues than the Commission's enforcement action, thus greatly increasing the need for extensive pretrial discovery. In particular, issues related to matters of damages, such as scienter, causation, and the extent of damages are elements not required to be demon-

(footnote continued)

Finally, it should be pointed out that in Hochfelder, the Supreme Court, noting its prior decision in the Capital Gains case, specifically declined to address the question whether the scienter requirement should apply to Commission injunctive actions, stating, 425 U.S. at 194, n.12:

> "[S]ince this case concerns an action for damages we * * * need not consider the question whether scienter is a necessary element in an action for injunctive relief under Section 10(b) and Rule 10b-5."

Thus, the Supreme court's holding in Hochfelder—that a private party cannot recover damages under Section 10(b) of the Securities Exchange Act and Rule 10b-5 against an accountant for alleged negligence in connection with an audit of a broker-dealer—does not restrict the application of its earlier holding in Capital Gains, that "[i]t is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages," 375 U.S. at 193, and that

> "To impose upon the Securities and Exchange Commission the burden of showing deliberate dishonesty as a condition precedent to protecting investors through the prophylaxis of disclosure would effectively nullify the protective purposes of the statute." Id. at 200.

The district court's holding in the instant case is not supported by Hochfelder, and is inconsistent with Capital Gains, with this Court's deci-

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65/ (continued)

> strated in a Commission injunctive action" (citation omitted, emphasis in original).

See Cox, Ernst & Ernst v. Hochfelder: A Critique and Evaluation of Its Impact upon the Scheme of the Federal Securities Laws, 28 Hastings L. J., 569, 583-586 (1977).

sion in Pearson, and with the post-Hochfelder decisions of other courts which have appropriately applied a negligence standard in Commission equitable actions.

2. The district court erred in holding that scienter is a necessary element of a Commission action for equitable prophylactic relief under Section 17(a) of the Securities Act.

The court below determined that the Commission was required to show scienter in an action brought under Section 17(a) of the Securities Act, without making any distinction between that section and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. The district court stated:

> "in order to find that Haswell violated Section 17(a) of the 1933 Act and Section 10(b) of the 1934 Exchange Act and Rule 10b-5 thereunder, it is necessary that this Court find that Haswell's conduct amounted to either fraudulent conduct or conduct so reckless that it was an extreme departure from the standards of ordinary care, conduct which presented a danger of misleading buyers that was either known to Haswell or was so obvious that he must have been aware of it" (R 447).

The court also stated:

> "It is clear that since Section 17(a) of the 1933 Act and Section 10(b) of the 1934 Exchange Act and Rule 10b-5 thereunder are fraud provisions, no violation of these provisions can occur unless the evidence supports a finding that Haswell's omissions were the result of fraudulent or culpably reckless behavior" (R 449).

Even assuming, arguendo, that the Commission would be required to demonstrate scienter under Section 10(b) of the Securities Exchange Act and Rule 10b-5, the court below erred in failing to make any distinction between, on the one hand, the language of Congress, and, on the other hand, the Supreme Court's interpretation of a Commission rule sought to be applied by a private litigant in a damage action. The lower court has seriously misread the opinion of the Supreme Court in Ernst & Ernst v. Hochfelder, 425 U.S 185 (1976).

Whatever may be the view of the Supreme Court with respect to the necessity for alleging and proving scienter in a Commission injunctive action—an issue which, as we have noted, the Supreme Court expressly declined to consider—it is clear that none of its reasoning with respect to the limitations inherent in the words "manipulative" and "deceptive" in Section 10(b) of the Securities Exchange Act, which the Court held precluded an interpretation of Rule 10b-5 which exceeded such limitations, is applicable to Section 17(a) of the Securities Act. Section 17(a) is, of course, a statutory provision, the purpose and scope of which can be determined from a reading of the statutory language itself.

In construing the reach of Section 17(a), the language of the Supreme Court in Hochfelder, discussing subsections (b) and (c) of Rule 10b-5, which are virtually identical to subsections (2) and (3) of Section 17(a), is particularly relevant:

> "The Commission contends, however, that subsections (b) and (c) of Rule 10b-5 are cast in language which—if standing alone—could encompass both intentional and negligent behavior. These subsections respectively provide that it is unlawful
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> > '[t]o make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading * * *'
>
> and '[t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person * * *.' Viewed in isolation the language of subsection (b), and arguably that of subsection (c), could be read as proscribing, respectively, any type of material misstatement or omission, and any course of conduct, that has the effect of defrauding investors, whether the wrong-doing was intentional or not" (emphasis added).

