[FINAL VERSION]

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

REPLY BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION

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1. Haswell's statement of the facts demonstrates that he violated the antifraud provisions of the securities laws and that he acted with scienter.

In his answering brief filed in this Court, Andrew J. Haswell, Jr., an experienced securities lawyer (Br. 8), 1/ admits at several points that his performance of legal duties in connection with three public offerings of industrial development revenue ("IDR") bonds under the aegis of the

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1/ Mr. Haswell's answering brief is cited herein as "Br.___;" the Commission's opening brief is cited "Comm. Br.______;" and the Joint Appendix filed herein is cited "A___."

Midwestern Oklahoma Development Authority ("MODA") was seriously deficient. 2/ Thus, in apparent recognition of the futility of defending the propriety of his conduct, Haswell—

(1) admits that he "may have exercised poor judgment" by failing to examine any final offering circulars prepared for the Western States Plastics, Inc., ("WSP") and Lee & Hodges, Inc. ("L&H") IDR bond offerings, after having examined preliminary circulars which the court below found were "not only misleading with respect to the facts, but were obviously full of omissions of material fact" (A. 835, emphasis added), a finding not contested by Haswell; 3/

2) admits that "perhaps" he was "negligent" in including wholly unrealistic sales projections in the offering materials he drafted for the Harper Industries, Inc. ("HII") bond offering

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2/ While Haswell begins by stating that he "does not accept" the statement of facts set forth by the Commission (Br. 1), he does admit that the facts are not in substantial dispute, since the evidence consists, in large part, of Haswell's own testimony and documents produced by him (id.). Later in his brief, Haswell acknowledges that, "[l]argely, the essential facts in this case are not in dispute" (Br. 8).

3/ "[A]dmittedly," Haswell states, he "did not exhibit that degree of care that, as the trial judge stated, 'a more careful attorney would have insisted upon'" (Br. 23; see A. 836). As Haswell further notes, he "did not insist upon delivery to MODA of a proper offering circular" with respect to the WSP or L&H issues (Br. 9), although he was aware that there were material inaccuracies in the preliminary offering circulars that he reviewed (Br. 10-12). With respect to the L&H issue, Haswell even wrote to the underwriter, "stating that he must receive" a copy of the revised offering circular (Br. 12). Although admittedly "[h]e received none," he nevertheless "later issued his bond opinion for the L&H issue, * * * without first insisting upon delivery to MODA of a proper offering circular" (id.).

(Br. 16); 4/ and

(3) admits that his failure to disclose the substantial risks involved in an investment in HII bonds "may have involved poor judgment or his own inexpertise" (Br. 18). 5/

Haswell himself prepared the offering circular for the HII offering, and that circular failed adequately to disclose the financial dealings which were planned between the company and its principal controlling person, defendant Harold T. Pehr. Pehr was to receive, from the proceeds of the offering, $250,000 of the $300,000 that had been allocated to make equipment purchases in return for his transfer to the company of a patent of dubious value. Haswell asserts that because the $250,000 purchase price is "discernible" (Br. 15), there was adequate disclosure of this transaction. As Haswell

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4/ The figures included by Haswell in the HII offering circular indicated that HII would produce and sell an increasing volume of disposable salt and pepper shakers ranging from 300 million units in 1972, the year following formation of the company, to 3 billion units in 1982— at a time when the company had not yet produced anything. Haswell states merely that these figures were "furnished to him by HII" and were "not checked by him for reasonableness." (Br. 16), since, as he explained at trial, "[n]obody ever asked me to" (A. 199).

5/ Although he has acknowledged the fact that he is an experienced and active securities lawyer (see Comm. Br. 68 and n.86), Haswell suggests that his conduct in connection with the IDR bonds here in issue is attributable to the fact that, "to his detriment," he did not "initially appreciate the difference between an IDR bond" and a "full faith and credit municipal bond" sold to "sophisticated bank bond departments and municipal bond underwriters." (Br. 9). The true "detriment" was suffered, of course, by those public investors who lost a substantial portion of their $2.2 million investment (see Comm. Br. 12).

