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 ANDREW J. HASWELL, JR., APPELLEE

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STATEMENT OF THE ISSUES

1. Was it a clearly erroneous finding by the trial judge that an attorney's actions and conduct, with respect to the offering circulars of three bond issuances, were neither fraudulent nor culpably reckless?

2. Was it a clearly erroneous finding by the trial judge that an attorney's tax opinion would not be the basis of civil injunctive relief sought by the Securities and Exchange Commission, whether such tax opinions were correct or incorrect on the tax law involved, since the opinions were honestly rendered?

3. Did the trial judge err in holding that the Commission had to demonstrate either fraud or culpably reckless conduct in civil injunctive relief proceedings based upon alleged violations of Section 17(a) of the Securities Act of 1933 and Section 10(b) of and Rule 10b-5 under the Securities Exchange Act of 1934?

4. Did the trial judge abuse his discretion in refusing to enjoin an attorney from future violations of the federal securities laws, due to the attorney's unblemished work for the last five years, the high quality of his work, and the failure of the Commission to demonstrate any past violations by him of the federal securities laws?

STATEMENT OF THE CASE

Appellee Andrew J. Haswell, Jr. ("Haswell") does not accept the Statement of the Case set forth in the Brief of the Securities and Exchange Commission ("the Commission"). Such statement does contain many averments not here contested; indeed, most of the evidence was either furnished by Haswell to the Commission or consists of Haswell's own sworn testimony. But the Commission repeatedly draws unwarranted inferences from the evidence and in some instances characterizes the evidence in a manner unfair to Haswell.

One subject needs to be addressed immediately. The Commission charges that District Judge Luther Bohanon was hostile toward and prejudiced against the Commission. It asks that the case be remanded and reassigned to a different district judge. The manner in which the Commission presents the record to support its charge against Judge Bohanon is illuminative of its careless approach to the facts concerning Haswell.

1. The Charge Against Judge Bohanon. The Commission first charges that Judge Bohanon rushed this case to trial four months after it was filed, granting Haswell's motion for severance and separate trial over the Commission's "pending requests for discovery," directing the Commission "to proceed to trial hastily" even though "certain important witnesses could not be located" by trial date. (SEC Br. 5)

This civil injunction action was filed against three corporations and six individuals. The corporations are all defunct. Of the six individuals, the Commission has proceeded against only three of them, two being attorneys, Haswell and Fred W. Rausch, Jr., and one corporate officer, Harold T. Pehr. The three remaining individual defendants, Messrs. Cowell, Capper and Lancaster, have never been served with process to this date - indeed, the Commission has never reissued service of process for them after the U.S. Marshall returned unserved, three days after the action was filed, the initial summons issued for them. These three persons are the very three "important witnesses" the Commission suggests it needed for its case against Haswell and whose absence Judge Bohanon ignored, the Commission suggests, because of prejudice against the Commission.

The truth is - and it was well known to both Judge Bohanon and the Commission - that the Commission had been unsuccessful in locating Messrs. Cowell, Capper and Lancaster, that it included these three persons as defendants in this action without real hope of locating them, that it had spent two years investigating this matter and building whatever case it might have against Haswell and was as prepared as it ever would be to litigate the case, that extensive discovery had been had by the Commission, that the Commission had settled upon the two attorneys, Haswell and Rausch, as its targets, and that Haswell's case should be severed from Rausch's because Rausch had no contact whatsoever with two of the three bond issues involved in the case against Haswell.

Haswell is an attorney whose professional reputation was clouded because of the publicity attending the Commission's filing of this action. (The Commission had distributed press releases which were published in numerous newspapers). Haswell prepared himself for trial. Judge Bohanon, mindful of the responsibility of the Commission not to file such actions without careful investigation and preparation, aware that the three "important witnesses" likely would never the found - particularly so because of cessation of the Commission's effort to serve them, and sensitive to the many distinctions between the Commission's cases against Haswell and Rausch, set Haswell's case for trial four months after it was filed. This, the Commission suggests, was prejudice.

The Commission fails to mention in its Brief that, prior to Judge Bohanon's setting the case for trial, the Commission had advised him by letter of July 1, 1977 that it "has decided to withdraw its Motion for Preliminary Injunction against defendant Haswell and proceed directly to the merits"! (A. 70) This letter was written after the Commission had served interrogatories on Haswell designed to assist it in determining if Haswell's work product since June 1972 showed any violation of the federal securities laws. The Commission had earlier requested Judge Bohanon by letter of June 10, 1977 (A. 67) not to rule on its Motion for Preliminary Injunction until it could analyze such work product of Haswell and had advised Judge Bohanon that if Haswell's "response to these Interrogatories shows that no subsequent violations have occurred, the Commission will voluntarily withdraw

its Motion for a Preliminary Injunction and proceed directly to the merits." (A. 68) Judge Bohanon took the Commission at its word, after subsequently receiving the Commission's July 1, 1977 letter (A. 70) stating that "[b]ased upon answers provided by defendant Haswell" the Commission withdrew its Motion for Preliminary Injunction and would "proceed directly to the merits." He set the case for trial. Yet, the Commission argues that Judge Bohanon required it "to proceed to trial hastily."

The Commission next suggests prejudice of Judge Bohanon due to his having entered an order requiring five Commission attorneys who had signed the Commission's post-trial brief to show cause why they should not be held in contempt of court. The Commission even expresses to this Court some puzzlement ("[t]he Court's order was unexplained," SEC Br. 6) but knows full well why Judge Bohanon issued such order. Despite the usual pretrial proceedings having been followed, with each side's attorneys having been required to advise the other side of all documentary evidence intended to be introduced, the Commission attached to its post-trial brief a letter it had earlier solicited from the Internal Revenue Service setting forth expert opinion evidence with respect

to unrevealed hypothetical questions touching tax law issues in this proceeding.

The IRS letter was objectionable as evidence, being the worst kind of hearsay evidence not subject to cross-examination. No effort was made by the Commission to introduce it during the trial, although its existence was well known to all parties. Instead, at the conclusion of the trial, the Commission requested the opportunity to argue its case by written brief and then attached to its post-trial brief the IRS letter and referred to such letter in its brief impliedly as expert opinion evidence supporting its construction of difficult provisions of the Internal Revenue Code! No wonder Judge Bohanon struck out at such a prohibited trial practice.

This Court should also consider whether the Commission is being careless with the facts in stating, in footnote 7 on page 6 of its Brief, that "[t]he letter had been filed with the court earlier in connection with the Commission's motion for preliminary relief." This implies the letter was already in evidence. It was not. The letter was "filed" with the court clerk at the commencement of this action as part of two boxes of documents that later were, by stipulation between Haswell and the Commission, admitted into evidence <u>solely</u> for purpose of the hearing on the Commission's motion for a <u>preliminary</u> injunction but not admitted for any other purpose. The Commission's application for preliminary injunctive relief was subsequently voluntarily withdrawn. (A. 70)

In further pursuit of its suggestion that Judge Bohanon was prejudiced, the Commission in its Brief comments repeatedly on Judge Bohanon's findings in his Memorandum Opinion and Order (A. 831) that "[i]t may be that a more careful attorney [than Haswell] would have insisted" (A. 836) upon viewing the underwriter's final form of the offering circular, that the court "is not inclined to find that Haswell's bond opinions were erroneous and incorrect" (A. 838), that after finding that Haswell had not violated the securities laws that "even if Haswell had violated the federal securities laws, the permanent injunction sought by the Commission should be denied under the circumstances" (A. 839) and that Haswell "has been gravely damaged by the Commission's wrongful actions in this case." (A. 840) These findings of Judge Bohanon are presented in the Commission's Brief as suggestions that Judge Bohanon was skirting his duty to address himself to the issues.

Judge Bohanon did not skirt the issues. He held that these proceedings require a finding of "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." (A. 836) (The Commission in commenting on this statement by Judge Bohanon of the law applicable to this case, incorrectly quotes the judge as defining the reckless standard to be conduct so reckless that it was an "extreme <u>fraudulent</u> departure" from the standards of

ordinary care. SEC Br. 3. Judge Bohanon's words were "extreme departure" not "extreme fraudulent departure." This misquote of the law applied by Judge Bohanon is repeated in the Commission's Brief on page 28 and twice on page 32.) The judge found neither fraudulent nor culpably reckless behaviour on Haswell's part. (A. 838) The judge also examined Haswell's work performed and conduct during the five years since the work was performed which is the subject of this action, and found it to be of such high quality - both legally and ethically - that no injunction should issue in any event. (A. 840)

In view of these direct statements of the law and the court's findings, which was all the judge was required to do, it is submitted that the Commission is stretching too far its prejudice case against Judge Bohanon because of his reference to what "a more careful attorney" would have done, because of his desire to avoid for the MODA bondholders a possible judicial determination that their interest received on the three MODA bond issues may not have been tax exempt, because of his statement directed at salvaging the local reputation of an attorney who may have used poor judgment years ago but whose conduct and work since then have been exemplary and beyond question, and because of his admonishment of a powerful governmental agency that resorted to prohibited practices in attempting by sleight-of-hand to bring to his attention what was inadmissible evidence.

2. Other Controversions of the Commission's Statement of the Case.

The Commission states that the essential facts in this case are not in dispute. (SEC Br. 10) Largely, this is so. What is in dispute are the inferences drawn from those facts by the district judge and the inferences drawn by the Commission. The Commission attempts to make a fraud case from what is at most a negligence case.

