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JURISDICTION AND PROCEDURE

Refocusing the Reliance on Counsel Defense in Securities Fraud Actions

BY JAY B. KASNER AND ALEXANDER C. DRYLEWSKI

This article addresses the so-called ''reliance on counsel defense'' as applied to securities fraud actions brought under Section 10(b) of the Securities Exchange Act of 1934[1] and Rule 10b-5 promulgated thereunder.[2] A defendant's reliance on counsel has traditionally been considered a formal, affirmative defense that may be invoked only where certain objective elements are satisfied. In the securities fraud context, however, such reliance is more appropriately considered not as a formal defense but rather simply as evidence tending to negate scienter – an essential element of the plaintiff's claim. Although surprisingly few courts have addressed the precise issue, viewing the ''defense'' through this frame of reference would de-emphasize strict adherence to rigid, objective criteria (e.g., whether the defendant made ''complete disclosure'' to counsel) and properly focus on more subjective factors (e.g., whether the defendant believed in good faith that counsel was in possession of all material information at the time the advice was provided). Adopting this approach is more consistent with the overarching purpose of reliance on counsel evidence and the burden placed on securities fraud plaintiffs to prove that the defendant acted with scienter. It also accords with the realities of how legal advice typically is rendered in today's corporate context, where executives may not personally furnish counsel with all relevant information but instead will rely upon existing policies and procedures to ensure that counsel is fully informed.

[1] 15 U.S.C. § 78j(b).
[2] 17 C.F.R. § 240.10b-5 (2014).

Jay Kasner is a partner and head of the national securities litigation practice at Skadden, Arps, Slate, Meagher & Flom LLP in New York. Alexander Drylewski is a litigation associate in New York. The views expressed in this article are their own and do not represent the views of Skadden, Arps.

I. Differing Views on Advice of Counsel Evidence

As scholars have explained, ''[t]he defense of reliance upon an attorney's advice has enjoyed a long, but uncertain, history.'' Douglas W. Hawes & Thomas J. Sherrard, *Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases*, 62 Va. L. Rev. 1, 4 (1976). Indeed, although it has been invoked by defendants and recognized by courts in a wide range of legal contexts – including criminal law, trusts and estates, tax law, bankruptcy and securities law, among many others, *see id.* at 9-11 – there has been a surprising paucity of recent in-depth analysis regarding its nature and purpose. The common thread (to the extent one can be gleaned) is that reliance on counsel typically is invoked ''to prove that a defendant acted in good faith or with due care when the breach of those standards of conduct

constitutes an element of the offense with which the defendant is charged.'' *Id.* at 7; *see, e.g.*, *Steed Fin. LDC v. Nomura Sec. Int'l, Inc.*, No. 00 Civ. 8058(NRB), 2004 WL 2072536, at *9 (S.D.N.Y. Sept. 14, 2004), *aff'd*, 148 F. App'x 66 (2d Cir. 2005).[3]

The Second Circuit has enumerated the following elements for invoking the reliance on counsel defense: that the defendant (1) ''made complete disclosure to counsel,'' (2) ''sought advice as to the legality of his conduct,'' (3) ''received advice that [the] conduct [in question] was legal, and'' (4) ''relied on [counsel's] advice in good faith.'' *Markowski v. SEC*, 34 F.3d 99, 104-05 (2d Cir. 1994) (citing *SEC v. Savoy Indus., Inc.*, 665 F.2d 1310, 1314 n.28 (D.C. Cir. 1981)).[4] In *Markowski*, the petitioner sought judicial review of an order by the Securities Exchange Commission (''SEC'') sustaining disciplinary action taken against him for violation of National Association of Securities Dealers (''NASD'') by-laws and rules of fair practice by refusing to allow the NASD to inspect his company's books and records. The petitioner argued that his refusal to comply with the NASD's investigative demands was the result of his reliance on advice he received from his lawyer. *Id.* at 101.