Haswell's admission that he agreed to serve as counsel in connection with securities offerings the nature of which he did not understand can hardly be accepted as an excuse for his conduct. Haswell held himself out as an expert, and, as the court pointed out in Securities and Exchange Commission v. Spectrum, Ltd., 489 F.2d 535, 542 (2d. Cir. 1973), "the smooth functioning of the securities markets will be seriously disturbed if the public cannot rely on the expertise proffered by an attorney * * *."

points out, however, in order to "discern" the purchase price, one would have had to compare a chart and footnote on page 5 of the disclosure document (A. 763), with a convoluted paragraph on page 8, (A. 766), and then perform the necessary mathematics (see Br. 14-15). Moreover, not until page 22 of the offering circular (A. 780) is the status of Pehr as the principal controlling person of the corporation disclosed. Thus, a reading of the description of the transaction alone, if it could have been understood at all by the potential investor in HII bonds, would have left the impression that it was a transaction with a person completely unrelated to the company. 6/ Haswell's concealment of material facts in this fashion, viewed in the light of his other conduct, cannot be excused as mere negligence.

Finally, there is Haswell's preparation and dissemination of the necessary tax opinions for the marketing of the MODA bond issues to the public. Haswell seeks to defend his opinion that interest paid to investors in MODA bonds would be tax-exempt under 26 U.S.C. 103 (b)(6)(A), which requires that "substantially all" the proceeds of the offering must be used to purchase land or depreciable property, by arguing that:

(1) the "substantially all" test should be applied to the net proceeds of the offering, after the deduction of such expenses as attorney's fees and printing costs, as well as the fee received by the underwriter, which in the case of the MODA offering amounted to 30 to 35 per cent of the face

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6/ The disclosure made by Haswell of the HII transaction is comparable to the amendment he supplied for the L&H offering circular, and which appears in the record in Haswell's own handwriting (A. 279, see stipulation at A.86). By describing all the proposed uses of the proceeds of the offering in one sentence, Haswell artfully concealed the fact that it was planned that less than seven percent of the proceeds would be used to acquire equipment (see Comm. Br. 18-19). In preparing disclosure documents, however, an attorney's task is more than to "avoid blatant fraud and still keep the stockholder from discovering which shell the pea is under." Gould v. American Hawaiian Steamship Co., 319 F. Supp. 795, 810 (D.Del. 1970).

amount of the offering (Br.4);

(2) proceeds placed in escrow in order to make interest payments to shareholders may be capitalized and thus be considered to have been used to purchase land or depreciable property (Br. 42); and

(3) Haswell's use of a "covenant" in connection with the L&H issue, pursuant to which the company merely agreed that it would, at some future time, purchase equipment in an amount equal to the proceeds of the offering, permitted the actual proceeds to be diverted to uses other than the purchase of land or depreciable property (Br.45).

In order for Haswell's tax opinions to be correct, each of these arguments must be accepted. (See Comm. Br. 23-28 and 59-63). In fact, however, in the circumstances of the MODA bond offerings, each of Haswell's arguments is misdirected.

The Commission does not argue, as Haswell contends (Br. 41) that the "substantially all" test is applied to the "face amount" of the bonds and not the "net proceeds." 7/ We do contend, however, that only the reasonable expenses of the offering should be deducted in computing the net proceeds of the offering. The 30 to 35 per cent discount to the underwriter of the MODA offerings was not a reasonable and normal expense. The evidence indicated, and Haswell does not deny, that IDR bonds are normally sold by an issuer to an underwriter at a discount of from one to seven percent (Comm. Br. 9; A.250-253). While investors might expect that the normal expenses of the offering would be deducted before "substantially all" of the proceeds were used by the company in which they were investing to purchase equipment,

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7/ As the chart set forth in our opening brief indicates (Comm. Br. 27, n. 49), even where "net proceeds" are computed by deducting the exorbitant sum received by the underwriter, the percentage of net proceeds used for qualifying purchases ranged from a low of 10% for L&H to 71% for WSP, thus failing to meet the 90% test accepted by Haswell (Br. 42).

underwriter's fees of the size involved in this case could not reasonably be anticipated. 8/

