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ETHICS AND PROFESSIONAL RESPONSIBILITY FOR ATTORNEYS IN SECURITIES TRANSACTIONS

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The public and regulatory focus on corporate malfeasance and recklessness has led to great attention to the individuals responsible for corporate governance, including corporate officers and directors, the SEC and other regulatory agencies, and the lawyers who are an essential element of all corporate action. Investor confidence in the quality and integrity of public company corporate governance is severely compromised.[1] When outside directors, auditors and lawyers, who have important roles in our system of independent checks on a corporation's management, fail to avert or even discover wrongdoing, there is inevitable pressure to seek to hold them responsible for investors' losses.[2]

Attorneys must balance significant competing interests while representing corporate clients in securities transactions. On the one hand, attorneys are obligated to preserve the integrity of the attorney-client relationship by maintaining the confidentiality of communications with their clients. On the other hand, the Securities and Exchange Commission (the "Commission" or "SEC") has long held that attorneys who practice securities law are obligated to assist the Commission in the enforcement of securities laws.[3] Attorneys who become aware that a corporate client is engaging in conduct that violates the securities laws face a dilemma in determining the nature and scope of their ethical obligations vis-à-vis the client and regulatory authorities.

In addition, because their corporate clients often include several different constituents whose interests diverge, attorneys may have to determine (i) to whom or to what they have a primary obligation and (ii) how to fulfill duties to each constituency of the corporation when interests conflict.[4] Historically, neither the Model Code of Professional Responsibility (the "Model Code") nor the Model Rules of Professional Conduct (the "Model Rules")[5] contemplated how attorneys should address the corporate client's interests in such circumstances.[6] It was only

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1 James H. Cheek, III et al., *Preliminary Report of the American Bar Association Task Force on Corporate Responsibility*, July 16, 2002, at 3, *available at* http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf. [hereinafter *ABA Task Force Preliminary Report*].

2 *Id*.

3 In *In re Emanuel Fields*, 45 S.E.C. 262, 266 n.20 (1973), the Commission noted that, because the Commission is a small agency with a limited budget and staff, the lion's share of the responsibility for enforcement of the securities laws lies with the securities bar.

4 These constituents include, among others, officers, directors, employees, and stockholders.

5 According to the American Bar Association, all but eight of the jurisdictions have adopted new professional standards based on the Model Rules. American Bar Association, Center for Professional Responsibility, *Model Rules of Professional Conduct* (2004).

6 George D. Reycraft, *Conflicts of Interest and Effective Representation: the Dilemma of Corporate Counse*l, 39 Hastings L.J. 605,609 (1988).

in 2003 that the American Bar Association (the "ABA") House of Delegates (the "House of Delegates") amended the Model Rules to provide guidelines for lawyers faced with wrongdoing by a corporate client or its constituents.

The trend has been toward imposing heightened obligations on attorneys. Both the SEC and the ABA Task Force on Corporate Responsibility (the "ABA Task Force") have set forth rules and standards that raise the bar for attorneys in the course of representing corporate clients.[7] Other interested groups, including the ABA and the Attorneys Liability Assurance Society, have issued a series of reports and proposals aimed at instituting elevated standards of conduct for attorneys representing corporate clients.[8]

A recurring theme of these reports is that, because of the many notorious failures of corporate governance, the rules of professional conduct governing lawyers should be analyzed to see if they adequately protect the public.[9] Section 307 of the Sarbanes-Oxley Act of 2002 (the "Act")[10] mandated that the SEC prescribe minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of issuers. Section 307 marked the first entry of Congress into the area of attorney regulation, which has

