



Professional Liability Fund present

# So You Think You Don't Practice "Securities Law?"

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1.5 MCLE General or Practical Skills Credits

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## **About our Speakers**

### **Matthew Kalmanson**

Matt is a litigation and appellate attorney practicing at Hart Wagner. He regularly serves as lead appellate counsel in cases before state and federal appellate courts in the Pacific Northwest. Matt has experience litigating matters involving complex business transactions, accounting, finance, statutes, and regulatory schemes; cases involving free speech and other federal and state constitutional rights; actions involving professional duties; class actions; securities actions; shareholder disputes; derivative actions; trust and partnership disputes; and many others.

### **Dan Keppler**

Dan's practice at Garvey Schubert Barer includes complex business litigation, securities litigation, professional malpractice, class action litigation, appeals and alternative dispute resolution. He has experience negotiating and implementing complicated settlement transactions involving numerous claims and parties. He also counsels professional and institutional clients on risk management issues

### **Emilee Preble**

Emilee graduated from Indiana University School of Law in Indianapolis, Indiana (JD 2009) and was admitted to the Oregon State Bar in 2010. She received her BA in Telecommunications from Butler University (Indianapolis, IN) in 2005. While at Butler, she studied abroad at the University of Stirling in Scotland (2003). She also spent the summer of 2007 studying Islamic Law and International Trade at the American University in Cairo, Egypt. Before attending law school, Ms. Preble was a data analyst for the Butler University Office of Admission and the Marketing Assistant for Clowes Memorial Hall (a prominent performing arts venue in Indianapolis, IN). Emilee joined the PLF in 2011 as the Administrator of the Excess Program and a Staff Attorney. In addition to her work with the Excess Program, answers general PLF coverage questions, and coordinates many technology-related projects for the PLF.

### **Sarah Troutt**

Sarah graduated from Willamette University College of Law in 1995 and became a member of the Oregon State Bar that year. From 1995 to 2008, Sarah was in private practice in Salem, Oregon. Her practice emphasized the defense of professionals, including attorneys, in cases alleging professional malpractice. Since 2008, Sarah has been a Claims Attorney at the Professional Liability Fund. She is the 2009 recipient of the Joyce Ann Harpole Award.

# So You Think You Don't Practice "Securities Law"?

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## So You Think You Don't Practice "Securities Law?"

Chad Cheatham is a developer and principal with the Cheatham Howe Group, LLC. Chad consults with Drew Dino, his long time attorney, about his newest project, an apartment building with retail shops. Drew discusses the project with him, but after a month of work, Drew retires. Chad then retains Annette Able, who agrees to draft an operating agreement for the new project, Sophomoric Station LLC, and to represent the LLC.

Chad found a variety of people to help fund the project:

- **Landra Rover** agreed to invest \$20,000 and manage the marketing of Sophomoric Station in exchange for an interest in Sophomoric Station LLC.
- **Claire Coder** agreed to invest \$1,200,000 based on Chad's statements that he had all of the land use approvals and that Moon Doe, a famous coffee shop, had agreed to be the anchor tenant. She will also receive an interest in Sophomoric Station LLC.
- **Hank Howe**, Chad's 89-year old grandfather, agreed to invest all of his \$120,000 savings in exchange for a promissory note.
- **Slim Lorde** agreed to exchange an \$800,000 property he owned for a Tenant-in-Common (TIC) interest in the project.

Annette drafts:

- Sophomoric LLC's operating agreement that reflects each member's LLC interest.
- The promissory note for Hank Howe.
- The tenant-in-common agreement for Slim.
- A "partner packet" for each investor. (This includes a summary of the project and a financial projection showing how the property will generate substantial income, states the name of the anchor tenant, and includes the caveat: "Investment in real estate involves a high degree of risk.")

Chad purchases the land for Sophomoric LLC with a bank loan secured by the property. He has difficulty obtaining all the needed land use approvals, and it turns out that the anchor tenant agreement had some substantial contingencies. The project eventually was completed but, unfortunately, Oregon was experiencing a substantial decline in real estate prices and rental prices. The local economy tanks, and the anchor tenant and other potential commercial tenants pull out. Sophomoric LLC is unable to service the bank loans, and all of the investors' investment is lost.