425 U.S. at 212.

Thus, Hochfelder affirmatively supports the proposition that subsections (2) and (3) of Section 17(a) are violated by negligent conduct. And, since Section 17(a) is a statute, the logic of the Hochfelder decision, which would limit the scope of a rule adopted by the Commission under Section 10(b), is simply inapplicable. The Court of Appeals for the Second Circuit so held in Securities and Exchange Commission v. Coven, supra, [Current] CCH Fed. Sec. L. Rep. at 93,678 (footnote omitted):

> "This wording [of Section 17(a)] is virtually identical to that of Rule 10b-5, which the Supreme Court suggested in Hochfelder would subject wrongdoers to liability for negligence were it not for the fact that the rule can be no broader than the statute under which the rule was promulgated. 425 U.S. at 212. As the Court stated, the language of subsection (2) of §17(a) gives no indication that liability is predicated on fraudulent intent. Id. Moreover, the clear import of the critical phrase in subsection (3), "operates as a fraud," is to focus attention on the effect of potentially misleading conduct on the public, not on the culpability of the person responsible. Absent any terminology in §17(a) comparable to "manipulative or deceptive device or contrivance" in §10(b), upon which the Supreme Court relied heavily in Hochfelder, we see no reason to give §17(a) a similarly narrow reading."

The Court of Appeals for the First Circuit also recently so concluded in Securities and Exchange Commission v. World Radio Mission, supra, 544 F.2d at 541, n. 10:

> "Defendants engage in a technical argument, that since the language of Section 17(a) of the 1933 Act is virtually identical to that of Rule 10b-5, and since Hochfelder read Section 10(b) of the 1934 Act, under which Rule 10b-5 was promulgated, as requiring scienter, Section 17(a) must be similarly interpreted. This is a nonsequitur. The Hochfelder Court recognized that Rule 10b-5(2), making it unlawful
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> > 'to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading,'

> is not, by itself, limited to intentional deceit; but the Court held that the rule, if so interpreted, would exceed the authority of Section 10(b) of the statute. 425 U.S. at 212-214, 96 S. Ct., at 1390-1391. Section 17(a), however, is a congressional enactment, not an SEC rule, and it contains the same language which the Hochfelder Court recognized did not require scienter. Thus, strictly speaking, since this action is founded on both Section 17(a) and Rule 10b-5, we need not decide what result would obtain in an SEC injunction action based solely on Section 10(b) and Rule 10b-5—though we do think it implausible to suppose that Congress intended to provide a mechanism for the SEC to protect the public from the injurious schemes of those of evil intent and yet leave the public prey to the same conduct perpetrated by the careless or reckless."

Thus, we submit that, regardless of whether the scienter requirement enunciated in Hochfelder is applicable to Commission injunctive actions under Section 10(b) and Rule 10b-5, the scienter standard does not apply to cases brought under Section 17(a) of the Securities Act. 66/ As the Court of Appeals for the Seventh Circuit remarked in Securities and Exchange Commission v. Van Horn, 371 F.2d 181, 185 (C.A. 7, 1966):

> "In view of the plain language employed by Congress, it would be presumptuous on our part to hold that the applicability of the clauses involved [Section 17(a)(2) and (3)] is dependent on intent to defraud."

As the court pointed out in Coven, this result is in accord with the Supreme Court's recognition, in Capital Gains, supra, 375 U.S. at 200, that language similar to that in Section 17(a) does not require the Commission to show "deliberate dishonesty as a condition precedent to protecting investors * * *." Although Capital Gains was brought under the Investment Advisers Act rather

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66/ As a contemporaneous comment on Section 17 stated, that section "makes unlawful even innocent acts to obtain money or property by means of untrue statements of material facts or omissions to state material facts." Douglas & Bates, The Federal Securities Act of 1933, 43 Yale L. J. 171, 181 (1933).

than the Securities Act, the antifraud provision of that Act is virtually identical to 17(a). 67/

* * *

To summarize, it should be remembered that Commission injunctive actions, which are prospective in nature, seek relief designed to protect public investors from future violations of the federal securities laws—violations which will have the same adverse impact on the public regardless of the defendants' state of mind or intentions. 68/ Private damage actions,