The issuer of the securities in question was Midwestern Oklahoma Development Authority ("MODA"), an Oklahoma development authority organized at the specific recommendation of the Department of Defense after the U.S. Air Force closed its base near Clinton and Burns Flat, Oklahoma. MODA's purpose was to buoy the local economy by attracting industry through the offer of financing in part through the issuance of tax exempt industrial bonds. (A. 832-3)

Haswell's practice prior to this time had been as a municipal or governmental bond attorney. Typically, the bond issues with respect to which he rendered legal opinions were backed by the full faith and credit of the issuing governmental body. Any offering circulars he may have prepared or reviewed typically were one or two-page sheets outlining only the most important details of the bonds. Such sheets were intended for review by the bank bond departments and the bond underwriters that specialized in municipal bonds and who made their investment decisions based upon their

knowledge of the creditworthiness of the issuing municipalities and the expertise of the bond lawyers who opined that all statutory requirements had been met by the issuing municipalities to bind their full faith and credit.

Of course, an industrial revenue bond is an entirely different creature than a full faith and credit municipal bond. It also was a relatively new creature to Oklahoma at the time in question, a creature being promoted at the time by the U.S. Congress and the Administration in Washington, D.C. through their passage of laws favorable to the issuance of this type of security.

Haswell, to his detriment, did not initially appreciate the difference in the material facts needed to be disclosed for issuance of MODA's industrial revenue bonds to the general public and for issuances of general obligation bonds to sophisticated bank bond departments and municipal bond underwriters. With respect to the first two MODA bond offerings, those involving Western States Plastics, Inc. ("WSP") and Lee and Hodges, Inc. ("L&H"), it appears that no offering circular may ever have been prepared. None was ever delivered by the underwriter to MODA or to Haswell and none was ever discovered by the Commission or introduced by it into evidence. Haswell left to the underwriter the responsibility and did not undertake himself to draft the offering circular for either of these two issues, and he did not insist upon delivery to MODA of a proper offering circular - or, indeed, any offering circular - before issuing his bond opinions.

Whether this conduct was fraudulent or culpably reckless is one of the issues in this case. To the Commission's detriment, it distorts the evidence on this issue.

a. The WSP bond issue. In the instance of the first bond issue, the WSP bonds, at the inception of discussions between MODA and the underwriter, the underwriter showed to Haswell a sketchy offering sheet the underwriter had prepared for use as a negotiating document with MODA. (A. 786 and 124) Haswell commented to the underwriter on certain inaccuracies on the first page of the draft and did not further concern himself with what changes or enlargements of disclosures of material facts should be made by the underwriter. Yet, the Commission characterizes this preliminary neogtiating document as "the disclosure document" (SEC Br. 12) and states, with no evidence to support the assertion, that certain facts not in this document were likewise not in the "final document actually distributed to purchasers of the bonds." (SEC Br. 13) No one knows what was in the "final document" or even if one was prepared.

More unfairly, the Commission imputes to Haswell knowledge that the underwriter was going to represent to the buyers of the WSP bonds that the underwriter's discount was $69,000 rather than the accurate figure, $210,000. This imputation is made from the fact that the negotiating document does state on its second page that the "fiscal fee" is $69,000. (A. 787) Yet, the undisputed evidence is that this document was shown to Haswell at the

commencement of the initial meeting at which the terms of the offering were discussed (A. 127) and during which meeting the underwriter restructured the underwriter's discount to be $210,000. (A. 127) Haswell was entitled to assume the change would be made by the underwriter in any final offering circular. The trial judge so found and also found that this evidence was insufficient to put any reasonable person on notice that a fraud was about to be perpetrated by the underwriter. (A. 835)

b. The L&H bond issue. In the instance of the second bond issue, the L&H issue, the evidence is similar. While Haswell did write to his client, MODA, on May 1, 1972 that he was meeting on May 3 with the underwriter "to finalize the circular" (A. 296), the circular shown by the underwriter to him at such meeting was extremely sketchy and incomplete. (A. 279-282) It could hardly have been intended by the underwriter as its final offering circular: it was labeled "Preliminary Circular" (A. 279) and referred to L&H's directors and officers as "Sandy," "Sam," "Guy" and "Bert." (A. 280) Haswell did offer some changes, primarily to the description of the purpose of the offering, but testified that he did not consider the draft a sales document. (A. 181) Several days after this May 3 meeting, Haswell wrote to the underwriter on May 8, 1972 and stated, "I must receive from you a copy of the Preliminary Offering Circular on the Lee & Hodges Bonds and the Final Circular on the Western States Plastics Bonds." (A. 297) He did not receive such circulars (A. 181) and later issued his bond opinion letter for the L&H issue without insisting upon delivery to MODA of a proper offering circular.

Also at issue with respect to the L&H offering circular is whether Haswell acted fraudulently or with culpable recklessness in not insisting that the L&H offering circular being prepared by the underwriter contain certain information known or imputed to Haswell. This information was (i) that the Small Business Administration earlier had declined to loan $65,000 to L&H for working capital and payment of bills (A. 132-7) , (ii) that a significant portion of the proceeds from the bonds would be used to pay past due obligations, including federal taxes (A. 144), (iii) that the bonds would be sold at a 35 percent discount (A. 295), (iv) that L&H would use immediately only about $13,000 of the proceeds of the offering to purchase land or depreciable property (A. 147-158), and (v) that the purchase of the bonds involved a high degree of risk.

Haswell did not insist upon the inclusion of these items at the time on May 3, 1972 he viewed the underwriter's initial "Preliminary Circular." However, on May 8 he wrote to the underwriter (A. 297) stating that he must receive a copy of the underwriter's preliminary offering circular - presumably the underwriter's revision of his initial document. He received none and later issued his bond opinion letter for the L&H issue, opining only on the tax exempt status of the bonds and the regularity of MODA's authorization of the issue, without first insisting upon delivery to MODA of a proper offering circular.

Again, one of the issues is whether this conduct was either fraudulent or culpably reckless. The trial judge concluded it was not (A. 835-6) but hints that he may have felt the conduct to have been negligent since "[i]t may be that a more careful attorney would have insisted" upon viewing the underwriter's final form of the offering circular. (A. 836) It is submitted, and argued later in this Brief, that the correct legal standard is fraud or culpable recklessness, not negligence.

c. The HII bond issue. In the instance of the third bond issue, the Harper Industries, Inc. ("HII") issue, Haswell undertook to draft, and did draft, the offering circular.

The offering circular is a 28-page document (A. 759) containing a wealth of information about the bonds, the industrial company, and the industrial project.

The Commission contends that Haswell's offering circular "inadequately disclosed" the existence of the underwriter's 30 percent discount and the fact that $250,000 of the bond proceeds would be used to purchase a patent of unknown value from the president of HII, Mr. Harold T. Pehr. What is being urged here by the Commission is a question of the placement and emphasis of facts in the offering circular.

The circular's cover sheet (A. 759) is the standard summary description of the bonds. Page 2 contains an "Introductory Statement" followed by a more complete description of "The Bonds,"

which description extends to the bottom of page 4, where a section entitled "Tax Exemption" is placed. On page 5 there commences a description of "The Project" which includes a subsection entitled "General" followed by "Use of Bond Proceeds." On page 5 appears the following statements:

> "The Bonds are being issued to provide funds required for acquisition by the Authority of tool and die shop equipment and machine tools . . . [and] of U.S. patent number 3,587,944 . . ." (emphasis added) (A. 763)

Immediately underneath the above statement appears the following:

"USE OF BOND PROCEEDS

SERIES 1972 A

Item	Amount
Tool and Die Shop Equipment and Machine Tools and Patent #3,587,944*	$300,280
Capitalization of portion of first two years interest on Series 1972 A and Series 1972B Bonds	186,220
Bond Discount	208,500
	$695,000

*Includes used equipment appraised by Soles Machinery Company, Kansas City, Missouri, which will remain in Kansas City. Appraisal value $50,280.00 - replacement cost." (A. 763)

SERIES 1972 B

Item	Amount
* * * *	
Bond Discount	181,500
	$605,000"

Immediately thereafter, on page 7, appears a copy of the U.S. Patent 3,587,944 and on page 8 appears a section "Certain Provisions of the Lease Agreement" in which the following statements are made:

> "$300,280 of the proceeds of the Series 1972 A Bonds shall be disbursed . . . for the purpose of acquiring tool and die shop equipment and machine tools and patent number 3,587,944. . . . The patent to be acquired by the Authority was acquired by Clyde M. Pool, d/b/a Midstates Tool & Mold Company from Harold T. Pehr, the inventor. The acquisition price paid by the Authority to the Company will be paid to Clyde M. Pool . . . who will pay $30,000 as down payment on the patent to Mr. Pehr. Mr. Pehr will receive a $220,000 note from Clyde M. Pool . . . for the balance of the purchase price."
> (A. 766) (Emphasis added)

On page 22 of the offering circular appears a list of management which identifies Harold T. Pehr as chairman, president and treasurer of HII and Clyde M. Pool as vice president of HII. (A. 780 and 782)

As for the "inadequate disclosure" of the underwriter's 30 percent discount, the "Use of Proceeds" section clearly identifies the existence and the correct amount of the discount, although admittedly the statement "these bonds are being sold at a 30% underwriter's discount," or words to such effect, never appear in the offering circular.

