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# Obligations and Potential Liabilities of Attorneys in Public and Private Offerings

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# VENTURE CAPITAL & Public Offering Negotiation

THIRD EDITION

VOLUME 2

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# SUMMARY OF CONTENTS

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## VOLUME 1

### PART ONE

#### FORMATION OF THE VENTURE CAPITAL FUND

Section Editor: Michael J. Halloran

Chapter 1

AGREEMENT OF LIMITED PARTNERSHIP

by Michael J. Halloran, Gregg Vignos and C. Brian Wainwright

Chapter 2

LIMITED LIABILITY COMPANY AGREEMENT

by Robert S. Fore and Lia Alioto Schmidt

Chapter 3

VENTURE FUND PRIVATE PLACEMENT MEMORANDUM

by Larry Sonsini, Jonathan Axelrad, Eric John Finseth and  
Kenneth W. Muller

Chapter 3A

SMALL BUSINESS INVESTMENT COMPANIES

by Michael K. Wyatt

Chapter 4

INVESTMENT BY RETIREMENT PLANS IN VENTURE CAPITAL  
FUNDS UNDER THE EMPLOYEE RETIREMENT INCOME  
SECURITY ACT OF 1974 ("ERISA")

by Joseph A. Hugg

Chapter 5

INVESTMENT COMPANY ACT AND INVESTMENT ADVISERS ACT  
CONSIDERATIONS FOR VENTURE CAPITAL FUNDS

by Richard M. Phillips and Michael J. Halloran

Chapter 5A

PUBLIC AND PRIVATE BUSINESS DEVELOPMENT COMPANIES

by Michael J. Halloran and Kurt J. Decko

# VENTURE CAPITAL AND PUBLIC OFFERING NEGOTIATION

## PART TWO

### MAKING PORTFOLIO COMPANY INVESTMENTS

Section Editor: Julie M. Robinson

Chapter 6  
PORTFOLIO COMPANY INVESTMENTS: HI-TECH  
CORPORATION—GETTING TO THE TERM SHEET  
by Julie M. Robinson and Robert V. Gunderson, Jr.

Chapter 6A  
COMPANY VALUATION NEGOTIATIONS  
By Dorothy Vinsky

Chapter 7  
HI-TECH CORPORATION: SERIES B PREFERRED STOCK PURCHASE  
AGREEMENT  
by Julie M. Robinson and Robert V. Gunderson, Jr.

Chapter 8  
HI-TECH CORPORATION: AMENDED AND RESTATED CERTIFICATE  
OF INCORPORATION  
by Julie M. Robinson and Robert V. Gunderson, Jr.

Chapter 9  
HI-TECH CORPORATION: [AMENDED AND RESTATED] INVESTORS'  
RIGHTS AGREEMENT  
by Julie M. Robinson and Robert V. Gunderson, Jr.

Chapter 10  
HI-TECH CORPORATION: SERIES B PREFERRED STOCK WARRANT  
by Julie M. Robinson and Robert V. Gunderson, Jr.

Chapter 10A  
DOWN ROUND FINANCINGS  
by Thomas Klaus Gump

Chapter 11  
HI-TECH CORPORATION: CONVERTIBLE SUBORDINATED  
PROMISSORY NOTE  
by Michael J. Halloran, Julie M. Robinson and Robert V. Gunderson, Jr.

## SUMMARY OF CONTENTS

### Chapter 12

#### HI-TECH CORPORATION: RIGHT OF FIRST REFUSAL AND CO-SALE AGREEMENT

by Julie M. Robinson and Robert V. Gunderson, Jr.

### Chapter 12A

#### VOTING AGREEMENTS

by Linda C. Williams, Babak Yaghmaie and Michael J. Sullivan

### Chapter 13

#### HI-TECH CORPORATION: EMPLOYEE STOCK PURCHASE AGREEMENT

by Julie M. Robinson and Robert V. Gunderson, Jr.

### Chapter 14

#### HI-TECH CORPORATION: PROPRIETARY INFORMATION AND INVENTIONS AGREEMENT

by Julie M. Robinson and Robert V. Gunderson, Jr.

### Chapter 15

#### TAX IMPLICATIONS OF EQUITY-BASED COMPENSATION PROGRAMS OF PORTFOLIO COMPANIES

by Joseph A. Hugg

## VOLUME 2

### Chapter 16

#### FEDERAL SECURITIES LAW EXEMPTIONS USED FOR VENTURE CAPITAL PLACEMENTS AND EMPLOYEE STOCK PURCHASES: REGULATION D, SECTION 4(a)(2), RULE 701, AND OTHER EXEMPTIONS

by Michael J. Halloran and Robert V. Gunderson, Jr.