After listing the elements of the advice of counsel ''defense,'' the Second Circuit emphasized that ''[e]ven where these prerequisites are satisfied, such reliance is not a complete defense, but only one factor for consideration.'' *Id.* at 105. The court concluded that ''[i]n light of the substantial evidence supporting the SEC's findings in this case, Markowski's reliance upon advice of counsel, even if established, would not furnish a ground for reversal.'' *Id.* Following *Markowski*, numerous courts have adopted the same or substantially similar elements in assessing the legal sufficiency of a defendant's advice of counsel defense in the context of securities fraud litigation. *See, e.g.*, *SEC v. Tourre*, 950 F. Supp. 2d 666, 682 (S.D.N.Y. 2013); *SEC v. Wyly*, 950 F. Supp. 2d 547, 565-66 (S.D.N.Y. 2013); *In re Reserve Fund Sec. and Derivative Litig.*, No. 09 MD. 2011(PGG), 2012 WL 4774834, at *2 (S.D.N.Y. Sept. 12, 2012); *In re Bank of Am. Corp. Sec., Derivative, & Emp. Ret. Income Sec. Act (ERISA) Litig.*, No. 09 MD 2058(PKC), 2011 WL 3211472, at *8 (S.D.N.Y. July 29, 2011); *Steed Fin. LDC v. Nomura Sec. Int'l, Inc.*, No. 00 Civ. 8058(NRB), 2004 WL 2072536, at *9 (S.D.N.Y. Sept. 14, 2004), *aff'd*, 148 F. App'x 66 (2d Cir. 2005); *SEC v. Cavanaugh*, No. 98 Civ. 1818(DLC), 2004 WL 1594818, at *27 (S.D.N.Y. July 16, 2004), *aff'd*, 445 F.3d 105 (2d Cir. 2006); *see also In re Fed. Nat'l Mortg. Ass'n Sec., Derivative, & ''ERISA'' Litig.*, 892 F. Supp. 2d 59, 70-72 & n.24-25 (D.D.C. 2012); *In re REMEC Inc. Sec. Litig.*, 702 F. Supp. 2d 1202, 1239-41 (S.D. Cal. 2010).

Despite general acceptance of the elements constituting the defense, courts have taken differing approaches regarding their applicability. In a recent criminal case, Judge Saylor of the District of Massachusetts recognized that ''[a]n advice-of-counsel defense is a somewhat amorphous term that has different meanings in different contexts,'' emphasizing that the term ''has a specific, relatively narrow meaning and a broader, somewhat more colloquial, meaning.'' *United States v. Gorski*, 36 F. Supp. 3d 256, 267 (D. Mass. 2014). Under the first meaning, ''a defendant may assert an advice-of-counsel defense and have the jury instructed to that effect'' once the defendant establishes the requisite elements. *Id.* ''The second, and broader, sense of the term arises when a criminal defendant seeks to introduce evidence, or argue to the jury, that the advice or involvement of a lawyer tended to negate his *mens rea*, even if the defendant could not establish all the elements of the formal defense.'' *Id.* at 268; *see also Howard v. SEC*, 376 F.3d 1136, 1147 (D.C. Cir. 2004) (''[R]eliance on the advice of counsel need not be a formal defense; it is simply evidence of good faith, a relevant consideration in evaluating a defendant's scienter.'').[5]

Other courts, by contrast, have rejected the notion that a defendant's reliance on counsel should be treated as anything other than a formal defense with prescribed elements. For example, in *SEC v. Tourre*, 950 F. Supp. 2d 666 (S.D.N.Y. 2013), the SEC brought claims against Goldman Sachs & Co. employee Fabrice Tourre relating to his involvement in the now-infamous ''Abacus'' collateralized-debt transaction. *See id.* at 672. In pretrial proceedings, the defendant asserted that he had ''no intention of relying on an advice of counsel defense'' because ''he would not be able to . . . meet the four factor test for the availability of an advice of counsel defense.'' *Id.* at 682. In view of this concession, the SEC sought to preclude from trial ''mentions of relying on the presence of lawyers, counsel, a legal process, [and] general practices of legal review . . . [as] ways of seeking to portray Tourre as having reasonably relied on the presence and general involvement of counsel.'' *Id.* at 683. The defendant argued in response that he should be permitted to present evidence of counsel's legal involvement with the Abacus transaction and related disclosures as ''relevant to the overall context of