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[7] On March 28, 2002, Robert Hirshon, president of the ABA appointed a task force charged with examining the "systematic issues relating to corporate responsibility arising out of the unexpected and traumatic bankruptcy of Enron and other Enron-like situations…" The ABA Task Force was to "examine the framework of laws and regulations and ethical principals governing the roles of lawyers, executive officers, directors, and other key participants" in corporate governance. On July 16, 2002, the ABA Task Force issued a preliminary report detailing recommendations regarding corporate governance and the ethical and governance framework in which the corporate lawyer can advance corporate responsibility. In addition, the report offered several recommended amendments to the Model Rules. *ABA Task Force Preliminary Report, supra* note 1, at 1. On March 31, 2003, the Task Force issued a final report recommending proposed corporate governance policies in addition to proposing several amendments to the Model Rules. James H. Cheek, III et al., *Report of the American Bar Association Task Force on Corporate Responsibility*, March 31, 2003, available at http://www.abanet.org/buslaw/corporateresponsibility/final_report.pdf [hereinafter *ABA Task Force Final Report*].

[8] In addition to amendments to the Model Rules, the House of Delegates also adopted recommendations made by the ABA Task Force regarding corporate governance policies. These policies do not affect any of the Model Rules but are intended to enhance the role of lawyers so that they may be more effective in representing corporate clients. The principles adopted include, among others, the following: (i) a company's general counsel must be actively involved in ensuring that its directors have the information and analysis they need to fulfill their duties, particularly information related to legal compliance; (ii) an attorney representing a public company serves the interest of the company, regardless of the personal interests of a particular director, officer, employee, or shareholder; (iii) when the board or a committee of the board hires special counsel to do a special investigation or provide independent legal advice, the arrangement should be structured to ensure an independent investigation and direct reporting to the board or to the committee; (iv) the SEC and state bar disciplinary authorities should share information to promote effective and appropriate enforcement of rules of conduct applicable to corporate counsel; and (v) law firms and law departments should adopt procedures to facilitate and promote compliance with rules of professional conduct governing the representation of public corporations. American Bar Association Task Force on Corporate Responsibility, *Report to the House of Delegates, available at* http://www.abanet.org/leadership/ 2003/journal/119c.pdf.

[9] *Id.* at 24.

[10] 15 U.S.C. §7201 (2002).

traditionally been dominated by state regulation. In 2003, the Commission adopted final rules implementing Section 307 (the "Final Rules").[11]

I. DEFINING THE CLIENT

A. The Corporation as Client

In the corporate context, an attorney's client is the corporation and its shareholders, not the management that most often will have hired the attorney. Model Rule 1.13(a) provides that "a lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents."[12] The premise of Model Rule 1.13 is that, when a lawyer represents an organization (such as an issuer), the lawyer owes the organization a duty of protection from harm. Such a duty requires the lawyer to serve the interest of the corporation and its shareholders rather than the interests of the individual officers or employees who are acting for the corporation.[13] Similarly, under Canon 5 of the Model Code, Ethical Consideration 5-18, "a lawyer employed or retained by a corporation or similar entity owes his allegiance to the entity and not to a stockholder, director, officer, employee, representative or other person connected to the entity."[14]

Because a corporate client can only act through its officers, directors, employees, stockholders or other constituents, the relationship between the attorney and the corporate client's constituents is often blurred. For example, the attorney who represents a corporate client is selected, hired, and fired by one or more constituents of that corporate client.[15] However, the attorney may not disclose to such constituents any information relating to the representation of the corporate client, unless the corporation authorizes the disclosures. Comment 10 to Model Rule 1.13 advises that, when the corporate client's interests are adverse to those of its constituents, the lawyer should advise the constituent of the following:

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[11] Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release Nos. 33-8185; 34-47276, (to be codified at 17 C.F.R. pt. 205), *available at* http://www.sec.gov/rules/final/33-8185.htm [hereinafter *Final Rules*].

[12] Model Rules of Prof'l Conduct R. 1.13 (Discussion Draft 1983) (amended 2003).

[13] *ABA Task Force Preliminary Report*, *supra* note 1, at 27.