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67/ Section 206 of the Investment Advisers Act, which was involved in the Capital Gains case, is quoted in the opinion of that case at 375 U.S. at 181-182, n. 2. Clauses (1) and (2) of that section use language identical to language contained in clauses (1) and (3) of Section 17(a) of the Securities Act. Thus, clause (1) of the Advisers Act makes it unlawful for an investment adviser "to employ any device, scheme, or artifice to defraud any client or prospective client" and clause (2) makes it unlawful for him "to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." Section 17(a) of the Securities Act prohibits "any person in the offer or sale of any securities", in clause (1), from the employment of "any device, scheme or artifice to defraud" and, in clause (3), from engaging "in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

The Investment Advisers Act has no language comparable to clause (2) of Section 17(a) of the Securities Act, which reads "to obtain money or property by means of any untrue statement of a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading" The addition of the language in Section 17(a)(2) would seem to make the Section 17(a) case for liability based on negligence alone a fortiori because there is nothing in that subsection to even remotely suggest the necessity for scienter or any form of knowing conduct.

68/ When the Commission seeks to invoke the aid of the district courts to enforce the federal securities laws, the Commission appears "not as an ordinary litigant, but as a statutory guardian charged with safeguarding the public interest." Securities and Exchange Commission v. Management Dynamics, 515 F.2d 801, 808 (C.A. 2, 1975).

(footnote continued)

on the other hand, are primarily retrospective, intended to provide monetary redress to the plaintiffs, and often others similarly situated, for past violative conduct. As pointed out in Securities and Exchange Commission v. Coven, supra, slip op. at 15, "impressive policies" argue in favor of

> "enabling the SEC to seek injunctive relief on the basis of negligent conduct. The essential nature of an SEC enforcement action is equitable and prophylactic; its primary purpose is to protect the public against harm, not to punish the offender * * *."

These purposes are best served by an interpretation

> "which enables the SEC to move against negligent conduct whose effects on the public may be every bit as detrimental as those produced by intentional misconduct." Id.

In light of these significant differences in nature and purpose of Commission injunctive actions vis-a-vis private actions, a scienter requirement in Commission actions, and the resulting burden of proof such a standard would impose on the Commission, would only serve to hamper, not further, the broad remedial pruposes of the federal securities laws. We respectfully submit that the negligence standard consistently applied by the courts in Commission injunctive actions is the appropriate standard.

68/ (continued)

See also S. Rep. No. 94-75, 94th Cong., 1st Sess. 77 (1975), where the Senate Committee on Housing, Banking and Urban Affairs stated that

> "although both the Commission's suit for injunctive relief brought pursuant to express statutory authority and a private action for damages fall within the general category of civil (as distinct from criminal) proceedings, their objectives are really very different. Private actions for damages seek to adjudicate a private controversy between citizens; the Commission's action for civil injunction is a vital part of the Congressionally mandated scheme of law enforcement in the securities area."

II. THE DISTRICT COURT ERRED IN HOLDING THAT HASWELL DID NOT VIOLATE, AND AID AND ABET VIOLATIONS OF, THE REGISTRATION PROVISIONS OF THE FEDERAL SECURITIES LAWS BY ISSUING FALSE TAX OPINIONS.

Haswell, as counsel to MODA in connection with the bond offerings involved in this case, violated and aided and abetted violations of the securities registration requirements of the Securities Act of 1933. 69/ Proof of a violation of the registration provisions requires a showing of three essential elements: (1) that no registration statement was filed or in effect as to the securities; (2) that the defendant offered or sold, or aided and abetted the offer or sale of, securities; and (3) that the means of interstate transportation or communication, or the mails, were used in connection with the offer or sale. Securities and Exchange Commission v. Continental Tobacco Company of South Carolina, 463 F.2d 138, 155 (C.A. 5, 1972). 70/

In the instant case, Haswell, as counsel for MODA, aided and abetted the sale of the securities of WSP, L&H and HII, which were not registered with the Commission, 71/ to an underwriter, and then to the investing public.

69/ The lower court essentially ignored the Commission's allegations as to violations of the registration provisions in its decision. We believe, as set forth herein, that the facts indicate that Haswell was well aware that the proceeds of the offerings would not be used as required by the tax code, and that Haswell's opinions were, therefore, false when issued.

