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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

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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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