Similarly, the Commission does not contend that escrowed interest may not, in appropriate circumstances, be treated as a qualifying use under 26 U.S.C. 103(a)(6)(B). But in the circumstances of this case, the escrowed interest was not "properly chargeable" 9/ to the capital accounts of the MODA companies, since none of these companies purchased sufficient capital equipment to justify charging the capital account with the escrowed interest payable on the entire offering. When less than half of the proceeds of an offering go to purchase equipment, and the rest is used for non-qualifying purposes, the interest on the entire issue may not be allocated to the equipment purchases. 10/

Finally, Haswell's contentions regarding the L&H "covenant" most clearly display the falsity and indeed, the fraudulent nature, of his tax opinions. As Haswell himself appears to recognize (Br. 46), tax regulations permitting the proceeds of tax-exempt bond issues to be temporarily invested if there is a covenant governing the use of the proceeds can hardly be considered "on point." In the situation covered by these regulations, after the temporary investment period, the proceeds of an offering will be available

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8/ In connection with the scheme of WSP officials to inflate invoices relating to equipment purchases made by that company and divert the company's funds, Haswell recognized that the tax exemption was endangered because the overcharges could not be considered as qualifying purchases of equipment (see Comm. Br. 15, 25). Similarly, proceeds diverted to the benefit of the underwriter in excess of a reasonable underwriting fee cannot be considered as either valid expenses of the offering or as a qualifying use of proceeds under the statute.

9/ As set forth in the Commission's brief, interest may be capitalized only in certain limited circumstances (Comm. Br. 61-62, n. 75). Haswell did not demonstrate, either in the court below or in this Court, that such circumstances were present.

10/ See Internal Revenue Regulation 26 CFR 1.103-10(b)(2)(ii)(e), cited at p. 43 of Haswell's brief.

to purchase land or depreciable property. Except for an insignificant portion, however, the proceeds of the L&H offering were used to pay overdue taxes and other obligations, and to provide desperately-needed working capital (A.502; A.790). As Haswell knew, it could not reasonably be expected that these proceeds would be available for capital expenditures, and there was little likelihood, in view of L&H's financial condition, that it would be able to satisfy the requirement of the "covenant" that it purchase, within three years, property equal in value to the net proceeds of the bonds (see Comm. Br. 26-27).

Thus, Haswell's tax opinions were false and their issuance violated the antifraud and registration provisions of the securities laws. The court below failed to address the legal issues involved because it was convinced of Haswell's good faith in rendering his opinion (A. 838). Even if it is assumed that opinions based on the assumptions apparently made by Haswell could be considered to have been issued in good faith, however, their issuance without disclosure of these questionable assumptions, and despite Haswell's awareness of the serious deficiencies in the offering materials being prepared for dissemination to investors, constituted, at a minimum, grossly reckless behavior.

In Securities and Exchange Commission v. National Student Marketing Corp., [Current] Fed. Sec. L. Rep. (CCH) ¶96,540 (D.D.C. Aug. 31, 1978), appeals pending D.C. Cir., it was held that the defendants, including attorneys, acted with scienter when they "made a conscious decision" not to take steps to correct material deficiencies in information provided to shareholders asked to approve a merger. [Current] Fed. Sec. L. Rep. (CCH) at 94,191. In any event, the court found that the defendants' actions clearly constituted "the kind of recklessness that is equivalent to willful fraud," id., explaining (citations and footnotes omitted):

> "The failure to disclose the material information in this case was neither inadvertant * * * nor the product of simple forgetfulness * * * but instead the result of a conscious decision made by the defendants. In view of the obviousness of the danger that investors would be misled by their failure to disclose the material information, such conduct must be considered reckless."

Similarly, in this case, the totality of Mr. Haswell's conduct, including (1) his failure even to examine final disclosure documents for the L&H and WSP issues, after becoming aware of and commenting upon the material omissions in the preliminary drafts; (2) his drafting of the HII disclosure document, which failed adequately to disclose material facts and which included production and sales projections that he did not question, despite their patent unreasonableness, and (3) his issuance of erroneous tax opinions, which he knew to be critical to the sale of these bonds, without disclosing the substantial questions that existed with respect to those opinions or taking any steps to correct the deficiencies in the disclosure documents, cannot be considered as less than culpably reckless. The trial judge's characterization of Mr. Haswell's conduct as merely negligent, under these circumstances, is not supported by the record and is erroneous. Cf. Securities and Exchange Commission v. Spectrum, Ltd., supra, 489 F.2d at 535.