[14] Model Code of Prof'l Responsibility EC 5-18 (1980). As SEC Chairman Harvey Pitt remarked in a public statement on February 22, 2003, "corporate lawyers represent the corporation and its shareholders, even though management may hire or fire them; they must be satisfied that objectives management asks them to pursue truly are intended to, and do, further the interests of the company and its shareholders. And, they need to ward against conflicts arising between management and the company's shareholders; if such conflicts arise, corporate lawyers must avoid lending assistance to any action that could harm shareholders. In sum, corporate attorneys should serve corporate constituencies in all they say and do; they should not use their skills primarily to serve the interests of corporate managers, even if the goals of those managers can be harmonized with the best interests of the corporation and its shareholders."

[15] As some commentators have noted, the stockholders, the closest human manifestation of the corporate client, are largely uninvolved and uninformed of the attorney's representation. The situation in which persons other than the client engage, consult with and terminate the lawyer has been described as "perverse." *See e.g.* Ralph Jonas, *Who is the Client?: The Corporate Lawyer's Dilemma*, 39 Hastings L.J. 617 (1988).

1. the existence of any conflict or potential conflict of interest;
2. the lawyer's inability to represent the constituent; and
3. that the constituent may wish to obtain independent representation.[16]

If the lawyer treats the corporate constituent as the client and if the lawyer obtains information that may subject that constituent to liability, the lawyer is bound by the rule of confidentiality (discussed below) and may not disclose the information to others. The prohibition against disclosure extends to members of the client's board of directors. Moreover, any attorney-client privilege for information related to the corporation's affairs that the officers and employees communicate to the attorney belongs to the corporation.[17] Conflicts between a corporation and its constituents may be particularly acute where the lawyer participates in a corporate legal compliance program in which employees are encouraged to report situations that may involve violations of law. See section entitled "Special Issues in Corporate Compliance Programs" below.

B. SEC Final Rule Section 205.3

At the core of the SEC's Final Rules is Section 205.3, which provides that "an attorney appearing and practicing before the Commission in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization. That the attorney may work with and advise the issuer's officers, directors, or employees in the course of representing the issuer does not make such individuals the attorney's clients."[18]

The Commission recognized that attorneys play a "varied and crucial role" in the Commission's processes by preparing and assisting in the preparation of materials that are filed with or submitted to the SEC.[19] Because investors rely on these materials, they must also be able to rely upon the integrity of in-house and retained attorneys who represent issuers. The Commission concluded, however, that existing state ethics rules have not proven to be an effective deterrent to attorney misconduct.[20]

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[16] Model Rules of Prof'l Responsibility R. 1.13 cmt 10 (1983)(amended 2003) (prior to 2003 amendment, Model Rules of Prof'l Responsibility R. 1.13 cmt. 7)).

[17] *Proposed Rules, supra* note 12, at 24 (citing e.g. *United States v. Int'l Bhd. of Teamsters, Chauffeurs, Warehousemen & helpers of America, AFL-CIO*, 119 F.3d 210,215-217 (2d Cir. 1997)).

[18] *Final Rules, supra* note 13, at 20. The corresponding Proposed Rule required that the attorney "act in the best interest of the issuer and its shareholders. Commentators raised several concerns with the proposed provision, including the fear that the proposed language would create a private right of action by suggesting that attorneys have a duty to shareholders. The Commission agreed with many of the comments and modified the rule. The Commission recognized that in certain situations (e.g. where an individual associated with the organization is violating a legal duty and the behavior is likely to result in substantial injury) it may be appropriate for counsel to act in the best interests of the issuer. However, the Commission appreciates that, "with respect to corporate decisions traditionally reserved for management, counsel is not obligated to act in the 'best interest' of the issuer." *Final Rules, supra* note 13, at 21.

[19] *Proposed Rules, supra* note 12, at 3.

[20] *Proposed Rules, supra* note 12, at 3.