70/ See also, Edwards v. United States, 312 U.S. 473, 483 (1941), in which the Supreme Court held that an indictment for violation of the registration provisions does not have to allege that no exemption was available.

71/ The requirement to register these IDR bonds, if not exempt, was the obligation of WSP, L&H and HII. On February 1, 1968, the Commission announced the reasons behind this requirement in its release announcing the proposal of Securities Act Rule 131, 17 CFR 230.131 (Securities Act Release No. 4896; Securities Exchange Act Release No. 8248 at p. 1, February 1, 1968). This release sets forth the reasons why the corporation, rather than the issuing governmental authority, must register securities which obligate the authority to repay monies loaned by members of the public.

> "Since the purchaser of an industrial revenue bond looks principally, if not entirely, to the lease payments for

(footnote continued)

Haswell made use of the mails and the instrumentalities of interstate commerce in connection with these securities which were ultimately distributed to investors. 72/ In view of this showing, the burden shifted to Haswell to demonstrate that some exemption from registration was available. Securities and Exchange Commission v. Ralston Purina Co., 346 U.S. 119, 126 (1953).

In the district court, Haswell claimed that the IDR bonds issued by WSP, L&H and HII Series B are exempt from registration with the Commission as "small issue industrial development bonds" pursuant to Section 3(a)(2) of the Securities Act which, in pertinent part, exempts from registration

> "any security which is an industrial development bond as defined in * * * the Internal Revenue Code * * *."

Haswell claims that these bonds are in fact qualified pursuant to 26 U.S. 103(b)(6). In fact, however, this exemption was not available.

Exemptions from the registration requirement of the Securities Act are narrowly construed. Securities and Exchange Commission v. Ralston Purina Co., supra, 346 U.S. at 124-25; Securities and Exchange Commission

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71/ (continued)

> the payment of principal and interest on the bond, he is in reality purchasing an interest in the lease obligation of the private company. The new rules [17 CFR 230.131] are proposed for the purpose of identifying the interest in the obligation of the private company as a separate "security" issued by the private company. These rules do not relate to, and have no effect on, the obligation of the government or its instrumentality nor does it require registration by the government or instrumentality. The purpose of the rules is to provide prospective investors with adequate information concerning the nature of the obligation of the private lessee and sufficient information about the lessee and its business as well as the terms, nature and identity of the persons involved in the distribution to enable investors to make informed investment judgments."

72/ Tr. 31, 83, 103 and 108.

v. Sunbeam Gold Mines Co., 95 F.2d 699, 701 (C.A. 9, 1938). 73/ The exemption for "small issue industrial development bonds" provided by Section 3(a)(2) of the Securities Act, like the other exemptions from registration, requires strict compliance with its terms. This, in turn, requires compliance with the terms of 26 U.S.C. 103(b)(6)(A), which mandates that "substantially all of the proceeds" of an offering must be used to purchase land or depreciable property. 74/ The WSP, L&H and HII Series A bond issues did not meet this test because, as we have seen, supra, pages 23-27, substantially all of the proceeds from these bond issues were not used for the purchase of depreciable property. 75/

73/ Not only must exemptions from registration under the federal securities laws be construed narrowly, but exemptions from taxation are also to be construed narrowly. United States Trust Company v. Anderson, 65 F.2d 575 (C.A. 2, 1953); American National Bank of Austin v. United States, 421 F.2d 442 (C.A. 5, 1970), cert. denied, 400 U.S. 819 (1971); and State Bank of Albany v. United States, 505 F.2d 1068-71 (C.A. 2, 1974). The burden is always on the taxpayer to establish his entitlement to an exemption. Harding Hospital, Inc. v. United States, 505 F.2d 1068, 1071 (C.A. 6, 1974). It is within this frame of reference that Haswell's argument, that the exemption for tax-exempt IDR issues was applicable, must be evaluated.

74/ On June 5, 1971, prior to the time Haswell issued his bond opinions, the Treasury Department issued proposed regulations under 26 U.S.C. 103(b)(6)(A). These regulations have since become effective, see 26 CFR 1.103-10(b)(ii), and specifically warn against using proceeds from industrial development bonds for working capital or to finance inventory.