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[3] The defense has also been held to include a defendant's reliance on various other third parties, including accounting experts. *See, e.g., In re Fed. Nat'l Mortg. Ass'n Sec., Derivative, & ''ERISA'' Litig.*, 892 F. Supp. 2d 59, 65, 72 (D.D.C. 2012) (granting summary judgment and dismissing Section 10(b) and Rule 10b-5 claims where defendant officer ''relie[d] in good faith on the professional judgment of the company's internal and external accounting and auditing personnel''). While this article addresses the advice of *counsel* defense in particular, much of the discussion herein applies equally to defenses based upon reliance on other third-party experts.

[4] This is consistent with the advice-of-counsel jury instruction approved by the Supreme Court in *Williamson v. United States*, 207 U.S. 425 (1908), over a century ago, which read:

'Having now placed before you the timber and stone law, and what it denounces, and what it permits, if a man honestly and in good faith seeks advice of a lawyer as to what he may lawfully do in the matter of loaning money to applicants under it, and fully and honestly lays all the facts before his counsel, and in good faith and honestly follows such advice, relying upon it and believing it to be correct, and only intends that his acts shall be lawful, he could not be convicted of crime which involves wilful and unlawful intent; even if such advice were an inaccurate construction of the law. But, on the other hand, no man can wilfully and knowingly violate the law, and excuse himself from the consequences thereof by pleading that he followed the advice of counsel.'

Id. at 453.

[5] Other decisions have been less transparent on the issue. *See, e.g., SEC v. Prince*, 942 F. Supp. 2d 108, 138-40 (D.D.C. 2013) (enumerating four elements and stating without further explanation that ''[w]hile the Court does not need to address whether [defendant] established an advice-of-counsel defense *per se*, all of its elements are directly relevant to [defendant]'s scienter'' and ''[t]hus, the Court addresses each in turn'').

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the transaction.'' *Id.* at 683-84. Judge Forrest rejected the defendant's argument:

> [T]hat [the presence of lawyers is relevant to the overall context of the transaction] is such a fine-grained distinction from a reliance on counsel defense, that it would likely confuse the jury. A lay jury could easily believe that the fact that a lawyer is present at a meeting means that he or she must have implicitly or explicitly ''blessed'' the legality of all aspects of a transaction. Likewise, the fact that lawyers saw and commented on disclosure language could be understood as ''blessing'' the sufficiency of that disclosure. This misunderstanding would give the defendant all of the essential benefits of an advice of counsel defense without having to bear the burden of proving any of the elements of the defense.

Id. at 684. Consequently, the court precluded the defense from introducing certain evidence relating to counsel's involvement and ''from placing undue focus on the fact of a lawyer's presence at a meeting or that counsel reviewed disclosures.'' *Id.*[6]

II. An Objective or Subjective Inquiry?

As the decisions above suggest, whether a court treats reliance on counsel as a formal defense or informal scienter-negating evidence can have a significant impact on its availability in a given case. A simple hypothetical illustrates this point. Let's assume a fairly common scenario: a securities fraud action is instituted by a lead plaintiff purporting to act on behalf of a class of investors of public company ''Corp.'' The plaintiff alleges that Corp issued an annual report containing materially false and misleading statements relating to a government investigation into violations of federal law by certain of Corp's sales employees. Assume further that the plaintiff also names as a defendant corporate executive D, who signed and certified the annual report in question. In his defense, D claims that he relied on the advice of Corp's in-house and external counsel with respect to the challenged disclosures. He argues that he is not a lawyer himself; was not personally involved in the government investigation; and understood the challenged statements in Corp's annual report to have been drafted, fully vetted and approved by Corp's legal counsel.

As discussed above, one of the formal elements of the advice of counsel defense is whether the defendant ''made complete disclosure to counsel.'' *Markowski*, 34 F.3d at 104-05. This has typically been interpreted to mean that ''[r]eliance on advice of counsel will not be available to the defendant if he failed to disclose all relevant facts to the attorney.'' Hawes & Sherrard, *supra*, at 29. In our scenario, D did not personally furnish Corp's disclosure counsel with any information relating to the challenged statements, but was generally aware of Corp's internal policies and procedures for ensuring that counsel was fully informed of all relevant facts and was not aware of any reason why those procedures were not followed in this case.