II. ISSUES RELATING TO WRONGDOING BY THE CORPORATE CLIENT

Prior to the enactment of the Act, the responsibility of an attorney to report wrongdoing by a corporate client was somewhat unclear. Attorneys faced a choice between their duty to maintain client confidences and their duty not to assist a client in an ongoing crime or fraud. While Section 307, mandating that the SEC promulgate rules *requiring* attorneys to report within the issuer the awareness of any evidence of a material violation of securities laws, provides fundamental guidance, attorneys still must attempt to balance competing duties to the corporate client, to the SEC, and to the bar.

A. Duty to Maintain Client Confidences

Attorney-client confidentiality is based on the law of agency. The professional codes of legal ethics impose on attorneys a fiduciary duty to their clients. A lawyer's ethical obligation of confidentiality pertains to all of the lawyer's activities relating to the representation of the client and extends past the term of the lawyer's employment. Neither the lawyer nor the lawyer's employees should accept employment that involves or may involve the disclosure or use of client confidences, either for the private advantage of the lawyer or his employees or to the disadvantage of the client, without the client's consent.

1. Professional Codes of Ethics Duties to Maintain Confidences

a. Model Rules

Since 1983, Model Rule 1.6 has governed an attorney's duty of confidentiality with regard to client information. Under Model Rule 1.6, a lawyer is prohibited from revealing information relating to the representation of a client unless the client gives informed consent[21] or there is implied authorization. Communications from any corporate constituent may constitute client confidences protected by Model Rule 1.6 if such communications are made to corporate counsel in the lawyer's capacity as such, for the purpose of obtaining legal advice for the corporation. Prior to amendment, Model Rule 1.6(b)(1) permitted, (but did not require) a lawyer to reveal confidential client information to the extent the lawyer believed it to be reasonably necessary to (i) prevent reasonably certain death or substantial bodily harm or (ii) establish a claim or defense on behalf of the lawyer.[22] Most states have not adopted these narrow exceptions to confidentiality.[23] Instead, many state supreme courts have modified Model Rule 1.6 to allow or require disclosure in a wider range of circumstances.[24]

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[21] Model Rule 1.0(e) provides that "informed consent denotes the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks and reasonably available alternatives to the proposed course of conduct."

[22] Model Rules of Prof'l Conduct R. 1.6 (Discussion Draft 1983)(amended 2003).

[23] In the states of Washington and Oregon, for example, a lawyer may reveal client confidences in situations that would not be permitted by the Model Rules. "Washington's Rule of Professional Conduct 1.6(b)(1), which corresponds to [this] Model Rule 1.6(b)(2), provides that 'a lawyer may reveal a client's confidences or secrets to

The ABA's Commission of Evaluation of the Rules of Professional Conduct (the "Ethics 2000 Commission") proposed an amendment to Model Rule 1.6 that would have permitted disclosure of confidential information to prevent a client from "committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services," however, the House of Delegates chose not to adopt the proposal.[25] Instead, on February 5, 2002, in response to other recommendations by the Ethics 2000 Commission, the House of Delegates adopted an amendment to Model Rule 1.6 that added two additional circumstances under which a lawyer may be permitted to reveal confidential information relating to the representation of a client ("Revised Model Rule 1.6"). Revised Model Rule 1.6, in addition to the existing exceptions to confidentiality, permits a lawyer to reveal a client's confidences to (i) secure legal advice about the lawyer's compliance with the Model Rules; or (ii) to comply with other law or court order.[26] In July 2002 and March 2003, the ABA Task Force further urged the House of Delegates to adopt additional amendments to Model Rule 1.6 that would extend the permissible disclosure under Model Rule 1.6 to reach conduct that "has resulted or is reasonably certain to result in substantial injury to the financial interest or property of another and require disclosure to prevent felonies or other serious crimes, including violations of the federal securities law, where such misconduct is known to the lawyer."[27]