> "Substantially all of the proceeds of such issue is to be used for the acquisition, construction, reconstruction or improvement of land or property of a character subject to the allowance for depreciation under Section 167. The exemption requirements are not satisfied if more than an insubstantial amount of the proceeds of such issue is loaned to a borrower for use as working capital or to finance inventory." (emphasis supplied) 26 CFR 1.103-10(b)(ii).

75/ For the WSP, L&H and HII bond issues, a substantial amount of the proceeds (R 510-512) was used for "escrowed interest" to pay for interest on those bonds during the early years of the issue, when the

(footnote continued)

Before bond counsel can express an opinion, in good faith, that particular IDR bonds are tax exempt, he must, among other things, ascertain that no more than an "insubstantial amount of the proceeds" 76/ is intended to be used for a purpose other than the purchase of land or depreciable property. To do this, bond counsel must carefully examine, or, as in Haswell's case, actually draft, the indenture and lease which govern how the proceeds of the issue are to be used and thereby satisfy himself as to the intended use of the proceeds. Without this inquiry, counsel has no way of opining as to whether "substantially all of the proceeds" of an issue will be used to purchase land or depreciable property. Thus, for example, if no covenants appear in the lease which forbid the lessee company from using more than an insubstan-

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75/ (continued)

respective companies would not have had sufficient income to meet these interest obligations. The use of proceeds for escrowed bond interest is equivalent to using proceeds for working capital, which does not qualify as the purchase of depreciable property. If interest is to be capitalized, it must be added to the cost basis of a particular item of depreciable property, which in this case was not required by the respective leases and indentures. Interest may be capitalized only in certain limited circumstances, such as when it is paid in connection with the financing of the purchase of a piece of capital equipment by a public utility until that capital item is available for use. See Accounting Series Rel. 163, 5 SEC Docket 436 (November 14, 1974). Haswell did not attempt to establish that any such circumstances were present, nor does it appear that this could have been the case. Indeed, in the case of L&H, the company made virtually no purchases of land or equipment to which the interest costs could be added.

One purpose that was served by placing funds to pay interest on the bonds in escrow in connection with the MODA scheme was the concealment of the fraud from investors in these bonds. Because escrowed interest for these bond issues was provided for up to two years (see R 513, p. 6), bondholders would not discover the desperate financial condition of WSP, L&H and HII until the interest was exhausted and bondholders stopped receiving interest payments.

76/ 26 CFR 1.103-10(b)(ii).

tial amount of the proceeds for working capital or for inventory purchases, 77/ if there is no mechanism to assure compliance with such covenants through regular review of the company's expeditures, 78/ and if, in addition, it is known that the company is in need of additional working capital, then an attorney may not in good faith issue an unqualified tax opinion.

The type of IDR bond involved in this case could not be marketed without a tax opinion of counsel (Tr. 128). Thus, by issuing tax opinions which he knew or should have known were false, Haswell violated and aided and abetted violations of the securities registration provisions of the federal securities laws.

III. THE DISTRICT COURT ERRED IN REFUSING TO ENJOIN HASWELL FROM VIOLATING FEDERAL SECURITIES LAWS BASED ON ITS CONCLUSION THAT THERE WAS NO LIKELIHOOD OF FUTURE VIOLATIONS.

The lower court denied any injunction against Haswell on October 19, 1977, after concluding that Haswell had not violated the federal securities laws because, among other reasons, he was not reckless and did not intend to violate the federal securities laws. Moreover, the court indicated that

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77/ Although Haswell knew that proceeds are often held in trust in a "construction fund," to provide a means to check on the company's expenditures (Tr. 27), he did not establish such a fund for L&H (Tr. 55). As a result, L&H was left free to use the proceeds of the offering for purposes other than those permitted by the Internal Revenue Code, and purchasers of L&H bonds were left without adequate security to protect their investment.