As for the "inadequate disclosure" of the $250,000 purchase of the patent from Mr. Pehr, an HII insider and controlling person, the amount is discernible, both from the footnote

under the table in the "Use of Bond Proceeds" section and from the statement on page 8 of the offering circular that Mr. Pehr will receive for the patent a $30,000 down payment plus a $220,000 note. Admittedly, Mr. Pehr is not identified until page 22 as a company insider and controlling person.

The Commission also questions Haswell's inclusion in the HII offering circular of company projections, unverified by him, for annual production and sales of disposable salt and pepper shakers, which ranges from 300 million shakers in the year following the offering, 1973, to over 3 billion shakers in 1982, when Haswell knew that HII was not yet in production. The circular also contained the statement, "The management team of Harper Industries has the capability to do all its own engineering and design work, and start national sales distribution immediately." (A. 780)

Perhaps Haswell was negligent in including in the offering circular these projections, which were furnished to him by HII and not checked by him for reasonableness. But as for Haswell's statement concerning the capability of HII to do its own engineering and design work and start national sales immediately, the evidence supports this statement.

The Commission's witness, Cleetus T. Groner, testified he was a design engineer with an impressive background (A. 232), went to work for HII immediately after the HII bonds were sold

(A. 233), engineered and designed the salt and pepper shaker production unit (A. 233-7), and left HII less than six months later, on March 1, 1973 (A. 233) when HII was in the process of assembling the production line (A. 237). He also testified that although the production line was not yet in production when he left, it would have made it. (A. 237)

Finally, Mr. Groner testified that HII's salt and pepper shaker, a throw-away plastic shaker intended to replace the paper shakers used by airlines, hamburger stands and the like, had been market tested and had met with "lots of enthusiasm" and general acceptance. (A. 238)

The Commission claims that Haswell prepared the HII offering circular without first having received or reviewed any actual or pro forma financial statements for HII. This is false. Pages 25 and 26 of the HII offering circular (A. 759) contain a Projected Statement of Annual Income for HII, which statement indicates the viability of HII's enterprise. Page 27 of the offering circular (R. 513) is a certified public accountant's statement as to the reasonableness of the projections for HII's operation.

To summarize the true merits of the Commission's case against the HII offering circular prepared by Haswell, the circular - though crammed with information - should have prominently

spotlighted the risks involved in a "Risk Factors" section immediately after the cover page. Haswell's failure to do this may have involved poor judgment or his own inexpertise but was not fraudulent or culpably reckless conduct. The trial judge found no fraud or culpably reckless conduct, and the evidence supports this finding.

d. Haswell's Tax Opinions. A defense of Haswell's tax opinions appears later in the legal argument section of this Brief. However, it must here be noted that there is wide disparity of opinion between the Commission and Haswell concerning (i) the proper meaning of the term "proceeds" as it is employed in 26 U.S.C. 103(b)(6)(A) and (ii) what type of expenditures qualify for the "substantially all" test set forth in the statute for the use of proceeds of an issue.

If the Commission's interpretation of the statute is correct, it would appear that none of the bondholders' interest received from the WSP, L&H and HII bonds was exempt from federal income taxation and that Haswell's bond opinions were incorrect. If Haswell's interpretation of the statute is correct, the bondholders' interest received was exempt from federal income taxation and his bond opinions were correct. Even if Haswell's bond opinions were incorrect but honestly rendered, this still does not make out a case for civil injunctive relief for fraud or culpably reckless conduct as charged by the Commission.

The Commission's recitation of facts under its section "Statement of the Case - Haswell's tax opinions" (SEC Br. 23) is most inflammatory. The Commission concludes its recitation of facts with the statement, "But he issued false opinions despite his knowledge." If Haswell agreed with the Commission's interpretation of the law, this would be a fair statement. But he does not agree. The Commission is wrong on the tax law involved, and the statement is most unfair.

Without going into the legal argument at this time, it should here be noted that Haswell and the Commission disagree in three respects concerning the proper interpretation of 26 U.S.C. 103(b)(6)(A), all of which differences are briefed later herein under "Argument": (i) the meaning of the word "proceeds," to which a test is applied concerning how substantially all of the "proceeds" are to be used, (ii) whether certain escrowed interest payments can be deemed as qualifying uses of bond proceeds, and (iii) whether Haswell's reliance upon a covenant rather than a construction fund satisfied the statutory requirement concerning the use of the proceeds of one of the bond issuances.

There is sharp difference between Haswell's and the Commission's interpretation of the law in these three respects. The Commission and Haswell do agree that approximately 90 percent of the "proceeds" (whatever that means) must be "used" (whatever that means) for certain qualifying ends. In footnote 49 to the

Commission's Brief (SEC Br. 27), the Commission sets forth a table based upon its interpretation of the tax laws, which table indicates that only somewhere between a low of 7 percent and a high of 71 percent of the bond proceeds were used for purposes qualifying the interest on the bonds as exempt from federal income taxation.

It should here be noted that Haswell's interpretation of 26 U.S.C. 103(b)(6)(A) led him to conclude, at the time he rendered the WSP, L&H and HII-B tax opinions, that the bond proceeds would be used in a manner consistent with statutory requirements, as follows:

	WSP	L&H	HII-B
Face amount	$700,000	$200,000	$605,000
Less bond discount	210,000	70,000	181,500
Less Attorney fees	12,459	6,750	-
Less trustee fees	1,400	700	2,600
Less trustee attorney fees	1,930	400	-
Proceeds	$474,211	$122,150	$420,900
Uses qualifying for "substantially all" test:			
Equipment purchases	$339,187	$ 13,318	$384,600
Escrowed interest	86,025	14,000	36,300
Covenanted purchases	-	94,832	-
	$425,212	$122,150	$420,900
Percent of Proceeds	90%	100%	100%

At trial, Haswell testified as to the legal basis for his tax opinions. The Commission's tax argument was based primarily upon an expert opinion letter it had earlier solicited from the Commissioner of Internal Revenue, which letter had never been offered or received into evidence but which was attached to the Commission's post-trial brief. The letter was, in fact, obviously inadmissible as expert opinion evidence since (i) it addressed itself to hypothetical questions set forth in a never-revealed letter from the Commission to the I.R.S. and (ii) it based some of its conclusions upon Treasury regulations not only neither proposed nor adopted at the time Haswell had rendered his three tax opinions but in one instance directly reversing the effect of proposed regulations existing at the time Haswell rendered his opinions.

The trial judge felt it was not necessary to rule directly on the highly technical points of the tax law involved, since (i) the nature of this proceeding is a civil injunction action based upon alleged violations of the federal securities law, (ii) since the alleged securities law violations require a finding of conduct either fraudulent or culpably negligent, and (iii) since Haswell's tax opinions were "carefully considered opinions and, whether right or wrong, were made in good faith" and "neither negligently nor recklessly reached." (A. 838)

SUMMARY OF AGRUMENT

Violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and violations of Section 17(a) and the Securities Act of 1933 both require findings of scienter, that is, fraudulent or recklessly culpably conduct. The evidence supports the trial judge's finding that scienter was not present.

The trial judge did not commit reversible error in failing to make a formal finding whether Haswell's tax opinions were correct or incorrect. Justice would not be served by such a finding, particularly in view of the trial judge's conclusion that even if they were incorrect, they were carefully and honestly rendered and did not provide the proper basis for the injunctive relief sought by the Commission.

The evidence supports the trial judge's exercise of discretion in refusing to grant the injunctive relief sought by the Commission. At the least, no abuse of discretion is shown.

ARGUMENT

I. THE TRIAL JUDGE WAS NOT ERRONEOUS IN HOLDING THAT HASWELL DID NOT VIOLATE, NOR AID AND ABET VIOLATIONS OF, THE ANTI-FRAUD PROVISIONS OF THE FEDERAL SECURITIES LAWS.

It is submitted that the Statement of the Case set forth earlier in this Brief demonstrates that Haswell's actions with respect to the three bond issues did not involve scienter, i.e.,

that he was not guilty of fraudulent conduct, and that the trial judge also was justified in concluding that such conduct was not culpably reckless.

Haswell may have exercised poor judgment. In failing to insist upon viewing the underwriter's final offering circulars for the WSP and L&H bond offerings before rendering his bond opinions, Haswell admittedly did not exhibit that degree of care that, as the trial judge stated, "a more careful attorney would have insisted upon." (A. 836) It should be stressed that Haswell never undertook to prepare these two circulars. The underwriter did. HAswell did not represent the underwriter.

As for the HII offering circular, which was prepared by Haswell, the Commission finds fault in Haswell's placement and emphasis of material. This is far from being fraudulent or culpably reckless conduct.

The tax opinions are challenged by the Commission not only as being wrong on the tax law questions involved but as being rendered with knowledge of the wrongness, i.e., given with scienter. The trial judge found, however, that the opinions were "carefully considered opinions and, right or wrong, were made in good faith" and "were neither negligently nor recklessly reached." (A. 838)

In essence, the worst characterization that the trial judge may have made of Haswell's conduct, other than the three bond

opinions, is negligence. And not even negligence was found to be involved in rendering the bond opinions. Placed sharply in issue is the question: does negligence alone suffice for injunctive relief by the Commission?