Each of the investors files a securities action against Sophomoric LLC, Chad Cheatham, Cheatham Howe Group LLC, Annette Able, and Drew Dino, claiming security registration violations and that the securities were sold by means of one or more untrue statements of material fact or misleading omissions.

The LLC and Chad have no money, so the investors pursue their claim against Annette and Drew, alleging that each participated or materially aided in the unlawful sale and are therefore liable "to the same extent as the seller" under ORS 59.115 (3).

## Issues:

- The lawyer may have done nothing wrong – and may still be exposed to liability to non-clients
- What is a security in Oregon, what isn't, and why
- Seller/Primary and Non-seller/secondary liability
- Participating or materially “aiding” in a “sale” vs. aiding in “fraudulent activity”
  - Misrepresentations
  - Omissions
- Reliance – what is required and what isn't
- Affirmative Defenses – didn't know/couldn't know
  - The role of due diligence
- Recognizing transactions that expose lawyers to Oregon securities law liability and liability to non-clients:
  - How a promissory note can be a security
  - Investment contracts
    - LLC/manager-managed – or not
    - Tenant-in-Common agreements
    - Limited partnerships
    - Jointly owned assets/fractional interests in almost anything
- What to expect if a securities claim is made against you:
  - Why the lawyer ends up getting dragged in
  - How the lawyer usually finds out about the problems caused by the seller
  - The impact
    - Shift in the lawyer's relationship to the client
    - Expense in time and money
    - Emotional drain
  - How the defense through the PLF works, process for discovery, available defenses
  - Coverage issues
    - Primary coverage
    - Excess coverage
- What you can do to reduce your risk of being sued
  - Reducing risk vs a “guaranteed safe harbor”
  - Red flags and tips for avoiding problem transactions

## So You Think You Don't Practice "Securities Law?" Here's What You Need to Know!

Daniel L. Keppler<sup>1</sup>  
Garvey Schubert Barer

### I. Why should I care as a transactional lawyer?

Oregon courts hold that a lawyer preparing documents in a transaction with investors may be liable for participating in or material aiding the unlawful sale of securities to those investors. *Prince v. Brydon*, 307 Or. 146, 764 P.2d 1370 (1988).

- Here's the kicker: the investors do not need to prove the lawyer knew about the unlawful conduct:

"ORS 59.115(3) makes one who is not himself the seller of a security liable for an unlawful sale if he 'participates or materially aids in the sale.' \* \* \* Whether one's assistance in the sale is 'material' **does not depend on one's knowledge of the facts that make it unlawful**; it depends on the importance of one's personal contribution to the transaction." *Prince*, 307 Or. at 149 (emphasis added).

- One consolation is that the lawyer can avoid liability by proving that the lawyer "did not know, and, in the **exercise of reasonable care, could not have known**, of the existence of facts on which the liability is based." ORS 59.115(3) (emphasis added).

But proving this "negative" is difficult. And maybe has never happened in an Oregon trial court. 🍀\*

So it's better to avoid the risk of securities liability altogether . . . .

<sup>1</sup> All commentary, suggestions and snarky quips contained in these materials constitute the opinions solely of the author and are not intended to create a standard of care, insurmountable defense, or safe harbor from securities claims.

## II. Does my client's deal involve the sale of a security in Oregon?

### A. What is a security?

- All-encompassing definition in ORS 59.015 (19).
- The usual stuff: stocks, bonds, debentures, notes.
  - **Beware:** stock sale of a small business is a sale of securities.
  - Asset sales of a business may avoid securities problems.

#### ❖ Wait . . . did you say notes?

- Promissory notes are often securities.
- *See Lahn v. Vaisbort*, 276 Or. App. 468, 369 P.3d 85 (2016) (holding that promissory notes in private loans could be securities).
- Certain commercial loans or mortgage loans **might** not be securities if Oregon adopted the federal “family resemblance test” under *Reves v. Ernst & Young*, 494 U.S. 56, 63–64, 110 S.Ct. 945, 108 L.Ed.2d 47 (1990) (involving the federal Securities Exchange Act).
- May also meet the definition of investment contracts.