2. Haswell's argument that the Commission is required to demonstrate scienter in order to obtain prospective injunctive relief ignores the public purposes served by Commission enforcement actions.

Haswell seeks to avoid the legal consequences of his actions by arguing that the Supreme Court's decision in Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), a private action for damages under Section 10(b) of the Securities Exchange Act and Rule 10b-5, should be extended to actions brought by the Commission to obtain prospective relief under those provisions and under Section 17(a) of the Securities Act of 1933 as well. Haswell's argument is based upon certain district court decisions which are not persuasive in view of the decisions, both before and after Hochfelder, of various courts of appeals including this Court. 11/ Indeed, one of the district court cases most strongly relied upon by Haswell (see Br. 30, 31, 32 and 40) has recently been reversed by a reviewing court of appeals. Securities and Exchange Commission v. American Realty Trust, No. 77-1839 (4th Cir., Nov. 17, 1978). 12/

In Securities and Exchange Commission v. American Realty Trust, supra, the Court of Appeals for the Fourth Circuit held that "in an action for an

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11/ This Court long ago recognized the remedial purposes behind Commission equitable proceedings in holding that "[p]roof of scienter or intent to defraud is not required to show violations justifying preliminary injunctive relief under such statutues." Securities and Exchange Commission v. Pearson, 426 F.2d 1339, 1343 (1970).

12/ Another of the decisions relied upon by Haswell, Securities and Exchange Commission v. E. L. Aaron & Co., [Current] Fed. Sec. L. Rep. (CCH) ¶96,043 (S.D. N.Y. 1977), is currently pending appeal in the Second Circuit. The Court of Appeals for the Fifth Circuit, in Securities and Exchange Commission v. Blatt, No. 76-2181, (Nov. 15, 1978), recently stated in language which may be considered dicta that the Commission must demonstrate scienter in order to obtain injunctive relief under Section 10(b) of the Securities Exchange Act. Since the court held in Blatt that the record in that case "reveals knowing omissions by each appellant," and that "'knowing' conduct satisfies the scienter requirement," it was not necessary for the court to decide if a lesser showing might also justify the entry of an injunction. The decision in Blatt is the subject of a pending motion by the Commission to amend or, alternatively, for extension of time to apply for reconsideration, by the Fifth Circuit en banc.

The rationale of the district court in Securities and Exchange Commission v. Bausch & Lomb, 420 F. Supp. 1226 (S.D.N.Y. 1976), as to which Haswell claims there is "no better reasoned opinion" (Br. 32), was not accepted by the Court of Appeals for the Second Circuit, which affirmed that decision on other grounds, 565 F.2d 8 (2d Cir., 1977), and which has indicated its disagreement with that rationale in numerous other decisions. See, Securities and Exchange Commission

(footnote continued)

injunction against future violations brought by the Commission, proof of scienter is unnecessary." Slip op. at 2. Confining its attention to Section 17 of the Securities Act, which it found sufficient for purposes of its decision, the court held that Section 17(a)(2) may be violated by negligent conduct, and that since such violations had been shown, "an injunction against future violations of the securities laws should be granted." Slip op. 3. The court reasoned that

> "[p]roof of negligent misstatements or negligent omissions in a prospectus establishes an affront to the goal the statutes sought to achieve of open disclosure of all relevant information which a reasonable person would wish in deciding whether to buy or sell. * * * An injunction in such a case can provide substantial assurance that the negligent issuer will take more pains the next time to avoid all falsity. If, because his conduct was merely negligent such an issuer is subject to no penalty and to no injunctive relief, he is free to act negligently in the future with the risk of production of more false statements, effectiveness of the statutes would be seriously impaired." 13/

The decision of the court in American Realty Trust is consistent with the prior decisions of the courts of appeals for the First 14/

12/ (footnote continued)

v. Coven, 581 F.2d 1020 (2d. Cir. 1978); Securities and Exchange Commission v. Universal Major Industries, 546 F.2d 1044 (2d Cir., 1976), cert. denied sub nom. Homans v. Securities and Exchange Commission, 434 U.S. 834 (1977). These cases reaffirmed the Second Circuit's pre-Hochfelder decisions, cited at p. 50 n.64 of our opening brief, which had "enunciated the negligence test principally in cases involving the antifraud provisions of the securities laws * * *." 546 F.2d at 1046-1047.