A. COMMISSION INJUNCTIVE RELIEF UNDER SECTION 10(b) OF THE SECURITIES EXCHANGE ACT AND RULE 10b-5 THEREUNDER REQUIRES A FINDING OF SCIENTER, THAT IS, FRAUDULENT OR RECKLESSLY CULPABLE CONDUCT.

On March 30, 1976, the Supreme Court held in Ernst & Ernst v. Hochfelder, 425 U.S. 185, that scienter on the part of the defendants was required for the plaintiffs to prevail in a private action for damages under Section 10(b) and Rule 10b-5 of the 1934 Act. The Supreme Court defined scienter as "a mental state embracing intent to deceive, manipulate or defraud." 425 U.S. 185, at 193 n. 12. The opinion relies solely upon the wording of the statute and the rule and their legislative or administrative histories. The Supreme Court refused to examine the policy behind the statute in reaching its holding. Id. at 214 n. 33. The Supreme Court first focused upon the words "manipulative," "device," and "contrivance" which are contained in Section 10(b), and emphasized that these terms "make unmistakable a congressional intent to proscribe a type of conduct quite different from negligence." Id. at 199.

The Supreme Court also rested its opinion upon an analysis of legislative history. It emphasized that the 1933 and 1934

Acts constitute interrelated components of the federal securities regulation scheme, and when the Congress intended to create civil liability under these Acts for negligence or innocent mistake, it did so with clear specificity. Id. at 207-208. The Supreme Court also examined the language and administrative history of Rule 10b-5 and reasoned that the scope of the rule cannot exceed the power granted by the Congress under Section 10(b).

Whether or not the Supreme Court's holding in Hochfelder requiring scienter is dispositive in Commission injunctive proceedings under Section 10(b) and Rule 10b-5 has been a question since Hochfelder was handed down. The Supreme Court was careful to state that the question involved was, whether a private cause of action for damages will lie in the absence of scienter, and the Supreme Court stated unequivocally in a footnote:

> Since this case concerns an action for damages we also 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. Id, at 193 n. 12.

The holding in Hochfelder was a severe blow to the "10b-5 class-action bar" as well as to the Commission. One can hardly blame the Commission for attempting to wring as much as it can from the sop set forth in footnote 12 on page 193 of the opinion. There are post-Hochfelder decisions of both circuit and district courts that seem to hold that a finding of negligence is sufficient for a

Commission injunctive action based upon alleged violations of this statute and rule. To the extent that such decisions have so held, it is submitted that they are patently wrong.

An injunctive proceeding is based upon there being a past violation, a present violation or a future likely violation of one of the sections of the federal securities laws. In the instance of Section 10(b) and Rule 10b-5 of the 1934 Act, Hochfelder settled one thing: there was "a congressional intent to proscribe a type of conduct quite different from negligence." Id. at 199. That type of conduct involves scienter, conduct that is either deemed to be fraudulent or so reckless that under traditional concepts a finding of fraud may be imputed. The burning question is, can it be that the Congress intended one thing for a private cause of action and another thing for injunctive proceedings?

It is submitted that this simple approach to this issue is unassailable. The Supreme Court's findings that scienter is required in a civil action brought under this section and rule is based upon its finding of a congressional intent extracted from the very words of the statute and upon the Supreme Court's analysis of the legislative history behind the adoption of the 1933 and 1934 Acts. If the Congress had intended that the words of Section 10(b) of the 1934 Act were to mean different things in different contexts, it should have been specific in so providing. It did not, and the words must have the same meanings in all contexts.

The Commission, in its Brief, cited several pre-Hochfelder cases, apparently to demonstrate that the great weight of authority prior to Hochfelder sustained the granting of injunctions to the Commission upon a finding of mere negligence on the part of the defendants. Among such cited cases was this Circuit's case, S.E.C. v. Pearson, 426 F.2d 1339 (10th Cir. 1970). Obviously, the line of authority of all such cases was placed in doubt by Hochfelder.

Subsequent to Hochfelder there have been several federal district court and federal circuit court opinions which have examined with some care the requirement of scienter in Commission injunctive actions under Section 10(b) and Rule 10b-5. Despite dicta with respect to a lack of a scienter requirement in certain of these judicial decisions, not one court has in fact granted the Commission an injunction in the absence of scienter on the part of the defendants.

The first judicial opinion after Hochfelder to deal in any depth with the question of scienter in Commission injunctive actions based upon Section 10(b) and Rule 10b-5 was S.E.C. v. Bausch & Lomb, Inc., 420 F. Supp. 1226 (S.D.N.Y. 1976), affim on other grounds, CCH Fed. Sec. L. Rep. Para. 96,186 (2d Cir. 1977). In Bausch the district judge concluded that the Supreme Court's reasoning in Hochfelder compels a scienter requirement in a suit for injunctive relief brought by the Commission. District Judge Ward stated as follows:

> The Supreme Court found, "the language and history of section 10(b) dispositive." . . . These stand at least as conclusively when the SEC is plaintiff. The private damage action brought under this section is a creation of the courts. . . . If the "language and history of section 10(b) [are] dispositive" as to the scienter question in private actions, must they not also be so in "SEC suits for injunctions [which] are 'creatures of statute'." . . . Argument drawing upon the words of section 10(b) and the history, legislative and administrative, of both section 10(b) and rule 10b-5 applies equally to private suits and actions brought by the Commission. Id. at 1240-41.

Soon after Bausch the U.S. Court of Appeals for the First Circuit decided S.E.C. v. World Radio Mission, Inc., 544 F. 2d 535 (1st Cir. 1976). Here the Commission had sought to enjoin a religious organization and its leader from selling interest bearing notes, in some cases together with a bonus acre of land, to the public under the guise of a bona fide investment. The district court had refused to grant the injunction, but the First Circuit reversed. Judge Aldrich, writing for the court, appeared to reject any requirement of scienter in a Commission injunctive action under Section 10(b) and Rule 10b-5. Such apparent holding, however, is undercut by the extended treatment which the Court of Appeals accorded to the defendants' misrepresentations and omissions of significant economic facts:

> [D]efendants make the contention that there was no intent to deceive. It is true that in the court below, perhaps moved by deference toward an admitted religious organization, plaintiff did not press a claim of intent to deceive, taking the position that it was immaterial. Had this been a concession of the factual issue, it might be thought over-generous. Assuming that defendants' religious motives and purposes were of the highest, it is nonetheless difficult to think they believed that every thing they said was accurate. . . . Confidence that they would be financially successful eventually, or even that no investor would lose money, is in no way equivalent to honesty as to particular representations. Id. at 539 (emphasis added)

Here the Circuit Court had a dilemma. It wanted to stop a clear violation of the securities laws, but it did not want to brand an accepted religious organzation as a collection of crooks. Had the same misrepresentations and omissions been disseminated by a business organization, they would undoubtedly had elicited findings of scienter by the First Circuit. It is submitted that World Radio Mission is poor authority for the position taken by the Commission that negligence alone suffices in a Commission injunctive proceeding based upon violations of Section 10(b) and Rule 10b-5 of the 1934 Act.

The next decision focusing upon this problem was S.E.C. v. Geotek, 426 F. Supp. 715 (N.D. Cal. 1976). Here the district court, without undertaking to analyze whether scienter or negligence is the proper standard in Commission injunctive relief actions under Section 10(b) and Rule 10b-5, held that this was an open legal question and concluded that "[f]or the purposes of this

action, however, we have decided to apply the strict standard of negligence (i.e., ordinary care or due diligence) as to all SEC claims against defendants." Id. at 726. The district court them purportedly proceeded to apply this negligence standard to the facts of the case before it. After finding against the principal defendants on certain charges and in their favor with respect to other charges, the district court then refused to enjoin the principal defendants in the absence of a finding of scienter:

> With respect to the several charges as to which the Court has found against the [principal] defendants, the Court has further found that the misrepresentations and/or omissions were made by those defendants, not merely negligently due to their failure to use ordinary care, but deliberately and with intent to deceive - i.e., "scienter" within the meaning of Ernst & Ernst v. Hochfelder . . . . Id. at 729 (emphasis added)

On February 24, 1977 the U.S. District Court for the Eastern District of Virginia decided S.E.C. v. American Realty Trust, CCH Fed. Sec. L. Rep., 1976-77 Transfer Binder, para. 95,913. Here, Chief Judge Kellam stated that the Supreme Court's decision to require scienter in Hochfelder was dispositive of the case at bar:

> If the language and history of 10(b) is dispositive as to a scienter requirement in private actions, it must also be so for SEC enforcement actions, since such suits are creatures of statute rather than implied rights of action. Only policy considerations which have traditionally been applied to distinguish the two kinds of cases . . . could support a contrary result, but the Supreme Court in Hochfelder found no reason to even examine such considerations, since in its opinion the language and history of the Act were dispositive. Id., at 91,440.

Chief Judge Kellam cited Bausch with approval, applied a scienter standard to the facts before it and found that the defendants "did not possess the requisite intent to deceive, manipulate or defraud." Id.