On August 11-12, 2003, the House of Delegates, adopting the recommendations of the ABA Task Force, amended Model Rule 1.6 to permit an attorney to reveal client information in order to prevent a client from committing financial fraud or to mitigate injury from a financial fraud ("Amended Model Rule 1.6").[28] Amended Model Rule 1.6(b)(2) permits, but does not

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the extent that the lawyer reasonably believes necessary to prevent the client from committing a crime.' Oregon's Disciplinary Rule 4-101(C)(3) provides that a lawyer may reveal the 'intention of the lawyer's client to commit a crime and the information necessary to prevent the crime.'" Althoff, *Ethics in Corporate Failures*, Washington State Bar News (March 2002), *available at* http://www.wsba.org/barnews/2002/03/ethics.htm.

24 Susan P. Koniak, *When Courts Refuse to Frame the Law and Others Frame It to Their Will*, 66 S. Cal. L. Rev. 1075, 1081 (1993).

25 Memorandum of Charlotte K. Stretch, May 16, 2002, *Re: Clearinghouse on Corporate Responsibility*, *available at* http://www.abanet.org/buslaw/mo/premium-cl/committees/cl995000/cheek.pdf.

26 Comment 12 to Model Rule 1.6 (prior to 2003 amendment, Comment 10) provides that "[w]hen disclosure of information relating to the representation appears to be required by other law, the lawyer must discuss the matter with the client to the extent required by Model Rule 1.4 (Communication Between Lawyer and Client). If, however, the other law supersedes [Model Rule 1.6] and requires disclosure, paragraph (b)(4) of [Model Rule 1.6, (after amendment, paragraph (b)(6)] permits the lawyer to make such disclosures as are necessary to comply with the law." The Commission indicated that the Final Rules, promulgated pursuant to the Act, will govern in the event the rules conflict with state law, but will not preempt the ability of a state to impose more rigorous obligations on attorneys that are not inconsistent with the Final Rules. Press Release, Securities and Exchange Commission, *SEC Adopts Attorney Conduct Rule Under Sarbanes Oxley Act* (Jan. 13, 2002). *See also*, SEC Today, *SEC Says State Bar's Proposed Interpretation Conflicts With SEC Rule*, Volume 2003-144 (Jul. 29, 2003) (noting that SEC General Counsel Giovanni Prezioso announced that U.S. Supreme Court precedent has consistently upheld the authority of federal agencies to implement rules of conduct that diverge from and supersede state laws that address the same conduct).

27 *ABA Task Force Preliminary Report*, *supra* note 1, at 45.

28 The amended rule is identical to the proposed rule that was rejected in 2001 by the House of Delegates. Greg Pease, *ABA Amends Rule on Client Confidentiality to Allow Lawyers to Disclose Financial Fraud*, Sec. Reg. & L., 1357 (Aug. 18, 2003).

require, a lawyer to reveal client confidences "to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services."[29] Amended Model Rule 1.6(b)(3) permits disclosure "to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services."[30]

In recommending the amendments, the ABA Task Force reasoned that, where the client abuses the lawyer-client relationship by using the lawyer's services to commit a crime or fraud which results in substantial economic harm to another, "the policy of protecting confidentiality is outweighed by the policy of protecting the interests of society and the professional integrity of the lawyer."[31] Opponents of the fraud disclosure amendment argued that the amended rule "erodes the 'core value' of client confidentiality."[32] However, defenders of the rule asserted that other Model Rules already impose duties on lawyers faced with client fraud, such as the duty to report fraud on a tribunal.[33] Moreover, Comment 7 to Amended Model Rule 1.6 makes clear that Amended Model Rule 1.6(b)(2) is a "limited exception to the rule of confidentiality" and permits the lawyer to reveal confidential information only "to the extent necessary to enable affected persons or appropriate authorities to prevent the client from committing a crime or fraud."[34] Where the lawyer does not learn of the client's crime or fraud until after it has been consummated, Comment 8 to Amended Model Rule 1.6 provides that the lawyer may disclose information "to enable the affected persons to prevent or mitigate reasonably certain losses or to attempt to recoup their losses."[35]

b. Model Code

Under Disciplinary Rule ("DR") 4-101 of the Model Code, an attorney is not required to reveal a confidence or secret of a client.[36] (A "confidence" is information protected by the

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[29] American Bar Association Task Force on Corporate Responsibility, *Report to the House of Delegates*, *available at* http://www.abanet.org/leadership/2003/journal/119a.pdf [hereinafter *Rule 1.6 House of Delegates Report*].