### Chapter 17

#### REGULATION S

by Page Mailliard and Kevin Haynes

## VENTURE CAPITAL AND PUBLIC OFFERING NEGOTIATION

Chapter 18  
SOME ASPECTS OF REPRESENTATION OF THE INVESTOR GROUP  
IN A VENTURE CAPITAL FINANCING  
by Michael J. Halloran

Chapter 19  
CREATING SUCCESSFUL TECHNOLOGY-BASED CORPORATE  
PARTNERING ARRANGEMENTS  
by Thomas F. Villeneuve, Robert V. Gunderson, Jr., Colin D. Chapman,  
James D. Riley and David P. Sharrow

### PART THREE

#### TAKING THE PORTFOLIO COMPANY PUBLIC

Section Editors: Gabriella A. Lombardi and Davina K. Kaile

Chapter 20  
INITIAL PUBLIC OFFERINGS; INTRODUCTION AND SUMMARY  
OF PART III  
by Michael J. Halloran, Nora L. Gibson and Thomas W. Kintner

Chapter 21  
[RESERVED]

Chapter 22  
THE IPO ORGANIZATIONAL MEETING  
by Gabriella A. Lombardi and Michael J. Halloran

Chapter 23  
TIME AND RESPONSIBILITY SCHEDULE AND CHECKLIST  
by Gabriella A. Lombardi and Michael J. Halloran

Chapter 24  
DUE DILIGENCE MATERIALS  
by Karen A. Dempsey and Michael J. Halloran

Chapter 25  
CORPORATE PUBLICITY AND THE OFFERING PROCESS  
by Andrew D. Thorpe and Michael J. Halloran

## **SUMMARY OF CONTENTS**

### **Chapter 26**

#### **MODEL SELLING STOCKHOLDER DOCUMENTS**

by Paul C. Graffagnino

### **Chapter 27**

#### **INITIAL SEC FILING LETTERS AND CONFIDENTIAL TREATMENT**

#### **REQUESTS**

by Gabriella A. Lombardi

### **Chapter 28**

#### **PROSPECTUS/FREE WRITING PROSPECTUS**

by Gabriella A. Lombardi and Heidi Mayon

### **Chapter 29**

#### **SEC COMMENT LETTERS AND RESPONSES**

by Gabriella A. Lombardi and Heidi Mayon

### **Chapter 29A**

#### **IDENTIFYING AND AVOIDING "CHEAP STOCK" PROBLEMS**

by David R. Lamarre, Michael J. Halloran and James J. Masetti

### **Chapter 30**

#### **BLUE SKY MEMORANDUM**

by Karen A. Dempsey and Lora D. Blum

### **Chapter 31**

#### **FINRA MATERIALS**

by Andrew D. Thorpe, Davina K. Kaile and Jeffrey B. Grill

### **Chapter 32**

#### **UNDERWRITER AND DEALER MATERIALS**

by Karen A. Dempsey, Michael J. Halloran, Lora D. Blum  
and Nora L. Gibson

### **Chapter 33**

#### **AUDITORS' MATERIALS**

by Linda L. Griggs and Patricia Woodbury



## VENTURE CAPITAL AND PUBLIC OFFERING NEGOTIATION

Chapter 34  
CLOSING MECHANICS, MEMORANDUM OF CLOSING AND  
CLOSING DOCUMENTS, INCLUDING LEGAL OPINIONS  
by Michael J. Halloran, Gabriella A. Lombardi and Matthew Hallinan

Chapter 35  
COMPLIANCE POLICIES AND PROCEDURES FOR NEWLY PUBLIC  
COMPANIES  
by Linda Williams, Brian M. Wong and Andrew D. Thorpe

Chapter 35A  
CORPORATE GOVERNANCE CONSIDERATIONS FOR PRE-IPO AND  
NEWLY PUBLIC COMPANIES  
by Linda C. Williams

Chapter 36  
OBLIGATIONS AND POTENTIAL LIABILITIES OF ATTORNEYS IN PUBLIC  
AND PRIVATE OFFERINGS  
by William O. Fisher

Chapter 37  
ELECTRONIC MEDIA IN THE INITIAL PUBLIC OFFERING PROCESS  
by Denis T. Rice and Andrew D. Thorpe