In S.E.C. v. E. L. Aaron & Co., Inc., CCH Fed. Sec. L. Rep. para. 96,043 (S.D.N.Y. 1977), the U. S. District Court for the Southern District of New York granted injunctions in a Commission action brought under Sections 17(a) of the 1933 Act, Section 10(b) of the 1934 Act, and Section 5 of the 1933 Act. Judge Gagliardi, after stating that a legal standard of negligence is all that is required under Sections 10(b) and 17(a), significantly made a specific finding of scienter on the part of the defendant. With respect to Section 5 of the 1933 Act, Judge Gagliardi also specifically found that the defendants acted with knowledge or reckless disregard of the illegality of the arrangement in question and that this was sufficient to establish scienter. Id. at 91,686.

To summarize the foregoing development of post-Hochfelder case law with respect to Section 10(b) and Rule 10b-5 under the 1934 Act, the courts have either (i) held that scienter or culpably reckless conduct is the proper legal standard for Commission injunctive relief actions or (ii) while stating that negligence is a sufficient standard have nevertheless found scienter or culpably reckless conduct to be present in each instance in which injunctive relief was granted.

In Bausch the court clearly stated that scienter is the proper legal standard and buttressed this decision with appropriate legal reasoning. In World Radio Mission, the court appeared to reject a scienter requirement but went to great lengths to describe and analyze an "intent to deceive" on the part of the defendants. In Geotek, the court assumed, without deciding, the propriety of establishing a standard of negligence but only enjoined where it found scienter. In American Realty Trust, the court followed the reasoning set forth in Bausch and clearly required scienter to be a necessary element in an action for injunctive relief. In Aaron, the court choose a legal standard of negligence but before granting the injunction made a specific finding that scienter was present.

It is submitted that there is no better reasoned opinion than District Judge Ward's opinion in Bausch. Since the Supreme Court found the language and legislative history of Section 10(b) dispositive in a civil damages action, such language and legislative history must stand equally as dispositive when the Commission is the plaintiff in an injunctive action which is a creature of statute.

B. COMMISSION INJUNCTIVE RELIEF UNDER SECTION 17(a) OF THE 1933 ACT REQUIRES A FINDING OF SCIENTER, THAT IS, FRAUDULENT OR RECKLESSLY CULPABLE CONDUCT.

The Supreme Court has not yet ruled on the question of whether a finding of scienter is a prerequisite to Commission

injunctive relief in actions bottoming upon Section 17(a) of the 1933 Act. Hochfelder is confined to Section 10(b) of the 1934 Act and Rule 10b-5 thereunder.

It will shortly be demonstrated that the language and legislative history of Section 17(a) of the 1933 Act present an even more compelling case for a necessity of scienter than does the language and legislative history of Section 10(b) of the 1934 Act. However, a few remarks are first in order to demonstrate the weakness of the argument advanced by the Commission in support of its theory that negligence alone suffices for Section 17(a) injunctive relief proceedings.

The Commission primarily relies upon a reference to a statement made by Justice Powell in Hochfelder discussing contentions of the Commission with respect to subsections (b) and (c) of Rule 10b-5, which subsections, the Commission points out, are drafted in language virtually identical to subsections (2) and (3) of Section 17(a). The Commission argues that the statement of Justice Powell "affirmatively supports the proposition that subsections (2) and (3) of Section 17(a) are violated by negligent conduct." (SEC Br. 54-5) Nothing could be farther from the truth.

Justice Powell referred to the contentions of the Commission as contentions. He then stated that "viewed in isolation" the language "arguable . . . could be read" as proscribing certain conduct that has the effect of defrauding investers whether the

wrong-doing was intentional or not. 425 U.S. 185 at 212. Justice Powell immediately proceeded to state that such a reading could not be harmonized with the administrative history of Rule 10b-5 but, more importantly, Justice Powell pointed out that the rulemaking power of the Commission is not the power to make law but is only the power to adopt regulations to carry into effect the will of the Congress as expressed by a statute. Justice Powell, referring to his earlier statements that both the language and the legislative history of Section 10(b) evidenced a congressional intent to require scienter, held that the Commission, through a rule, could not extend the scope of the statute to negligent conduct. Id. at 212-214.

The Commission has misread Justice Powell's language. It has failed to give proper respect to Justice Powell's reference to this line of argument as a Commission contention and his precatory comments such as "viewed in isolation," "arguably," and "could be read."

This same error in reasoning was picked up by the Court of Appeals for the Second Circuit in S.E.C. v. Coven, CCH Fed. Sec. L. Rep. para. 96,462 (1978), which case is cited with approval by the Commission in its Brief. Coven is also subject to attack on the ground that, even through the Second Circuit held that negligence is an appropriate standard for Commission injunction relief in an action based upon a violation of Section 17(a), the court specifically found that the conduct of the enjoined defendant involved scienter. As stated that Judge Mansfield:

> After the June 12 meeting, which clearly put appellant on notice that a question existed as to whether 3,000,000 shares had been sold, he promptly wrote a letter falsely stating that 3,075,000 shares had been purchased without having any basis for this representation. This action not only was negligent for purposes of Section 17(a), but also amounted to the kind of "reckless disregard" we have recently held sufficient to support a finding of scienter in a private damage action under Section 10(b) of the 1934 Act. CCH Fed. Sec. L. Rep. at 93,680-1.

The Commission also cites with approval the holding in World Radio Mission, which holding has already been discussed above in the argument with respect to Section 10(b) of the 1934 Act. As earlier noted, even though Judge Aldrich in World Radio Mission appeared to reject any requirement of scienter, he made findings of fact strongly suggesting scienter but he refrained from characterizing the acts as fraudulent apparently because the defendant was a religious organization.

The Commission also relies upon a 1966 case decided by the Seventh Circuit, S.E.C. v. Van Horn, 371 F.2d 181. It was held in Van Horn that under Section 17(a) of the 1933 Act, proof of scienter or fraudulent intent is not essential in a suit for injunctive relief. The decision was based upon approval of the rationale as to certain "policy considerations" employed in S.E.C. v. Capital Gains Research Bureau, 375 U.S. 180 (1963), an injunctive action brought under the Investment Advisors Act of 1940, and upon a specific finding that the legislative history of the 1933 Act indicated that no requirement of an intent to defraud was necessary for Commission injunction actions.

The reference in Van Horn to the legislative history of the 1933 Act is interesting. The Seventh Circuit stated:

> In view of the plain language employed by Congress, it would be presumptous on our part to hold that the applicability of the clauses involved is dependant on intent to defraud. Not only did Congress fail to include such a requirement, but legislative history indicates that it did so deliberately. An earlier version of the Securities Act of 1933 passed by the Senate would have required that the Commission prove wilfulness and "intent to defraud" even for an injunction. The House version contained no such requirement. In conference, the House version of Sec. 17(a) was adopted and became the law. 371 F.2d 181 at 185.

As will next be shown, Senior Judge Major, in Van Horn, misread the legislative history of the 1933 Act.

a. Legislative history of Section 17(a) of the 1933 Act. In the hearings on the Roosevelt Administration's bill preceding enactment of the Securities Act of 1933, which hearings were held on March 31, 1933 before the Committee on Interstate and Foreign Commerce, House of Representatives, 73d Congress, 1st Session, two witnesses who had framed and drafted the proposed legislation appeared before the Committee. They were Mr. Huston Thompson, a former member of the Federal Trade Commission who was introduced by Chairman Sam Rayburn as a man "who has had quite a lot to do with the framing of this bill," (Hearings on H.R. 9314 Before the House Committee on Interstate and Foreign Commerce, 73d Cong., 1st Sess. (1933), p. 1) and Mr. Ollie M. Butler, Foreign Service Division, Department of Commerce, who qualified himself in his statement set forth below.

In the original bill, what now appears in the 1933 Act as Section 17(a) and Section 20 (the civil injunction and criminal prosecution provision) were placed together in one section, Section 13. The following testimony, with reference to Section 13 of the original bill, is made with reference to what is today's Sections 17(a) and 20 of the 1933 Act.

The opening statement was made by Mr. Huston Thompson.

Mr. Thompson (While reciting earlier efforts to pass similar legislation in earlier Congresses and in referring to the third attempt, which was a bill introduced in an earlier Congress by Rep. Sabath)

> Then we had the Sabath bill - Cong. Sabath's bill. That was a fraud bill. We cover the subject of fraud in this bill of ours. (Id., p. 11)
>
> * * * * * * *
>
> There are several other points which I want to bring up.
>
> We have the fraud section. Let me read briefly a paragraph from the fraud clause, section 13, page 24:
>
> "Section 13. That it shall be unlawful for any person . . . in any interstate sale, promotion, negotiation, advertisement or distribution of any securities defined by this Act willfully to employ any device, scheme, or artifice to defraud or to obtain money or property by means of any false pretense, representation or promise, or to engage in any transaction, practice or course of dealing relating to the interstate purchase or sale of any securities which operates or would operate as a fraud upon the purchaser . . .. Whenever it shall appear to the Commission that the practice investigated constitutes a fraud or an attempt to defraud under the provisions of this section (13) it shall transmit such evidence as may be available concerning the transaction or facts complained of to the Attorney General, who may in his discretion bring an action . . . to enjoin the continuance of such practices or transactions and/or may institute the necessary criminal proceedings . . . under this Act."

In substance, that is a combination of, I would say, the Denison bill and the Sabath bill on that subject, and I ask you to keep in mind when you go into the bill that always in the background there is this fraud section. (Id., p. 13)

* * * * * * *

The Chairman Will you proceed, Mr. Thompson?