#### ❖ Catchall: “investment contracts” are defined as securities.

- Four-part test for investment contracts:
  - (1) **investment** of money (or money's worth)
  - (2) in a **common enterprise**,
  - (3) with the **expectations of a profit**,
  - (4) to be made through the **management and control of others**.
- *Pratt v. Kross*, 276 Or. 483, 497, 555 P.2d 765 (1976) (holding that limited partnership interest was a security); *see also Computer Concepts, Inc. v. Brandt*, 310 Or. 706, 714–15, 801 P.2d 800 (1990) (discussing contours of *Pratt* test).
- Common investment contracts
  - **Limited Liability Company** membership interests — especially in a manager-managed LLC, but can be any LLC that meets the test.

- **Limited Partnerships** — or any partnership that meets the test.
- **Tenant-in-Common** or other joint ownership interests in real estate. *See Bergquist v. Int'l Realty, Ltd.*, 272 Or. 416, 427, 537 P.2d 553 (1975) (undivided fractional interests in a sale and leaseback transaction was investment contract).
- **Other jointly-owned assets**, e.g., a *racehorse!* *Marshall v. Harris*, 276 Or. 447, 455, 555 P.2d 756 (1976) (sale of a fractional interest in a racehorse is an investment contract).

B. What is a “sale” of a security?

- Includes virtually any “disposition” of a security for value.
- *Towery v. Lucas*, 128 Or. App. 555, 560, 876 P.2d 814, 817 (1994) (“disposition of” stock in settlement agreement constituted a sale of security).
- See definition in ORS 59.015 (17)(a).

C. When does Oregon Securities law apply to a sale?

- An offer to sell is made in or directed to Oregon.
- An offer to buy is made and accepted in Oregon.
- The offer to sell or buy originates in Oregon.
- The offer to buy or sell is communicated in Oregon.
- See ORS 59.335 and 59.345.
  - Practically any Oregon connection is enough!

### III. What makes the sale of a security unlawful and actionable?

#### A. Untrue statements and misleading omissions

- The most common seller liability allegation in Oregon securities litigation.
- Security sold “by means of” untrue statement of material fact.
- Or “by means of” omission to state a material fact necessary to make statements made not misleading (i.e. half-truths).
- Purchaser does not know the truth.
- Seller has burden to prove affirmative defense that the person did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.
- ORS 59.115 (1)(b).

#### B. Securities Fraud

- To employ any devise, scheme or artifice to defraud.
- To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.
- ORS 59.115 (1)(b) and ORS 59.135 (1) and (3).
- Note: Fraud claims may also be asserted under ORS 59.137, which can be more difficult to prove. *See State ex rel. Oregon State Treasurer v. Marsh & McLennan Companies, Inc.*, 269 Or. App. 31, 50, 346 P.3d 504 (2015).

#### C. Technical violation of the Oregon Securities Law

- Failure to register or to qualify for registration exemption
  - Registration unrealistic in many small business deals.
  - Commonly-used exemptions:
    - **Accredited investors** —
      - individual or joint **net worth** with spouse, exceeds **\$1,000,000**, excluding the value of the natural investor's primary residence, **or**
      - **individual income in excess of \$200,000** in each of the two most recent years or **joint income with spouse in excess of \$300,000** in

each of those years and has a reasonable expectation of reaching the same income level in the current year.

- **No public advertising/solicitation.**
- See ORS 59.035 (5); OAR 441-035-0010.
- See also 15 USC § 77b (15).
- **Under 10 Purchasers of securities**
  - For last 12 months.
  - No commissions or remuneration for sale.
  - No public advertising.
  - ORS 59.035 (12).
- **Exemption analysis is complicated!** — Get help from experienced securities counsel.
- Other technical violations, e.g, unlicensed brokers.

#### **IV. Statutory Damages for Seller Liability**

- Amount investor paid for security minus amount received on security — sometimes called a rescissionary remedy. Bottom line: a \$5 million investment deal = \$5 million base damages. ORS 59.115(2).
- Plus interest at 9% or at the rate stated in the security — whichever is higher.
- Plus discretionary court-awarded attorney fees. ORS 59.115 (10).