INDEX

## CHAPTER 36

# OBLIGATIONS AND POTENTIAL LIABILITIES OF ATTORNEYS IN PUBLIC AND PRIVATE OFFERINGS

by  
William O. Fisher\*

---

1. Introduction .....	36-4
2. The Principal Roles of the Attorney in a Private Offering and the IPO .....	36-5
3. Who Is the Client? .....	36-9
4. State Common Law Duty of Care Owed to Clients When Advising on Securities Offerings and Reliance on Facts Provided by Client .....	36-14
5. Attorney Liability Under the Federal Securities Laws .....	36-24
A. Section 11 of the 1933 Act .....	36-26
B. Section 12 of the 1933 Act .....	36-31
C. Section 5 of the 1933 Act .....	36-35
D. Rule 10b-5 Under the 1934 Act .....	36-39
1. When Are Attorneys Accountable Under Rule 10b-5 for Their Statements or Actions? The Developing Law of Primary Liability .....	36-40

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VENTURE CAPITAL AND PUBLIC OFFERING NEGOTIATION

- (a) Private Civil Actions ..... 36-41
  - (1) Lawyers Are Liable in Private Civil Actions for Their Own Fraudulent Statements To Investors ..... 36-44
  - (2) In Light of *Janus*, Lawyers Are Not Liable in Private Civil Actions for Statements or Omissions in Offering Documents That Lawyers Draft or Edit and That They Know To Be Fraudulent, Unless the Statements Are Attributed to the Lawyers and the Lawyers Can Control That Attribution ..... 36-47
  - (3) In Light of *Stoneridge*, Lawyers Whose Only Participation in a Fraud Is by Work on Sham Transactions That They Know Will Produce Misstatements or Omissions in Offering Documents Are Unlikely To Be Liable in Private Civil Actions Brought Under Rule 10b-5 ..... 36-54
- (b) SEC Enforcement Actions ..... 36-58
  - (1) Attorneys as Primary Violators ..... 36-59
    - (aa) Lawyers Are Liable in SEC Enforcement Actions for Their Own Statements ..... 36-59
    - (bb) Unclear Whether Lawyers Are Liable in SEC Enforcement Actions as Primary Rule 10b-5 Violators for Statements in Offering Documents That Lawyers Help Prepare, Except Where the Documents Attribute Statements to the Lawyers and the Lawyers Can Control That Attribution ..... 36-62
    - (cc) Lawyers Whose Only Participation in a Fraud Is by Work on Sham Transactions That Produce Misstatements or Omissions in Offering Documents May Be Sued by the SEC as Primary 10b-5 Violators in SEC Enforcement Actions ..... 36-70
  - (2) Attorneys as Aiders and Abettors in SEC Enforcement Actions ..... 36-73

**ATTORNEY OBLIGATIONS IN PUBLIC AND PRIVATE OFFERINGS**

2.	What Degree of Knowledge Must the Attorney Have To Be Liable Under Rule 10b-5? .....	36-78
E.	Section 17(a) of the 1933 Act .....	36-80
F.	SEC Rule 102(e) .....	36-89
G.	New SEC Rules Governing Attorney Conduct .....	36-94
6.	Special Risks for Attorneys in Performing Due Diligence ....	36-95
7.	Attorney's Duty Under Ethics Rules and SEC Rules To Inform Third Parties, Report "Up the Ladder" and/or Resign .....	36-96
A.	Ethics Rules .....	36-97
1.	Disclosure To Third Parties—Prohibited, Permitted, or Required? .....	36-97
2.	Steps To Take Before Resigning, Including Reporting up Through the Corporation—ABA and State "Up the Ladder" Rules .....	36-102
3.	Resignation When the Client Is Violating the Law ..	36-107
4.	Disclosure upon Resignation .....	36-110
B.	SEC Rules Requiring Counsel To Report Evidence of Material Violations "Up the Ladder" .....	36-112
8.	Attorney's Malpractice Exposure To Third Parties .....	36-126
9.	Attorney Liability for Common Law Fraud and Negligent Misrepresentation .....	36-132
A.	Fraud .....	36-132
B.	Negligent Misrepresentation .....	36-137
C.	Limited Exposure for Attorneys in Public Offerings on These State Law Theories .....	36-144
10.	May an Attorney Invest in a Client? .....	36-144
A.	Ethical Issues .....	36-145
B.	Securities Law Issues .....	36-152
11.	May an Attorney Serve as a Director or Officer of a Client? .....	36-153
A.	Possible Impact of a Board Seat or Officership on Independence of Legal Counsel .....	36-154
B.	Possible Impact on Attorney-Client Privilege .....	36-157
C.	Possible Effect on Attorney's Liability Under the Securities Laws.....	36-158
D.	Possible Impact on Attorney's Ability To Represent the Corporation in Litigation .....	36-160
E.	Ethics Opinions and Insurance Considerations .....	36-161
F.	Corporate Governance Considerations .....	36-163