Mr. Thompson Section 13 covers fraud. We have already discussed that.

Section 14 covers the violation of State laws. (Id., p. 32 and 33)

* * * * * * *

Mr. Wolverton (A member of the Committee).

Is there not any general jurisdiction or power in the FTC to stop unfair practices?

Mr. Thompson Yes; there is. But you have overlooked the fact that if a fraud is committed, there is a fraud section in this bill that I would like to come back to. Let us get that, because that is very important in line with your question. Let us go back to Section 13. You will recall that I asked you to keep that in mind all the way through this hearing.

* * * * * * *

Mr. Wolverton The clause referred to by you does give some measure of help it is true - how much, I am not prepared to say. Theoretically it gives some measure of relief to a person who has suffered by reason of fraud. (Id., p. 54).

The next person to appear before the Committee and make a statement was Mr. Ollie M. Butler, Foreign Service Division, Department of Commerce.

Mr. Butler — I have been associated daily with the drafting of this bill for some months past. I have seen it grow from a skeleton outline to a full-bodied bill. I have seen clauses put in and taken out and I know the reasons for most of the changes, and feel that I am perhaps peculiarly familiar with the various provisions.

* * * * * * *

Sections 13 and 14 are auxiliary to this main body of the bill (Sections 1 through 12) and were inserted for two reasons: First, because it has been necessary to include exemptions from the main body of the bill in order to facilitate normal and legitimate business transactions. Every time that an exemption is made to this main provision it opens a way for evasion, and it is almost impossible to insert an exception without it being used by the fraudulent promotor as a vehicle for the evasion of that provision.

Therefore, Section 13, the fraud section, was added to control those who managed to evade the main provisions of the law. (Id., p. 116)

The bill with respect to which the above testimony was given was replaced by a clean bill substantially similar to it for purposes of the legislative history of interest to us. One interesting difference is that while the original bill did not state that one of its purposes was to prevent fraud in the interstate sale of securities, the reported bill and the bill approved by the conference committee (which became the Securities Act of 1933) was amended to provide that it was:

> An Act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes. (Preamble of the Securities Act of 1933) (Emphasis added)

Of particular interest is that the legislation's original Section 13 (with respect to which the above testimony was directed) was broken into two sections, today's Sections 17 and 20, and that Section 17 was labeled by the draftors to carry the heading "Fraudulent Interstate Transactions," the only section in the 1933 Act labeled with the word fraud and the only section in the 1933 Act in which the word "fraud" appears.

The above legislative history is exceptionally strong evidence of the congressional intent with respect to Section 17(a) of the 1933 Act. The Congress had fraud in mind when it drafted and enacted Section 17(a) of the 1933 Act.

It was so held by the District Court of the Eastern District of Virginia earlier this year in S.E.C. v American Realty Trust, supra, which court also stated that the Commission, in a civil injunction action, must either prove scienter or the kind of recklessness that is equivalent to willful fraud. In accord is the Southern District of New York in S.E.C. v. Bausch & Lomb, supra, and the Northern District of Illinois in S.E.C. v. Cenco, CCH Sec. L. Rep. para. 96,133 (1977).

II. THE TRIAL JUDGE DID NOT COMMIT REVERSIBLE ERROR IN FAILING TO MAKE A FORMAL FINDING WHETHER HASWELL'S TAX OPINIONS WERE CORRECT OR INCORRECT IN VIEW OF THE TRIAL JUDGE'S CONCLUSION THAT, EVEN IF THEY WERE INCORRECT, THEY WERE CAREFULLY AND HONESTLY RENDERED AND DID NOT PROVIDE THE PROPER BASIS FOR INJUNCTIVE RELIEF.

a. Haswell's tax opinions were correct.

The first difference between the Commission's and Haswell's interpretations of the language of 26 U.S.C. 103(b)(6)(A) is the meaning of the word "proceeds" as it appears as follows:

> 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 . . .. (Emphasis added)

The Commission interprets "proceeds" to mean the same thing as "face amount" despite the fact that the two terms both refer to the word "issue" in the same sentence. Tax laws are tightly drafted. It makes no sense to suppose, as the Commission does, that our tax law drafters intended that "the face amount of an issue" shall mean the same thing as "the proceeds of an issue" when the two terms appear in the same clause of a single sentence of the Internal Revenue Code. The "proceeds of an issue" means the proceeds received by the issuer after the offering expenses are paid. This is what the issuer gets, and it is this net proceeds that the issuer must be careful to devote "substantially all" of to certain ends if the interest on the bonds is to be exempt from federal income taxation.

What are the expenses of an issue? At the time Haswell wrote his three tax opinion letters in question, the example under then proposed (and made effective August 2, 1972) Treasury Regulation 1.103-8(a)(5) (relating to tax exempt bonds to finance certain exempt facilities) stated in part:

> "The arrangement provides that (1) A will issue bonds the proceeds of which (after deducting bond election costs, costs of publishing notices, attorneys' fees, printing costs, trustees' fees for fiscal agents, and similar expenses) will be $20 million . . ." (emphasis added)

The example is illuminating not only in demonstrating that Treasury itself recognizes that the "substantially all" test applies not to the face amount of a bond issue but to the proceeds to the issuer after deducting expenses related to the issuance of the bonds but it demonstrates that Treasury also recognizes that attorneys' fees and trustees' fees are part of these issuance expenses. Haswell, like Treasury, so recognized them in preparing his tax opinions. The Commission does not, but gives no reasons. (SEC Br. 24)

Incidentally, Haswell does not quarrel with the Commission's position that at least 90% of the proceeds should be devoted to qualifying uses to satisfy the "substantially all" test. This percentage appeared no place in the Code or the regulations in 1972, the year of the opinions involved, and did not appear until 1975, when it appeared in the regulations. Nevertheless, in the many examples in the Treasury regulations related to the many classes of tax exempt bonds recited in Section 103 of the Code, the test consistently applied by the Treasury was and is 90%. Haswell in 1972 observed this 90% gloss of the Treasury Department, as will be seen later.

The second difference between the Commission's and Haswell's interpretation of 26 U.S.C. 103(b)(6)(A) is whether interest payments escrowed for payment to bondholders during the start-up period - the installation or construction period -can be deemed to be used for qualifying purposes, that is

> ". . . 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 used for purposes described in clause (i) or this clause."

Haswell contends such escrowed interest payments are qualifying uses, and the Commission takes the position they are not qualifying uses if the taxpayer (i.e., WSP, L&H and HII) does not elect to capitalize such payments on its books but, rather, expenses them for its income tax purposes (SEC Br., p. 24-5, footnotes 43 and 45).

The Commission cites no authority for its position. It cannot. There is none. The truth is, at the time Haswell wrote his three tax opinions there were no regulations on the subject. On June 5, 1971 - i.e., before the three tax opinions were written by Haswell - Treasury proposed a regulation on point and adopted it with some revisions on August 3, 1972 - i.e., after Haswell's tax opinions were written. This regulation, Regulation 1.103-10(b)(2)(ii)(e), confirms the position Haswell took with respect to treating the escrow of interest payments for the start-up installation and construction period as a qualifying use under 26 U.S.C. 103(b)(6)(A).

Such regulation deals with what qualifies as a "capital expenditure" during the three years before and the three years after the issuance of bonds for purposes of calculating the $5

million limitation set forth in 26 U.S.C. 103(b)(6)(D). These are the expenditures to which the "substantially all" test applied. Such regulation provides, in pertinent part, as follows:

> ". . . an expenditure (regardless of how paid, whether in cash, notes or stock in a taxable or nontaxable transaction) is a Section 103(b)(6)(D) capital expenditure if -
>
> * * * * *
>
> "(e) The capital expenditures were properly chargeable to the capital account of any person . . . determined, for this purpose, without regard to any rule of the Code which permits expenditures properly chargeable to capital account to be trested as current expenses. With respect to obligations issued on or after August 8, 1972, determinations under the preceding section shall be made by including any expenditure which may, under any rule or election under the Code, be treated as a capital expenditure (whether or not such expenditure is so treated)." (Emphasis added)

What this Regulation says is that if WSP, L&H or HII could have capitalized the escrowed installation and construction period interest payments, they must treat such payments as capital expenditures for Section 103 purposes even if they elected not to capitalize them but, instead, to expense them. The three companies all had such an election to either expense or capitalize these payments by reason of 26 U.S.C. 266 and Regulation 1.266-1(a), (b)(1)(ii), and (iii). What elections they made are immaterial.