78/ A construction fund was used in connection with the WSP and HII Series B bond offering (Tr. 28, 113). No such fund was used for L&H because, as Haswell explained, "nobody asked me to." Tr. 55. Haswell further excused his failure to establish a construction fund for L&H by pointing out that such a fund "wasn't appropriate to the kind of structuring of that transaction as it came out." Id. Indeed, Haswell himself had structured the L&H offering so that L&H was not required to purchase any land or depreciable property for up to three years, and was free to spend the proceeds for other purposes. See, supra, pp. 26-27.

even if it had concluded that Haswell had violated the law, it would deny an injunction "under the circumstances," citing Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F.2d 1082 (C.A. 2, 1972). In this regard, the Court observed that Haswell's subsequent work in the area of securities law has been "scholarly and of very high quality," 79/ and finally, that the activities complained of by the Commission occurred more than five years in the past. For the reasons set forth supra, we believe that the Court erred when it found that Haswell did not violate the federal securities laws,

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79/ While exonerating Haswell, the district court took the Commission to task for having failed to enact rules, after statutory amendments where necessary, "requiring disclosure in the initial offering of the initial discount rate as a percentage figure, and delineating those other factors * * * which are material and subject to disclosure" (R 450). In the district court's opinion, this could have avoided the "alleged misconduct of which the Commission complains in this case," and would be a better way to proceed than by "initiat[ing] enforcement procedures against attorneys who were forced to act in areas where no clear guidelines existed." Id. The court stated:

> "The Commission's failure to seek creation of a well understood framework of disclosure principles as to long-standing problem areas fairly could be criticized as having contributed more to spectacular losses by investors in recent years than the actions of bond counsel, certainly Mr. Haswell included" (R 450).

The district court's statement indicates its fundamental misunderstanding of the antifraud statutes and rules involved in this case. Section 10(b) of the Securities Exchange Act was designed as "a catch all clause to prevent manipulative devices," the underlying command of which was: "Thou shalt not devise any other cunning devices." Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934), quoted in Ernst & Ernst v. Hochfelder, 425 U.S. 185, 202-203 (1976). Accordingly, a primary concern of the Commission in enacting rules under Section 10(b) is the promulgation of rules of general applicability. While the Commission sometimes enacts rules in specific areas where they are needed, the concealment of large discounts to underwriters in connection with the issuance of IDR bonds is not an area which other securities counsel have frequently abused in the manner involved in this case.

and in holding that scienter must be alleged and proved in an action by the Commission for equitable relief. For the reasons set forth in this section, we submit that if this Court concludes that the district court applied an erroneous legal standard in deciding that Haswell did not violate the law, or if this Court concludes that Haswell did in fact violate the federal securities laws, there is no basis on which the district court could have found that further violations in the future were so unlikely as to preclude the need for injunctive relief. 80/

Section 20(b) of the Securities Act, 15 U.S.C. 77t(b), and Section 21(d) of the Securities Exchange Act, 15 U.S.C. 78u(d), pursuant to which the Commission's enforcement action was instituted, provide that the Commission may institute an action "[w]henever it shall appear * * * that any person is engaged or is about to engage in" violations of any provisions of those laws. These statutes further provide that an injunction shall be granted by the Court upon a "proper showing" by the Commission. Thus, Commission suits for injunction are "creatures of statute," unlike private actions which are rooted wholly in the equity jurisdiction of the federal courts. 81/

80/ Moreover, as the Supreme Court noted in United States v. Parke, Davis & Co., 365 U.S. 125, 126 (1960), when the government seeks an injunction for alleged violations of the law, it is entitled to the entry by the lower court of findings of fact, even it the court should conclude, on the basis of those facts, that injunctive relief is not warranted. As the Supreme Court recognized in Parke, Davis, such findings could well be useful in the event it becomes necessary for the Government to reapply for injunctive relief due to the "resumption * * * of illegal activity." In view of the fact that Haswell has an active legal practice as counsel to those involved in the issuance and sale of securities to the public, there is a particular need for correct findings of fact in this instance. Such findings will also serve as a guide to other securities law practioners.

81/ Securities and Exchange Commission v. Management Dynamics, Inc., 515 F.2d 801,808 (C.A. 2, 1975).

The statutes do not, of course, deprive a district court of discretion; but "the standards of the public interest, not the requirement[s] of private litigation, measure the propriety and need for injunctive relief * * *," Hecht Co. v. Bowles, 321 U.S. 321, 331 (1944).

Injunctive relief requested by the Commission has been characterized by the Supreme Court as a "mild prophylactic" to be issued to effectuate the salutary goals of the federal securities laws. Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., supra, 375 U.S. at 193 (1963); cf., United States v. W. T. Grant Co., 345 U.S. 629 (1953) (suit under the antitrust laws); and Hecht Co. v. Bowles, supra, 321 U.S. 321 (suit under the Emergency Price Control Act).