## 1. INTRODUCTION

This chapter examines issues that attorneys face when performing services for developing companies, with particular focus on private offerings and the initial public offering ("IPO"). In private and public offerings, both the securities laws and the issuer's interests mandate that the offering document present full and fair disclosure of the issuer's business and financial condition. In assisting an issuer, attorneys share this goal, and can face liability if they err when providing services in such a transaction.

For the protection of investors, the securities laws place the burden on the issuer, its officers, and its directors to assure that private offering documents and the prospectus in a public offering contain no misstatement of a material fact, or omission of a material fact required to avoid misleading by the statements the company makes. There may be subtle or overt conflicts between the desire to market a company's securities and the need for conservative disclosures. The issuer, the underwriter, the counsel for the issuer and the underwriter, and the company's independent public accountants will often spend hours discussing the required disclosures in an IPO. The inherent risks of an IPO may be exacerbated if management is unfamiliar with the reporting, disclosure, and other obligations of public companies. In assisting companies through the private and public offering process, attorneys should devote significant time to educating management and helping the issuer minimize these risks.

In both public offerings and private placements, attorneys face the usual risks of professional liability and must address the usual rules of ethics. Additional risks result, however, from the specialized nature of the work to be done, the multiple parties involved, the many actual and potential conflicts of interest, the need to consider duties to the public and to government agencies, and the opportunities for legal professionals to profit in offerings by virtue of the ownership of stock in the client or options for such stock. There is also the overarching risk that, if the offering company fails, lawyers for the company will incur defense costs when sued in private securities lawsuits as a deep pocket, even if they have in fact done nothing wrong. Attorneys may in addition face SEC civil actions, professional discipline, or SEC administrative actions.

Attorneys representing start-up companies commonly face conflict of interest issues. The attorneys often work closely with the founders and principal investors on an ongoing basis. Consequently, if the attorneys' roles are not clearly defined, misunderstandings may arise as to whom the attorneys are representing. The attorneys may have an opportunity to invest in a start-up client, or to receive stock or options as partial payment for services. Whether or not to invest requires consideration of ethical issues. A client may wish to have an attorney serve on the client's board of directors or as an officer. This too may

## ATTORNEY OBLIGATIONS IN PUBLIC AND PRIVATE OFFERINGS

not be advisable without careful consideration of the risks involved in serving both as a director or officer and as legal counsel.

This chapter examines:

- the roles of the attorney and client in private placements and IPOs (section 2);
- the identity of the client and, in particular, potential conflicts between companies and management (section 3);
- the standard of care applicable to work on offerings and the extent to which an attorney may rely on facts provided by the client (section 4);
- liability for federal securities violations (section 5), under Section 11 of the 1933 Act, Section 12 of the 1933 Act, Section 5 of the 1933 Act, SEC Rule 10b-5, and Section 17(a) of the 1933 Act; and discipline under SEC Rule 102(e);
- special risks that an attorney runs in performing due diligence for offerings (section 6);
- an attorney's duties to inform third parties (e.g., investors or the SEC) of facts about a client company, report "up the ladder" inside a client when the attorney learns of wrongdoing within the company and, in the last resort, resign (section 7);
- an attorney's exposure to third parties (e.g., investors) on common law negligence (section 8) and fraud and negligent misrepresentation (section 9) theories; and
- ethical and practical issues to address when an attorney considers investing in a client (section 10) or serving as an officer or director of a client (section 11).

### 2. THE PRINCIPAL ROLES OF THE ATTORNEY IN A PRIVATE OFFERING AND THE IPO

The clients who ask an attorney to assist in a private offering or an IPO may range from the exceptionally sophisticated to the exceptionally naive. Whatever the case, the attorney almost always has at least two advantages: he or she has experience (or access to others' experience) in preparing offerings and is trained to consider the views of investors. The first advantage furnishes the lawyer with wisdom about the mistakes of others, and the common pitfalls likely to be encountered by the company and its management. The second advantage gives