13/ Slip op. at 14-15. As we demonstrated in our opening brief (Comm. Br. 54-55), the language of the Supreme Court in Hochfelder affirmatively supports the proposition that subsections (2) and (3) of Section 17(a) are violated by negligent conduct. And, since Section 17(a) is a statute, the logic of the Hochfelder decision, which would limit the scope of a rule adopted by the Commission under Section 10(b), is simply inapplicable.

14/ Securities and Exchange Commission v. World Radio Mission, Inc., 544 F.2d 535 (1st Cir. 1976).

and Second 15/ Circuits, which were fully discussed in our opening brief (see Comm. Br. 55-57), 16/ and directly contrary to the holding of the court below that the Commission was required to show either "fraudulent conduct or conduct so reckless that it was an extreme departure from the standards of ordinary care" (A. 836). 17/

Haswell incorrectly contends that the Court in Hochfelder relied "solely" upon the wording of the statue and its legislative history, and disregarded "the policy behind the statute" (Br. 24). To the con-

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15/ Securities and Exchange Commission v. Coven, supra, 581 F.2d 1020 (2d. Cir. 1978). The court in American Realty Trust expressed "complete agreement" with the conclusion of the Second Circuit in Coven that there is nothing in the legislative history of Section 17 which would indicate that Congress intended Section 17(a)(2) to be read to require a showing of scienter. Slip op. 13. In view of the extensive canvass of the legislative history made by Judge Mansfield in Coven, Haswell's few citations from the legislative history designed to show that "Congress had fraud in mind" when it enacted Section 17(a) (Br. 40, emphasis in original; see id. at 36-40) are unavailing. As Judge Haynesworth pointed out in American Realty Trust, slip op. 12-13, Section 17(a)(2)

> "speaks only of untrue statements of material fact and material omissions. Material misstatements and material omissions may be the product of negligence as well as of willfulness, and there is nothing in the language of §17(a) to suggest that the Congressional intent was to reach the one and not the other. Moreover, §17(a)(2) is bracketed between §17(a)(1) and §17(a)(3), which contain explicit references to fraud. Surely when enacting these sections, it would have included in §17(a)(2) language referable to fraud or willfulness if that had been the Congressional intent."

16/ Recently, in denying the defendant's motion to dismiss in Securities and Exchange Commission v. Western Geothermal & Power Corp., No. CV-77-504 (D. Ariz. October 16, 1978), the court held that the Commission is not required to allege or prove scienter to show violations of either Section 17(a) or Section 10(b), or to obtain injunctive relief against violations. Accord, Securities and Exchange Commission v. Shiell, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,190 (N.D. Fla. Sept. 21, 1977).

17/ The Commission regrets its inadvertant misquotation, at pages 28 and 32 of its opening brief, of this part of the district court's decision. The passage was correctly cited at page 42 of our brief and was correctly set forth in full at page 53.

trary, in Hochfelder, Mr. Justice Powell took particular note of the effect the interpretation of the law for which the plaintiff in that case had argued would have had on private damage actions, noting that the "standard urged by respondents would significantly broaden the class of plaintiffs who may seek to impose liability upon accountants and other experts who perform services or express opinions with respect to matters under the Acts," 425 U.S. at 214 n.33. In this same regard, the Court cited with approval Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 747-748 (1975), which had expressed concern that the "broadening of the class of plaintiff who may sue in this area will ultimately result in more harm than good." The Court concluded that "[a]cceptance of respondent's view would extend to new frontiers the 'hazards' of rendering expert advice under the Acts, raising serious policy questions not yet addressed by Congress." 425 U.S. at 216, n.33.