The third difference between the Commission's and Haswell's interpretation of 26 U.S.C. 103(b)(6)(A) is the effect

of Haswell's having rendered a favorable tax opinion and drafted a lease agreement for the L&H bond issue which involved the following application of the net proceeds received from the sale of the bonds: MODA paid the net proceeds to L&H in consideration of (i) a bill of sale for L&H's interest in equipment already installed in and leasehold improvements earlier made to MODA's facility and (ii) L&H's covenant to use such net proceeds to acquire and construct, during the next three years, the capital assets adequate for the needs of L&H in manufacturing its products. (A. 502) No construction fund was provided to insure that L&H would so use such net proceeds. In fact, L&H immediately used most of the net proceeds to pay off existing indebtedness and for working capital, and MODA and Haswell were aware this would likely be the immediate use of the proceeds. (A. 147-8)

Haswell's L&H tax opinion was grounded importantly upon a covenant given by L&H. The use of covenants in tax-exempt bond financing is widely employed and recognized. For example, any of the many categories of Section 103 bonds may lose tax-exempt status if, except for a temporary period - generally, the installation or construction period, the bond proceeds are expected to be invested in other obligations with materially higher yields. Prop. Reg. 1.103-13 and 14, published June 1, 1972. In such case, the bonds became taxable "arbitrage bonds." 26 U.S.C. 103(c)(2). One month after Haswell wrote his L&H tax opinion based upon the use of a

covenant, the Treasury Department proposed regulations recognizing that what would otherwise appear to be arbitrage bonds will not be deemed to be so if the issuing authority provides its covenant that it will make no use of the bond proceeds that would cause the bonds to be classified as arbitrage bonds. Prop. Reg. 1.103-13(a)(2)(iii), proposed June 1, 1972 and set forth in the Appendix attached to this Brief.

Admittedly, the covenant technique used to defeat classification of bonds as arbitrage bonds is not precisely on point and was not even proposed by Treasury until a month after Haswell rendered his L&H tax opinion. But he testified that at the time he rendered his L&H bond opinions he was already aware of the pending proposed regulation by having attended a professional seminar given by the very person who was drafting the proposed regulation for Treasury. (A. 154-5)

He also had learned at this seminar that the proposed regulation was going to recognize a three-year (and longer in some instances) period within which bond proceeds could be invested in other obligations with materially higher yields before employment of the proceeds for the uses for which they has been obtained.

He also had before him the statutory language of Section 103(b)(6)(D) which recognized a three-year period after a bond issuance for accounting for capital expenditures for the purpose of increasing from $1,000,000 to $5,000,000 the exemption for small issue industrial development bonds.

Based upon the foregoing knowledge of statutory law and of regulations soon to be proposed that recognized temporary other uses of bond proceeds for three years and employed covenants to protect tax exempt status, Haswell concluded it would be permissible to allow L&H to make other uses of the L&H bond issue for three years provided L&H covenanted to acquire during such period capital assets in an amount substantially equal to the bond proceeds.

It may be - without suggesting that it is so - that Haswell was wrong. If so, this is the first forum in which his judgment has been challenged. Indeed, for the purposes of this proceeding it is not even necessary to determine whether he was correct or not, something the trial judge recognized. (A. 838) What is material here, a civil injunction proceeding looking to the future, is whether Haswell honestly rendered his three MODA opinions.

In this respect, there is little in the record to support the Commission's statement (SEC Br. 27) that "Haswell knew, there was little likelihood that L&H . . . would be able to purchase, within three years, the substantial amount of equipment it was required to purchase under the terms of the leases drafted by Haswell." Haswell was aware of L&H's distressed financial position but testified he was also aware at the time that L&H was contemplating cutting its production costs by developing its own frame and lathe turning facilities, that L&H was discussing with MODA the

leasing of another building for that purpose, that such would place L&H in a position to increase its productive facilities, and perhaps that L&H was considering acquiring its own transportation rolling stock to further cut its costs. (A. 158-9) He did not, however, regard it as his duty to make an economic evaluation of L&H or make financial judgments with respect to L&H's future earnings abilities; he directed his inquiry toward L&H's business intentions for the next three years. (A. 159-60)

Perhaps he should have insisted upon being provided an expertly prepared economic evaluation of L&H's earnings ability after the infusion into it of the proceeds of the bond issuance. It is submitted that the sole issue before the Court is whether such failure amounted to fraudulent or culpably reckless conduct. The trial judge, who heard Haswell's testimony and weighed the evidence, found Haswell's defense of his bond opinions "most convincing," that the bond opinions were "carefully considered opinions and, whether right or wrong, were made in good faith," and that "Haswell's opinions were neither negligently nor recklessly reached." (A. 838) It is submitted the record contains a amplitude of evidence to support this finding by the trier of facts.

b. Even if Haswell's tax opinions were incorrect, since he honestly rendered them, his actions do not constitute aiding and abetting a violation of Section 5 of the 1933 Act.

The Commission, on page 63 of its Brief, notes that the three bond issues in question could not have been marketed without a tax opinion of counsel. The Commission then states that, by issuing tax opinions which he knew or should have known were false, Haswell violated and aided and abetted violations of Section 5 of the 1933 Act.

It should be noted that the Commissions's position is that Haswell "knew or should have known" that his tax opinions were false. It is here conceded that, if such were the case - and this is contrary to the trial judge's findings - the Commission would be correct. In fact, an attorney who issues tax opinions which he knows or should know are false not only violates Section 5 of the 1933 Act but also violates the anti-fraud provisions of the 1933 and 1934 Acts, due to the presence of scienter or culpably reckless conduct.

The important point here is, the Commission is not arguing or taking the position that a negligent rendering of an incorrect tax opinion makes a bond counsel an aider and abettor of the registration provisions of the 1933 Act. It is acknowledged that the correctness of Haswell's three tax opinions is subject to honest debate by lawyers. This Court may possible conclude that his opinions were, in fact, incorrect and the result of poor judgment. But the Commission itself has limited the scope of this appeal to whether the fraudulent or culpably reckless, as

distinguished from the negligent, rendering of a tax opinion is the basis for injunctive relief. Haswell does not quarrel with the Commission's theory; he contends only that the evidence amply demonstrates that he carefully and honestly rendered his opinions and that there is an absence of fraudulent or culpably reckless conduct on his part.

III. THE TRIAL JUDGE DID NOT ERR IN REFUSING TO ENJOIN HASWELL FROM VIOLATING FEDERAL SECURITIES LAWS BASED ON ITS CONCLUSION THAT THERE WAS NO LIKELIHOOD OF FUTURE VIOLATIONS.

The trial judge concluded that Haswell had not violated the federal securities laws as charged. The court went on to state that "even if Haswell had violated the federal securities laws, the permanent injunction sought by the Commission should be denied under the circumstances." (A. 839)

The trial judge cited with approval the statement in S.E.C. v. Manor Nursing Centers, Inc., 458 F.2d 1082 at 1100 (2nd Cir. 1972):

> The critical question for a district court in deciding whether to issue a permanent injunction in view of past violations is whether there is a reasonable likelihood that the wrong will be repeated.

The trial judge noted that Haswell had issued many other opinions in the five years since the three MODA bond issues in question, all of which opinions were furnished to the court by Haswell, that the activities of Haswell complained of by the Commission had occurred more than five years in the past, that

since such time Haswell had been counsel in dozens of bond issues in which there had been no showing of wrong doing, that the Commission had found no fault nor alleged any violations with respect to actions taken or bond opinions rendered by Haswell subsequent to July of 1972, that Haswell had been employed by many prestigious underwriters, issuers and public authorities during the past several years and that the court had examined such work and found it to be scholarly and of very high quality. The court found no evidence to support the inference, urged by the Commission, that Haswell is likely to commit a future violation of the federal securities laws. (A. 839-40)

The Commission seeks an injunction against Haswell in this proceeding pursuant to the authority of Section 20(b) of the 1933 Act and Section 21(d) of the 1934 Act which authorize such proceedings whenever it shall appear to the Commission that any person "is engaged or about to engage" in any act which constitutes a violation of the securities laws or rules or regulations thereunder. Unless there is evidence that a person "is engaged or about to be engaged" in violations of the federal securities law, the Commission must demonstrate that the person's "past behavior gives indication that without injunctive measures he might again engage in such activities." S.E.C. v, Management Dynamics, Inc., 515 F.2d 801 at 807 (2nd Cir. 1975).

In considering this question, the Supreme Court has stated:

> The necessary determination is that there exists some cognizable danger of recurrent violation, something more than the mere possibility which serves to keep the case alive. U.S. v. W. T. Grant Co., 345 U.S. 629 at 633 (1953) (Emphasis added)

The Court of Appeals for the Tenth Circuit has described the standard as follows:

> The critical question for a district court in deciding whether to issue a permanent injunction in view of past violations is whether there is a reasonable likelihood that the wrong will be repeated. SEC v. Pearson, 426 F. 2d 1339 at 1343 (10th Cir. 1970). (Emphasis added)

There is no quarrel with the Commission's theory that a past violation by a person creates an inference that a reasonable likelihood exists that such person, unless restrained by a permanent injunction, will commit future violations. But inferences can be rebutted. And the evidence in this case has amply rebutted any inference that may arise from any conduct of Haswell in 1972.