[6] *See also United States v. Westbrooks*, 780 F.3d 593, 596-97 (4th Cir. 2015) (affirming district court's conclusion that advice of counsel defense did not apply where defendant failed to produce evidence that counsel had been furnished with all pertinent facts).

The hypothetical plaintiff may then move to exclude from trial any evidence of D's reliance on counsel on the ground that D did not make ''complete disclosure to counsel'' as required by *Markowski*. Under a strict analysis of the advice of counsel defense – such as the one employed by the court in *Tourre* – the motion might be granted for failure to satisfy all four objective elements of the defense. Under the more ''colloquial,'' informal analysis articulated by the court in *Gorski*, however, D likely would be permitted to introduce evidence of his reliance on counsel and his subjective belief that counsel had been fully informed. As the *Gorski* court put it:

> [A] defendant might testify that he negligently, but not intentionally, failed to provide a complete set of facts to the lawyer, or that he received accurate advice but innocently misinterpreted it. That would not qualify for an advice-of-counsel defense in the formal sense; nonetheless, such evidence would surely be admissible on the issue of defendant's state of mind.

Gorski, 36 F. Supp. 3d at 268.[7]

To further complicate matters, assume that the plaintiff puts forth evidence that Corp's counsel in fact was *not* fully informed of all relevant facts at the time the challenged advice was rendered (though through no fault of D). The plaintiff would almost certainly view such evidence as a death knell for the formalistic advice of counsel defense. Whether counsel was objectively in possession of all material facts should not alter the analysis under an informal scienter-negating analysis, however, if D can put forth evidence that he did not know, and had no reason to know, that counsel lacked full information. Unfortunately, there has been no clear judicial guidance on this issue. *See* Hawes and Sherrard, *supra*, at 19-20 (''One problem that has not been articulated in the cases is whether each element is to be measured solely by defendant's good faith and due care, or whether other criteria should be employed. . . . Will a court deny the defense if it finds the defendant failed to make full disclosure to the attorney, even though such failure was not the product of bad faith or negligence?'').

[7] A similar (though not identical) fact pattern was presented in *Jones v. Pfizer Inc.*, No. 1:10-cv-03864-AKH (S.D.N.Y. filed May 11, 2010), a securities class action recently pending before Judge Hellerstein in the United States District Court for the Southern District of New York. In *Jones*, the lead plaintiffs alleged that defendants – including the corporate defendant and certain current and former company executives – made materially false and misleading statements about a government investigation regarding alleged off-label promotion of drugs. *See generally* Consolidated Class Action Complaint for Violations of the Federal Securities Laws, *Jones v. Pfizer Inc.*, No. 1:10-cv-03864-AKH (S.D.N.Y. filed Dec. 6, 2010), ECF No. 51. The plaintiffs moved for summary judgment on several grounds, as well as for preclusion of evidence of the defendants' reliance on advice of counsel, because the company's disclosure counsel had not been ''fully informed.'' Several of the individual defendants argued in response that counsel was in fact fully informed, and even assuming *arguendo* that it was not, the individual defendants had believed in good faith that counsel had access to all material information necessary to render the relevant advice. The action settled before the court could resolve the particular dispute.

III. Application to Securities Fraud Litigation

In the context of securities fraud litigation, it is more appropriate to treat the defendant's reliance on advice of counsel not as a formal, affirmative defense but rather – in the words of the *Gorski* court – as ''more basic lack-of-*mens-rea*'' evidence that can be introduced at trial ''even if the defendant could not establish all the elements of the formal defense.'' *Gorski*, 36 F. Supp. 3d at 268. This conclusion only makes sense given that a securities fraud plaintiff bears the burden of establishing that the defendant acted with scienter. Requiring the defendant to affirmatively establish an advice of counsel defense shifts the burden of proof on an essential element of the plaintiff's securities fraud claim.