## V. Nonseller Liability — *The Scary Part*. ☠

These nonsellers are **jointly and severally liable** with **and to same extent as the seller** of securities under ORS 59.115(3):

- Any person who directly or indirectly controlled the seller.
- Every partner, LLC manager, officer, director, manager, or person who occupied a similar role .
- **Any Person who participated or materially aided** in the sale — including professionals just doing their jobs such as:
  - **Attorneys**
    - Especially if prepared prospectus, private placement memorandum, offering circular or similar offering documents. See *Prince*, 307 Or. at 148 (preparing partnership agreement and offering circular sufficient to give rise to liability for materially aiding).
  - ❖ **Don't like it? Move north of the Columbia River:**
    - Compare Washington vs. Oregon securities law:
      - *Hines v. Data Line Sys., Inc.*, 114 Wash. 2d 127, 150, 787 P.2d 8 (1990) (affirming **summary judgment in favor of law firm** that prepared offering documents). — Lawyers win! 😊
      - *Ainslie v. Spolyar*, 144 Or. App. 134, 145, 926 P.2d 822, 828 (1996) (affirming **summary judgment in favor of investors against lawyer** who prepared securities documents) — Lawyer loses. (Ouch!) ☹
    - Doubtful whether mere business formation and basic entity documentation is material aid in the sale — but there are no safe harbors.
    - It's going to be a case-by-case analysis of the importance of the attorney's work to the transaction. *Prince*, 307 Or. at 149 (“it is a drafter's knowledge, judgment, and assertions reflected in the contents of the documents that are ‘material’ to the sale.”).

- Accountants
  - Doubtful whether audits or tax work materially aids sale of securities, but there are no safe harbors.
  - Preparation of financial projections or pro formas provided to investors might increase risk of liability for material aiding.
- Brokers / Finders
  - Recommending or promoting investment.
  - Bringing in investors is probably enough, but depends on circumstances.
- Financial Advisors
  - Recommending or promoting investment.
  - Bringing in investors is probably enough, but depends on circumstances.
- Banks / Financial Institutions
  - Bridge loans to facilitate investor financing.
  - Unclear whether merely acting as a lender or custodian materially aids in security.
  - Recommending investments to customers is probably risky.

➤ Note: Nonsellers can also be liable in securities fraud claims brought under ORS 59.137. But in contrast with ORS 59.115(3) to prove material aiding liability, the investor must prove that the person **materially aided in *the violation*** of the anti-fraud provisions of ORS 59.135 (i.e. not merely materially aid in *the sale* of securities).

## VI. Affirmative Defenses

A. “Due diligence” defense to nonseller liability:

“[E]very person who participates or materially aids in the sale is also liable jointly and severally with and to the same extent as the seller, **unless the nonseller sustains the burden of proof that the nonseller did not know, and, in the exercise of reasonable care, could not have known, of the existence of facts on which the liability is based.**” ORS 59.115(3). This means:

- The nonsellers must prove **they could not have known** about bad facts giving rise to investor liability.
- For lawyers, this can be difficult if the lawyer has a close relationship with the client.
- Also requires the nonseller to **prove a negative** “could not have known.”
- This must be evaluated on a case-by-case basis.

#### B. Statutes of Limitation Defense

- For claims alleging untrue statements, material omissions or securities fraud under ORS 59.115(1)(b) (or under ORS 59.137): **three years from the sale of securities or two years from discovery** of the facts giving rise to liability. ORS 59.115(6). *See also Anderson v. Carden*, 146 Or. App. 675, 934 P.2d 562 (1997) (construing earlier version of the statute of limitation).
- For registration or other technical violations, the statute of limitations for private rights of action is three years from the sale. ORS 59.115(6).

### VII. What can I do as a transactional lawyer to manage these risks?

- Unfortunately, there are no safe harbors — and no established best practices and no clear standards.
- Here are some general suggestions, but they are not “litigation tested” or supported by specific legal authorities:
  - Even if your legal work is perfect, you can still be sued and taken to trial under ORS 59.115 (3).
  - Securities law is not for beginners — get securities law advice if you have a deal involving investors.
  - Don’t assume you will be protected from claims by the accredited investor exemption.
  - If the deal loses money, disgruntled investors and their lawyers may take advantage of any minor problem they can find with the deal or with the offering documents and allege a misrepresentation or material omission.