The Commission also argues that where a defendant refuses to appreciate the wrongfullness of his prior conduct and makes no claim that there have been any significant changes in circumstances, the showing of a past violation of the federal securities laws is sufficient basis for the imposition of injunctive relief. It is true that Haswell believes that his bond opinions were legally correct and defensible at the time they were rendered and that he did not violate the federal securities laws. He does acknowledge that his performance of legal duties in the early part

of 1972 is subject to honest debate on the charge that he may have exercised poor judgment. The record does show, however, that Haswell has a most positive and respectful attitude toward the securities laws. During the entire, several years investigation of this matter by the Commission, Haswell cooperated fully with the Commission. The Commission has stipulated this to be true. (A. 97-8)

In sum, the Commission's entire case for an injunction rests upon inferences to be drawn from conduct that occurred five years in the past plus Haswell's present refusal to confess to the Commission's charges. Surely any inferences that can reasonably be drawn therefrom are rebutted by the better than five years of unblemished legal performance by Haswell in the securities and tax law fields and the fact that his subsequent and present performance - all fully revealed to and reviewed by the Commission and the trial judge - has not been and is not being questioned. Such unblemished subsequent performance was the basis for a decision to deny injunctive relief in a much stronger case, one in which scienter was found on the part of attorneys, in S.E.C. v. National Student Marketing Corp., CCH Fed. Sec. L. Rep., para. 94,175 (D.C. of D.C. 1977)

CONCLUSION

The purpose of an injunction is to prevent present or future violations of the law. The moving party must satisfy the

Court that the relief is needed. The necessary determination is that there exists some likelihood or cognizable danger of present or future violations. The Court's decision is based upon all of the circumstances: his discretion is necessarily broad and a strong showing of abuse must be made to reverse it. United States v. W. T. Grant & Company, 345 U.S. 629, 73 S.Ct. 894 (1953) and S.E.C. v. Manor Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972).

Here there is an abundance of evidence and legal authority which support the findings and judgment of the trial judge. Indeed, the evidence is unrefuted that there is neither "some cognizable danger" nor "a reasonable likelihood" of a present or future violation by Haswell. The Commission even has admitted it has examined Haswell's work product for the five-year period since the actions complained of herein and that it found no violations. (A. 67-68 and 70)

Finally, there is no basis for the charge by the Commission that Judge Bohanon was either hostile toward or prejudiced against the Commission.

Respectfully submitted,

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CERTIFICATE OF SERVICE

The undersigned certifies that on the 5th day of December, 1978, a true and correct copy of the above and foregoing Brief was mailed, postage prepaid, to the following:

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APPENDIX OF PROPOSED TREASURY REGULATIONS

Prop. Regs. § 1.103-13, 14, Published June 1, 1972
(Fed. Reg. No. 106, June 1, 1972, pp. 10946-10956)

DEPARTMENT OF THE TREASURY

Internal Revenue Service

[26 CFR Part 1]

INCOME TAX

* * * * *

Internal Revenue Service

[26 CFR Part 1]

INCOME TAX

Arbitrage Bonds

Notice is hereby given that the regulations set forth in tentative form in the attached appendix are proposed to be prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury or his delegate. Prior to the final adoption of such regulations, consideration will be given to any comments or suggestions pertaining thereto which are submitted in writing (preferably six copies) to the Commissioner of Internal Revenue, Attention: CC:LR:T, Washington, D.C. 20224, by July 25, 1972. Any written comments or suggestions not specifically designated as confidential in accordance with 26 CFR 601.601(b) may be inspected by any person upon written request. Any person submitting written comments or suggestions who desires an opportunity to comment orally at a public hearing on these proposed regulations should submit his request, in writing, to the Commissioner by July 25, 1972. A public hearing will be held, and notice of the time, place, and date is simultaneously published herewith. The proposed regulations are to be issued under the authority contained in sections 103(d) and 7805 of the Internal Revenue Code of 1954 (83 Stat. 656, 68A Stat. 917; 26 U.S.C. 103, 7805).

[SEAL] JOHNNIE M. WALTERS,
Commissioner of Internal Revenue.

In order to conform the Income Tax regulations (26 CFR Part 1) to certain amendments made to the Internal Revenue Code of 1954 by section 601(a) of the Tax Reform Act of 1969 (83 Stat. 656), relating to arbitrage bonds, such regulations are hereby amended as set forth below. Section 1.103-13 of the regulations hereby adopted supersedes the provisions of § 13.4 of this chapter which were prescribed by T.D. 7072, approved November 7, 1970, and published in the FEDERAL REGISTER for November 13, 1970 (35 F.R. 17406).

PARAGRAPH 1. Section 1.103-1 is amended to read as follows:

§ 1.103-1 Interest upon obligations of a State, Territory, etc.

* * * * *

(b) Obligations issued by or on behalf of any State or local governmental unit by constituted authorities empowered to issue such obligations are the obligations of such a unit. However, section 103(a)(1) and this section do not apply to industrial development bonds except as otherwise provided in section 103(c), or to arbitrage bonds except as otherwise provided in section 103(d). See section 103(c) and §§ 1.103-7 through 1.103-12 for the rules concerning interest paid on industrial development bonds. See section 103(d) and §§ 1.103-13 and 1.103-14 for the rules concerning interest paid on arbitrage bonds. Certificates issued by a political subdivision for public improvements (such as sewers, sidewalks, streets, etc.) which are evidence of special assessments against specific property, which assessments become a lien against such property and which the political subdivision is required to enforce, are, for purposes of this section, obligations of the political subdivision even though the obligations are to be satisfied out of special funds and not out of general funds or taxes. For purposes of this section, the term "political subdivision" denotes any division of any State or local governmental unit which is a municipal corporation, or to which has been delegated the right to exercise part of the sovereign power of the unit. As thus defined, a political subdivision of any State or local governmental unit may or may not include special assessment districts so created, such as road, water, sewer, gas, light, reclamation, drainage, irrigation, levee, school, harbor, port improvement, and similar districts and divisions of any such unit.

PAR. 2. There are inserted immediately after § 1.103-12 the following new sections:

§ 1.103-13 Arbitrage bonds.

(a) *Scope*—(1) *In general.* Under section 103(d)(1), any arbitrage bond shall be treated as an obligation not described

in section 103(a)(1) and § 1.103–1. Thus, the interest on an arbitrage bond will be included in gross income and subject to Federal income taxation. In general, arbitrage bonds are obligations issued by a State or local governmental unit, the proceeds of which are reasonably expected to be used to acquire other obligations where the yield on such acquired obligations will be materially higher than the yield on the governmental obligations. The term "arbitrage bond" is defined in paragraph (b)(1) of this section.

Under paragraph (a) of § 1.103–14, the investment of all or a portion of the proceeds of an issue of obligations for a temporary period or periods will not cause such obligations to be arbitrage bonds regardless of the yield produced by such investments. Similarly, under paragraph (f) of § 1.103–14, the investment of a portion of the proceeds as a reasonably required reserve or replacement fund will not cause such obligations to be arbitrage bonds regardless of the yield produced by such investments. Even if an obligation is not an arbitrage bond under section 103(d), such bond may nevertheless be treated as an obligation which is not described in section 103(a)(1) and § 1.103–1 if it is an industrial development bond under section 103(c). For regulations as to special issues of Federal Treasury obligations offered to State and local governmental units, see 31 CFR Part 344.

(2) *Reasonable expectations*—(i) Under section 103(d)(2), the determination whether an obligation is an "arbitrage bond" depends upon the reasonable expectations, as of the date of the issue, with respect to the uses to be made of the proceeds of the issue. Thus, an obligation is not an arbitrage bond if it is reasonably expected on the date of issue that the proceeds of the issue will not be used in a manner that would cause the obligations to be "arbitrage bonds" under section 103(d)(2), this section, and § 1.103–14. Except as provided in subdivision (iv) of this subparagraph, the reasonable expectations with respect to the use of the proceeds of a governmental obligation may be established by either of the methods described in subdivisions (ii) or (iii) of this subparagraph.

(ii) A State or local governmental unit may certify, in the bond indenture or a related document, that on the basis of the facts and circumstances in existence on the date of issue, and set forth in such indenture or related documents, it is not expected that the proceeds of the issue of obligations will be used in a manner that would cause such obligations to be arbitrage bonds. This expectation will be deemed reasonable unless it would be clear, to a reasonably prudent person having the degree of expertise possessed by bond counsel, underwriters, or other persons having specialized knowledge in such fields, that such expectation is not reasonable. A certification by the issuer under this subdivision is not affected by subsequent events which could not have been reasonably expected on the date of issue by such a reasonably prudent person.

(iii) Alternatively, the State or local governmental unit may establish a reasonable expectation by a covenant, to the purchasers of the obligations contained in the bond indenture or a related document, that the issuer will make no use of the proceeds of an issue of obligations which, if such use had been reasonably expected on the date of issue of such obligations, would have caused such obligations to be arbitrage bonds. The covenant must impose an obligation on the issuer to comply with the requirements of section 103(d), this section, and § 1.103–14, throughout the term of the issue. Thus, for example, the State or local governmental unit may establish a reasonable expectation under this subdivision where the facts and circumstances as of the date of issue are not sufficiently clear for a certification under subdivision (ii) of this subparagraph.

(iv) The Commissioner may give notice by publication in the Internal Revenue Bulletin that the statements of certification or the covenants of a State or local governmental unit may not be relied upon with respect to issues of governmental obligations to be issued by it subsequent to the date of publication of such notice. If such notice has been published, neither the certification as to specific expectations described in subdivision (ii) of this subparagraph, nor the covenant described in subdivision (iii) of this subparagraph, may be relied upon with respect to any obligations issued by the State or local governmental unit after the date of such notice unless it is established prior to the date of any subsequent issue to the satisfaction of the Commissioner or his delegate that such certification or covenant may be relied upon. No State or local governmental unit shall be listed in such notice unless the unit has been advised that such a listing is contemplated and such unit has been given an opportunity to consult thereon with the Commissioner or his delegate.

(3) *Effective date.* The provisions of section 103(d) apply with respect to obligations issued after October 9, 1969. See paragraph (b)(7) of this section for definition of the term "date of issue."