[30] *Rule 1.6 House of Delegates Report, supra* note 31.

[31] *Rule 1.6 House of Delegates Report, supra* note 31*,* at Executive Summary.

[32] Greg Pease, *ABA Amends Rule on Client Confidentiality to Allow Lawyers to Disclose Financial Fraud*, Sec. Reg. & L., 1357, 1358 (Aug. 18, 2003).

[33] *Id*. The Model Rules currently authorize or require a lawyer to reveal client information in a variety of circumstances where important policy considerations outweigh the policy of protecting the confidentiality of client information. "For example: (i) where a lawyer's withdrawal from representation will not avoid continued assistance to a client's crime or fraud, the lawyer may be required under the existing Model Rule 4.1(b) cmt 3 to 'disaffirm an opinion, document, affirmation or the like' previously given by the lawyer; and (ii) to the extent reasonably believed to be necessary, the lawyer is allowed to disclose information relating to the representation of a client in order to establish a claim or defense in a case against the client." *Rule 1.6 House of Delegates Report, supra* note 31.

[34] Model Rules of Prof'l Responsibility R. 1.6 cmt. 7 (1983) (amended 2003).

[35] Model Rules of Prof'l Responsibility R. 1.6 cmt. 8 (1983) (amended 2003).

[36] Model Code of Prof'l Responsibility DR 4-101 (1980).

attorney-client privilege. A "secret" is information gained in the professional relationship that the client has requested to be held inviolate or which would be embarrassing or detrimental to the client.) DR 4-101 permits an attorney to reveal (i) confidences or secrets of the client if the client consents and (ii) the intention of the client to commit a crime and any information necessary to prevent the crime. In addition, an attorney may reveal confidences or secrets when the lawyer is permitted to do so under Disciplinary Rules or required by law or court order.

2. SEC Rules of Confidentiality

The SEC's Final Rules set forth specific circumstances under which an attorney is authorized to disclose confidential information related to his appearance and practice before the Commission in the representation of an issuer. Similar to Amended Model Rule 1.6(b)(5) (prior to 2003 amendment, Model Rule 1.6(b)(3)), Final Rule Section 205.3(d)(1)[37] *allows* an attorney to use any report, response thereto, or contemporaneous record thereof, to defend himself against charges of misconduct.[38] Further, Final Rule Section 205.3(d)(2) provides additional protection for investors by *allowing, though not requiring*, an attorney to reveal to the Commission, without the issuer's consent, confidential information relating to the attorney's appearance and practice before the Commission to the extent the attorney reasonably believes necessary to: (i) prevent the issuer from committing a material violation that the attorney reasonably believes is likely to result in substantial injury to the financial interest or property of the issuer or investors; (ii) to prevent the issuer from perpetrating a fraud on the Commission;[39] or (iii) to rectify the consequences of an issuer's material violations that have caused or may cause substantial injury to the issuer's financial interest or property in the furtherance of which the attorney's services were used.[40]

Although commentators have raised concerns that permitting attorneys to disclose information to the Commission without the client's consent would undermine the issuer's trust in their attorneys, the vast majority of states already permit (and some require) disclosure of

[37] The proposed version of this rule provided that the attorney could reveal to the Commission, without the issuer's consent, confidential client information related to the representation of an issuer to the extent the attorney reasonably believes necessary to prevent the commission of an *illegal act* which the attorney reasonably believes will result in either perpetration of fraud upon Commission, substantial injury to the financial or property interest of the issuer or investor, or information necessary to rectify an issuers *illegal actions* that have been advanced by the issuer's use of the attorney's services. *Proposed Rules, supra* note 12, at 48. Several comments to the proposed rules argued that permitting attorneys to disclose "illegal acts" to the Commission, in the situations delineated by the proposed rule, would undermine the relationship of trust and confidence between lawyer and client, and may impede the ability of lawyers to steer their clients away from unlawful acts.