- Choose your transactions carefully:
  - Avoid deals involving passive investors if possible.
  - Ideally, all people putting in money should have a role in management of the business.
  - Refer out cases involving passive investors to securities counsel.
  - Stay away from the financing part of a transaction — try to limit your role to non-financing aspects of the transaction, e.g., just the transfer of real estate.
  - Avoid deals that seem unlikely to succeed or are poorly conceived.
  - Beware of deals that depend heavily on existing market conditions, market bubbles, or overly optimistic views of reality.
  - Consider having a business or investment consultant or similar professional conduct an analysis of the deal.
  - Avoid deals involving investors using self-directed IRAs or that rely heavily on tax avoidance strategies.
  - Be skeptical of businesses lacking in financial controls.
  
- Choose your clients carefully:
  - Good business clients should have a solid business plan and financial controls in place.
  - Avoid clients who will oversell or puff about their project.
  - Emphasize the need for transparency with investors.
  - Beware of clients who intend to solicit investors from their religious congregation or social organization in which trust among members is unquestioned.
  
- Try to persuade your client to choose investors carefully:
  - Ideally, investors should be wealthy, accredited, experienced, cognizant of risks and maybe even represented by their own counsel before investing.
  - Avoid investors who plan to invest their retirement savings, are inexperienced, uneducated or vulnerable.
  - Avoid investors who will place unearned trust in promoters regardless of the merits of the business idea, business strategy or business risks.

- Tips for preparing offering documents and disclosures:
  - ❖ Reminder: These are not safe harbors, standards of care or best practices — they are only suggestions that are untested in litigation. Every situation requires judgment and a fact-specific approach.
  - Don't do securities offering documents unless you know what you are doing. Bring in an experienced securities lawyer.
  - Assume your documents will be scrutinized for accuracy and completeness in litigation by counsel representing the investors as plaintiffs.
  - Avoid having the offering circular or private placement memo that reads like a marketing brochure — it should be a risk disclosure document.
  - Try to identify all obvious and nonobvious investment and business risk factors. Consider adding risk factors that are specific to this particular deal.
  - Beware of forms and boilerplate.
  - Consider using a detailed questionnaire or other method to discover and disclose potentially “bad facts” including any black marks against your clients.
  - Consider using management (client) representation letters or similar documents for having your clients “sign off” on all disclosures and certify that they cannot think of any other risks or material matters to disclose.
  - Consider having a business financial or investment professional analyze the deal and potential risks.
  - Recommend that your client use financial projections or pro formas that are conservative, realistic, and based on the most reliable information available.
  - If possible, try to make sure at least two registration exemptions apply.
  - Make sure you are adequately insured.

## Lessons from Securities Litigation

Choose your clients carefully. That is the golden rule when it comes to representing clients who are doing securities offerings. The risks faced by attorneys who represent clients doing securities offerings were evidenced by the recent \$6.2 million settlement paid by a Reno law firm that represented a Bend-based real estate investment operation.

The securities laws present unique challenges and risks for attorneys practicing in Oregon. First, the term “security” is broadly defined; hence, the securities laws cover a wide range of investments. Second, attorneys who “materially aid” in their client’s securities offerings can be held jointly and severally liable for their client’s violation of the securities laws. Due to a combination of these factors, well-intentioned attorneys can find themselves subject to claims brought on behalf of investors who invested in their client’s failed business transactions.

To protect yourself from liability, you must be able to identify what constitutes a security. This is not an easy task given that the term “security” is broadly defined. Most attorneys readily identify stock as a security. However, the definition of a security includes many other forms of investment, including promissory notes and “investment contracts.” The courts have defined certain rules for determining when a promissory note constitutes a security, but those rules start with the presumption that the promissory note is a security. Transactional attorneys should also evaluate whether their client’s deals may constitute an “investment contract” and thus a security. In general, an “investment contract” is formed when there is an investment of money in a common enterprise with the expectation of profits derived from the efforts of others. A wide variety of transactions have