The concerns expressed by the Court in Hochfelder with respect to private actions for monetary damages have no application to equitable actions by the Commission. We have fully discussed in our opening brief 18/ the reasons why Haswell's arguments have consistently not been accepted by those appellate courts that have considered them, and should be rejected by this Court as well.

3. There was no basis upon which the district court could have concluded that further violations were unlikely, in view of Haswell's concededly unprofessional behavior in connection with a sophisticated scheme to defraud investors.

In his brief, Mr. Haswell asserts that there is no likelihood of further violations on his part, noting the five-year period between the violations and the time of the trial, and arguing that injunctive

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18/ See Comm. Br. 48-53 with respect to Section 10(b) and Rule 10b-5, and Comm. Br. 53-59 with respect to Section 17(a).

relief was denied in "a much stronger case, one in which scienter was found on the part of the attorneys" (Br. 53). See, Securities and Exchange Commission v. National Student Marketing Corp., supra, [Current] Fed. Sec. L. Rep. (CCH) ¶96,540 (D.D.C., Aug. 31, 1978), appeals pending, D.C. Cir. But in denying injunctive relief in National Student Marketing, the district court emphasized that the violations proven by the Commission "principally occurred within a period of a few hours" at the closing of a merger, and were thus "part of an isolated incident, unlikely to recur and insufficient to warrant an injunction." [Current] Fed. Sec. L. Rep. (CCH) at 94,202. The case here is different. Haswell engaged in a fraudulent course of dealing in connection with a series of IDR bond offerings; detection of that fraudulent scheme, moreover, was made difficult by its complicated nature and by the fact that the defendants named by the Commission escrowed part of the proceeds of the offering, from which payments of "interest" were made to lull investors as to the safety of their investments and to conceal the dire financial condition of the MODA companies. In these circumstances, it is hardly surprising that it required a period of years to detect and investigate Haswell's violations, and to bring him to trial.

In the absence of any valid mitigating circumstances, and particularly in view of Haswell's failure to appreciate the wrongfulness of his conduct and his continuing activities as a practicing securities attorney, the inference is warranted that, unless enjoined, he is likely to violate the the law in the future (see Comm. Br. 63-69). It is respectfully submitted that Haswell violated the securities laws deliberately and repeatedly, and that there is no basis on which it may be assumed that future violations are unlikely.

Conclusion

For the foregoing reasons and those set forth in our opening brief, the judgment of the district court should be reversed, and the case should be remanded to the district court with instructions to grant the relief requested by the Commission. Alternatively, the court below should be directed to reconsider, in the light of correct legal standards, the need for the injunctive relief requested by the Commission. 19/

Respectfully submitted,

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19/ Should the Court remand for further proceedings in the district court, the Commission further suggests, for the reasons set forth in our opening brief (pp. 4-6), that the Court should direct that the matter be reassigned to a different district judge. In his brief, Haswell argues that the Commission has "stretched too far its prejudice case" (Br. 7); but Haswell himself appears to admit that the district judge's actions and decision are explicable only if assumed to be the result of a "desire to avoid for the MODA bond holders a possible judicial determination that their interest received on the three MODA bond issues may not have been tax exempt," and by his attempt to "salvag[e] the local reputation of an attorney who may have used poor judgment * * *" (Br. 7). The Commission did not ascribe either motive to the district judge; but either motive, if present, would have been, at the least, irrelevant to the events of the case. As for MODA bondholders, who were not parties below, the proceedings could not have determined their tax liability in any way; in any event, it appears that MODA bondholders never received any actual income, but only a return of capital from the funds placed in escrow in order to enable the companies to make payments denominated as "interest." And, any desire on the part of the court below to salvage Haswell's "local reputation" at the expense of the public interest which the federal securities laws are designed to protect, would have been most inappropriate. In view of Haswell's acknowledgement that these considerations may have entered into the district court's decision, the Commission submits that the need for reassignment to a different judge if a remand is made is indicated.

* Mitchell D. Dembin, who has passed the New York State bar examination but has not yet been admitted to the bar, assisted in the preparation of the Commission's brief.

Conclusion

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