[38] *Final Rules, supra* note 13, at 30. The Commission states that this rule is effectively equivalent to Model Rule 1.6(b)(5) (prior to 2003 amendment, Model Rule 1.6(b)(3)) and corresponding "self defense" exceptions to client confidentiality rules in every state.

[39] The term 'perpetrate a fraud' in this paragraph refers to conduct involving the "knowing misrepresentation of a material fact to, or the concealment of a material fact from the Commission with the intent to induce the Commission to take, or to refrain from taking, a particular action." *Final Rules, supra* note 13, at 33.

[40] *Final Rules, supra* note 13, at 30-31. This paragraph corresponds to Model Rule 1.6 as proposed by the ABA's Kutak Commission in 1981-1982 and by the Ethics 2000 Commission in 2000, and as adopted by the vast majority of states.

information in the limited circumstances covered by Final Rule Section 205.3(d)(2).[41] Moreover, the Commission noted that in these states there had been no evidence that those already-existing disclosure obligations have undermined the attorney-client relationship.[42] Commentators expressed concern that a rule of this type would preempt state law ethics rules that do not permit disclosure of information concerning such acts. However, Final Rule Section 205.1 makes clear that Part 205 supplements state ethics rules and is not intended to limit the ability of any jurisdiction to impose stricter ethical obligations upon an attorney not inconsistent with Part 205.

After much criticism, the Commission withdrew Proposed Rule Section 205.3(e)(3), which would have provided that "[w]here an issuer, through his attorney, shares with the Commission, pursuant to a confidentiality agreement, information related to a material violation, such sharing of information shall not constitute a waiver of any otherwise applicable privilege or protection as to other persons."[43] The Commission reasoned that that the production of such information does not circumvent courts' rejection of the selective waiver doctrine because the Commission enters into confidentiality agreements only when it has reason to believe that obtaining reports will enhance the Commission's ability to conduct expeditious investigations and/or provide more prompt monetary relief to defrauded investors."[44] Several commentators stated that it was uncertain if the Act granted the Commission the authority to promulgate a rule that would control determinations by state and federal courts regarding whether a disclosure to the Commission, even if conditioned on a confidentiality agreement, waives the attorney-client privilege or work product protection. Commentators expressed concerns that attorneys might disclose information to the Commission in the belief that the evidentiary privileges for that information were preserved, only to have a court subsequently rule that the privilege was waived.[45] While abandoning Proposed Rule 205.3(e)(3), the Commission affirmed that it will continue to follow its policy of entering into confidentiality agreements where it determines that

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[41] The North Caroline State Bar Ethics Committee, however, has concluded that Rule 205.3(d)(2) should be assumed to have superseded state law. While admitting that the Federal rule was permissive in permitting disclosure in certain situations, and that one could comply with more stringent state rules without violating the Federal rule, the Committee found that the state rule "impinges on the flexibility provided by Rule 205," and therefore "created an obstacle to the achievement of 'the full purposes and objective' of the federal regulation." 2005 Formal Ethics Opinion No. 9 (January 20, 2006). The Committee noted that 42 states had ethics rules that were not inconsistent with the Federal rule and that in those states, the issue did not arise, and also acknowledged that at least two states, California and Washington, had refused to find that the Federal rule pre-empted state ethics rules.

[42] *Final Rules, supra* note 13, at 33.