The relevant question for a district court, in considering the need for a requested statutory injunction, is whether it may reasonably be expected that a defendant who has violated the law in the past will engage in similar illegal activities in the future if he is left free of the restraints of an injunction. United States v. W. T. Grant Co., supra, 345 U.S. at 632-633; Securities and Exchange Commission v. Continental Tobacco Co., 463 F.2d 137, 161-162 (C.A. 5, 1972). 82/

In evaluating the likelihood of future violations, courts have identified a number of relevant factors. Thus, past fraudulent conduct by itself has repeatedly been held by courts to raise an inference that a defendant is

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82/ See also Securities and Exchange Commission v. Management Dynamics, 515 F.2d 801, 808 (C.A. 2, 1975); Securities and Exchange Commission v. Manor Nursing Centers, Inc., supra, 458 F.2d at 1100 (C.A. 2, 1959); Securities and Exchange Commission v. Advance Growth Capital Corp., 470 F.2d 40, 53 (C.A. 7, 1972); United States v. Diapulse Corp. of America, 457 F.2d 25, 28 (C.A. 2, 1972); and Securities and Exchange Commission v. Tax Service, Inc., 357 F.2d 143, 145 (C.A. 4, 1966).

likely to engage in similar misconduct in the the future. 83/ When, as in the instant case, the fraudulent conduct involved was a part of a complicated, sophisticated scheme to defraud investors, and not a single inadvertant act, courts should properly conclude that there is a high degree of probability that such misconduct will recur. In addition, when the defendant refuses to appreciate the wrongfulness of his illegal conduct or to take appropriate steps to alleviate its consequences, this inference becomes virtually compelling. Securities and Exchange Commission v. MacElvain, 417 F.2d 1134 (C.A. 5, 1969), certiorari denied, 397 U.S. 972 (1970). See also Otis & Co. v. Securities and Exchange Commission, 106 F.2d 579, 584 (C.A. 6, 1939).

The Court of Appeals for the Ninth Circuit recently analyzed the issue of the need for an injunction in the light of material changes in circumstances in Securities and Exchange Commission v. Koracorp Industries, Inc., [Current] CCH Fed. Sec. L. Rep. ¶96,370 (C.A. 9, 1978). The court held that "neither changing jobs nor deterioration of health, in and of itself, or in combination with the cessation of illegal activities and proclaimed reformation, provides a complete defense to an injunction suit." (Id. at p. 93,274). 84/

83/ Securities and Exchange Commission v. Koracorp Industries, Inc., [Current] CCH Fed. Sec. L. Rep. ¶96,370 at p. 93,274 (C.A. 9, 1978); Securities and Exchange Commission v. Management Dynamics, Inc., supra, 515 F.2d at 807; Securities and Exchange Commission v. Shapiro, 494 F.2d 1301, 1308 (C.A. 2, 1974); Securities and Exchange Commission v. First American Bank & Trust Co., 481 F.2d 673, 682 (C.A. 7, 1963); and Securities and Exchange Commission v. Culpepper, supra, 276 F.2d at 249-250. But see, Securities and Exchange Commission v. Bausch & Lomb, Inc., [Current] CCH Fed Sec. L. Rep. ¶96,186 (C.A. 2, 1977).

84/ See Securities and Exchange Commission v. Penn Central Co., 425 F. Supp. 593, 597-598 (E.D. Pa., 1976) where an injunction was denied against a defendant who was partially paralized by an acute stroke and who suffered other serious physical disabilities, since the precarious state of his health made resumption of any business activities too remote a possibility. See also Securities and Exchange Commission v. Pearson, 426 F.2d 1339 (C.A. 10, 1970).

The Court further concluded that "[p]romises of reformation and acts of contrition are relevant in deciding whether an injunction shall issue, but neither is conclusive or even necessarily persuasive, especially if no evidence of remorse surfaces until the violator is caught." (Id.) 85/

Here, however, Haswell makes no claim that there have been any significant changes in circumstances. In fact, Haswell continues to be very active as a securities lawyer, having worked on more than seventy-four muncipal bond issues since the offerings complained of in the court below (R 114). 86/ Haswell is young and apparently in good health; he has not proclaimed any reformation, but has consistently denied any wrongdoing. It has been held that "in a suit for injunction, a defendant's assertion of the correctness of his behavior is a ground for restraint." Securities and Exchange Commission v. MacElvain, 417 F.2d 1134 (C.A. 5, 1969).