been classified as “investment contracts,” including the sale of fractional interests in race horses – *Marshall v. Harris*, 276 Or 447 (1976); undivided interests in real property – *State of Oregon v. Jacobs*, 55 Or App 406 (1981); and interests in master music recordings – *Cleveland v. Jerden Industries, Inc.*, 1985 US Dist LEXIS 23747 (Or Dist Ct 1985). In recent years, the structures used to finance real estate transactions have become increasingly elaborate and creative. You should review these types of transactions carefully to determine whether a security may have been created. A number of good summaries explain what constitutes a security, including those found in Chapter 15 of *Advising Oregon Businesses* (Oregon CLE 2001, Supp 2007) and Chapter 6 of *Fundamentals of Real Estate Transactions* (Oregon CLE 1992, Supp 2001). However, even with careful research, you may still be uncertain whether or not a particular transaction involves a security. In these situations, it is prudent to take the safe path and assume the transaction involves a security.

Being able to identify a security is critical. If a security is sold in violation of the Oregon securities laws, the investor has a right of rescission against the seller of that security. Essentially, this right allows the investor to recover the amount of the investment, statutory interest, and potentially attorney fees. ORS 59.115(3) provides that every person who materially aids in the sale of a security is jointly and severally liable with, and to the same extent as, the seller. The Supreme Court of Oregon, in *Prince v. Brydon*, 307 Or 146 (1988), held that an attorney who had advised his client concerning the requirements for private placements of limited partnership interests, drafted the limited partnership agreement, and prepared

*Continued on page 2*

### DISCLAIMER

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portions of the offering circular had “materially aided” in the sale of a security as contemplated in ORS 59.115(3). The reasoning is that an attorney “materially aids” in the sale of the security by having his or her “knowledge, judgment and assertions” reflected in the offering documents. *Id.* at 149.

If you materially aided in the sale of a security, you can avoid liability by sustaining the burden of proof that you did not know and, in the exercise of reasonable care, could not have known of the existence of facts on which the liability is based. This “due diligence” defense provides a measure of protection. However, it is important to consider that securities claims arise after an investment has failed. Against the backdrop of a failed deal and with the benefit of hindsight running in favor of the investor, you can face a difficult challenge proving that your actions were, in fact, reasonable.

What can you do? First, accept that ignorance is not an excuse. Ignoring the requirements of the securities laws places you at great peril. This is true whether you consider yourself a “securities lawyer” or not. If the deal involves a security and you do not feel sufficiently competent to handle the matter, refer the securities work to another attorney.

Second, insist that your client structure the offering in a manner that complies with the securities laws and fully cooperate in disclosing the risks associated with the proposed securities transaction. This can become an issue when a client is desperate for capital or otherwise unwilling to pay the legal fees necessary to comply with the applicable securities laws. It can also become an issue when a client is under time constraints to close a transaction. In these situations, you cannot escape liability by merely advising your client of the risks associated with not complying with the securities laws. If your client refuses to structure the offering in a manner that complies with the securities laws, you should walk away from the deal.

Third, keep in mind that although certain elements of the securities laws provide very clear guidance on what is required, many of the rules involve inherently subjective determinations. For example, a person may not sell a security by means of an untrue statement of material fact or omit a material fact necessary in order to make the other statements made, in light of the circumstances under which they are made, not misleading. ORS 59.115. What is “material” is a subjective determination. Due to these subjective determinations, it is not possible for you to completely insulate yourself from a claim. This is especially true when the investor can look back with the benefit of hindsight and question why certain disclosures were or were not made. While experience and careful research can help mitigate a large portion of these risks, such risks cannot be eliminated either for you or your client. Given that securities work will always involve some

inherent level of risk, the golden rule is to choose your clients carefully. If you do not feel confident about the offering or have reservations about the client, you should strongly consider passing on the work.

Similarly, encourage your clients to select their investors carefully. Both you and your client should feel confident that the investor is sufficiently sophisticated and knowledgeable to understand the risks involved with the particular investment. In addition, both you and your client should consider whether the investor can afford to lose the investment and how the investor might react to such loss.

To summarize, keep the following rules in mind to help minimize your potential exposure to liability under the securities laws:

- Know how to spot a security.
- Do not ignore the securities laws.
- Insist that clients comply with the securities laws.
- Encourage your clients to select their investors carefully.
- Choose your clients carefully.

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