This conclusion is bolstered by the view that it is more appropriate within the securities fraud context to assess the defendant's scienter under a subjective – as opposed to objective – standard. Indeed, because securities fraud litigation typically focuses on the defendant's subjective state of mind at the time of the alleged misstatement or omission, courts should assess the defendant's purported reliance on counsel with respect to his or her challenged conduct through that same subjective lens.[8]

Moreover, refocusing the reliance on counsel defense as an informal, subjective inquiry accords with the practicalities of how legal advice is provided in today's corporate context. Most public companies devote tremendous resources to implementing and maintaining legal compliance programs, which typically include the development of policies and procedures to ensure that legal counsel is furnished with all information material to the advice it provides. Thus, although corporate executives may not personally provide company counsel with information, they may rely – reasonably and in good faith – on the effectiveness of those procedures. *See* Hawes & Sherrard, *supra*, at 5 (''[T]he reliance defense today appears to be of even greater significance because of the extensive role of attorneys in all facets of corporate activity. It is inconceivable that corporate executives would enter into a public offering, merger, or other major corporate transaction without the assistance of legal counsel.'').

[8] One possible response is that strict compliance with the *Markowski* elements is required only where the defendant seeks to invoke reliance on counsel as a complete defense that fully exculpates the defendant. This view is refuted by the language of *Markowski* itself, however, where the Second Circuit made clear that even where a defendant satisfies all of the elements, reliance on counsel ''is not a complete defense, but only one factor for consideration.'' *Markowski*, 34 F.3d at 105. Moreover, as the *Tourre* decision illustrates, some courts have taken an all-or-nothing approach where failure to satisfy the *Markowski* elements renders nearly all reliance-related evidence inadmissible at trial. *See Tourre*, 950 F. Supp. 2d at 682-85.

Justice Scalia acknowledged this reality, albeit in a different legal context, when articulating what he believed to be ''common sense'':

> When a client receives advice from his lawyer, it is surely implicit in that advice that the lawyer has conducted a reasonable investigation – reasonable, that is, *in the lawyer's estimation*. The client is relying on the expert lawyer's judgment for the amount of investigation necessary, no less than for the legal conclusion. To be sure, if the lawyer conducts an investigation that he does not believe is adequate, he would be liable for misrepresentation. And if he conducts an investigation that he believes is adequate but is *objectively unreasonable* (and reaches an incorrect result), he may be liable for malpractice. But on the latter premise he is not liable for misrepresentation; all that was implicit in his advice was that he had conducted an investigation *he* deemed adequate. To rely on an expert's opinion is to rely on the expert's evaluation of *how much time to spend* on the question at hand.

Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund, 135 S. Ct. 1318, 1336 (2015) (Scalia J., concurring in part and concurring in the judgment). Consistent with the above passage, an individual's reliance on counsel necessarily and implicitly includes reliance on that counsel's information-gathering process – a view that holds especially true for corporate executives relying on company counsel within the framework of a fully-developed legal compliance program.

IV. Conclusion

In securities fraud actions, the plaintiff bears the burden to plead and prove that the defendant made materially false or misleading statements with scienter. As is frequently the case, the defendant may have relied on the advice of legal counsel and other experts in signing or certifying the public statements at issue. In this context, it is more appropriate to treat such reliance simply as evidence tending to negate the intent element of the plaintiff's claim rather than a formal defense requiring strict adherence to objective elements.[9] As such, the defendant's reliance should be assessed solely from a subjective standpoint, the application of which better accords with the nature and purpose of such evidence and the realities of how legal advice is rendered in today's corporate setting.

[9] Though not a topic of this article, this distinction may have further implications to the attorney-client privilege and whether a waiver of the privilege occurred. For a recent discussion of privilege issues in the context of the advice of counsel defense, see generally Jennifer Hurley McGay & Sujata M. Tanikella, Sujata M., *Implications of Relying on Advice of Counsel in the Second Circuit*, N.Y.L.J., June 23, 2015. *See also U.S. Commodity Futures Trading Comm'n v. McCrudden*, No. CV 10-5567(DRH)(AKT), 2015 WL 5944229, at *26 (E.D.N.Y. Oct. 13, 2015) (discussing privilege waiver when invoking formal advice of counsel defense).

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