The delay of over four years between the acts complained of and the time the Commission brought this injunctive action was not unreasonable in this case. This delay was due, in part, to the nature of the fraudulent scheme involved in this case. A portion of the bond proceeds for these issues was, as we have noted, supra, pages 24-25 notes 43-45, escrowed and used

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85/ Accord, United States v. W. T. Grant Co., supra, 345 U.S. at 633; Los Angeles Trust Deed & Mortgage Exchange v. Securities and Exchange Commission 285 F.2d 162, 180-181 (C.A. 9, 1960); and Securities and Exchange Commission v. Manor Nursing Centers, supra, 458 F.2d at 1101 (C.A. 2, 1972).

86/ The opening paragraph of Haswell's brief in support of his motion to affirm in this Court states that he is "an attorney who practices in the area of securities law." Haswell stated in the court below that in recent years he "has been employed as counsel by many prestigious underwriting firms, manufacturing companies and public authorities to assist in the legal work related to the sale of securities." Argument of defendant Haswell in support of his proposed findings of fact and conclusions of law, filed in the district court on October 3, 1977, at page 20.

to pay interest on these three bond issues for periods of up to two years. Thus, because these companies had no requirement to report their financial condition to any regulatory authority, and because public investors were lulled by receiving a return of their capital denominated as interest payments, the true financial problems and the other elements of the fraud were not discovered for a period of time. In addition, because of the complicated nature of the transactions and the various roles of the individuals involved, it required two years to investigate and to unravel the interworkings of this sophisticated scheme. Some of the principals involved in the scheme, such as Cowell and Lancaster, have not been located. Because of these complicating factors, it was unreasonable for the district court to expect, and to require as a predicate for granting injunctive relief, that the Commission show ongoing violations of the federal securities laws by Haswell.

The evidence in this case demonstrates that Haswell's illegal conduct was willful and deliberate. We submit that, in the absence of any valid mitigating circumstances, and particularly in view of his continuing activities as securities counsel, this conduct gives rise to an overpowering inference that the defendant is likely to violate the law in the future. Thus, if this Court determines that Haswell's past conduct violated the federal securities laws, it should also determine that there is a likelihood that such conduct will persist unless his violative conduct is enjoined.

CONCLUSION

For the foregoing reasons, the judgment of the district court should be reversed and the case should be remanded to the district court with instructions to grant the relief requested by the Commission.

Alternatively, this court should direct the court below to reconsider, in the light of proper legal standards, the need for the injunctive relief requested by the Commission. In view, however, of the past procedural history of this case, the district court's unexplained hostility toward Commission counsel, and its unsupported references to the Commission's "wrongful actions" in bringing this action (see supra pages 5-6), it is respectfully requested that any remand be accompanied by instructions that the action be reassigned by the Chief Judge to a different district judge.

Respectfully submitted,

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SECURITIES ACT OF 1933, 15 U.S.C. 77a, et seq.

Section 3(a)(2)

Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:

* * *

(2) * * * any security which is an industrial development bond (as defined in section 103(c)(2) of the Internal Revenue Code of 1954) the interest on which is excludable from gross income under section 103(a)(1) of such Code if, by reason of the application of paragraph (4) or (6) of section 103(c) of such Code (determined as if paragraphs (4)(A), (5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c) does not apply to such security * * *.

SECTION 5. (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

* * *

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding of examination under section 8.

SECTION 17. (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

SECURITIES EXCHANGE ACT OF 1934, 15 U.S.C. 78a, et seq.

Section 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange--

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule Under the Securities Exchange Act of 1934

Rule 10b-5. Employment of Manipulative and Deceptive Devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

INTERNAL REVENUE CODE, Section 103(b)(6)(A), 26 U.S.C. 103(b)(6)(A)

"(6) Exemption for certain small issues—

(A) In general.—Paragraph (1) shall not apply to any obligation issued as part of an issue the aggregate authorized face amount of which is $1,000,000 or less and substantially all of the proceeds of which are to be used (i) for the acquisition, construction, reconstruction, or improvement of land or property of a character subject to the allowance for depreciation, or (ii) to redeem part of all of a prior issue which was issued for purposes described in clause (i) of this clause."