[43] *Proposed Rules, supra* note 12, at 46. If adopted as a final rule, this section would have set forth the Commission's position on an unsettled question: whether an issuer waives attorney client privilege and/or other protection (such as work product protection) by sharing with the Commission, pursuant to a confidentiality agreement, confidential information regarding misconduct by the issuer's employees or officers.

[44] *Id*. at 49. The Commission noted that the proposed rule is consistent with the confidentiality provisions that Congress enacted regarding investigations by the Public Company Accounting Oversight Board in §105 of the Act. 15 U.S.C. 7215 (2002). "Like §105(b)(5) of the Act, proposed §205.3(e)(3) would facilitate investigations by the Commission and protect investors by maintaining the privileged or protected status of internal reports shared with the Commission." "Section 105(b)(5)(A) provides that 'documents and information received by the … [Public Company Accounting Oversight] Board … shall be confidential and privileged' until the documents or information are used in a public proceeding." *Id*. at 50.

[45] *Final Rules, supra* note 13, at 34.

its receipt of information pursuant to those agreements will ultimately further the public interests, and will vigorously argue in defense of those confidentiality agreements where litigants argue that the disclosure of information pursuant to such agreements waives any privilege or protection.[46]

B. Duty to Respond to Discovery of Client Misconduct

1. General Duty to Respond to Client Misconduct

a. Model Rule 1.13

A lawyer who becomes aware of possible misconduct by a corporate client must inquire into the facts and circumstances of the situation in order to advise the client of its rights and obligations. Model Rule 1.13 provides that if a lawyer representing a corporate client is confronted with corporate misconduct, the lawyer must consider whether, among other alternatives, to present the lawyer's concerns about that misconduct to a higher level of authority within the organization while proceeding "as is reasonably necessary in the best interest of the organization."[47] Prior to amendment, Model Rule 1.13 directed that in determining the appropriate course of action, corporate counsel should consider: (i) the seriousness of the violation of law and the possible consequences; (ii) the nature and scope of the lawyer's representation; (iii) the chain of responsibility in the organization and the apparent motivation of the person involved; (iv) the policies of the organization concerning such matters; and (v) other relevant considerations.[48] Amended Model Rule 1.13, imposing a system of reporting up, contains three substantive revisions: (i) a refinement of the definition of the circumstances that trigger the lawyer's duty to take action within the organization; (ii) clarification of the circumstances in which the lawyer is required to communicate with a higher authority within the organization; and (iii) the lawyer's permissive right to reveal client information to persons outside the organization.

Under Amended Model Rule 1.13, a lawyer's reporting up obligation would be triggered when the lawyer knows[49] of facts from which a reasonable lawyer, under the circumstances, would conclude that an officer's conduct involves: (i) a violation of a legal obligation to the organization or (ii) a violation of law which reasonably might be imputed to the organization, and that violation is likely to result in substantial injury to the organization.[50] Amended Model Rule 1.13 Comment 3 explains that "the lawyer's obligation to proceed as is reasonably necessary in the best interest of the organization is determined by the conclusions that a

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[46] *Final Rules, supra* note 13, at 35.

[48] *Id*.

[49] As defined in Model Rule 1.0(f) knowledge can be inferred from the circumstances and a lawyer cannot ignore the obvious.

[50] *ABA Task Force Final Report, supra* note 8, at 44.

reasonable lawyer would, under the circumstances, draw from the facts known."[51] The ABA Task Force believed that such a standard recognizes that there is range of reasonable conduct for a lawyer facing these circumstances and that a lawyer satisfies the Model Rule by acting within that range. Moreover, the standard does not imply any duty on the lawyer's part to investigate or inquire further as to the information provided by the corporate client or the client's agent. [52]

Once triggered, Amended Model Rule 1.13 requires the lawyer to refer the matter to a higher authority in the organization unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so.[53] Where the organization's highest authority fails or refuses to act *with respect to a clear violation of law* and the lawyer believes that the violation is reasonably certain to result in substantial injury to the organization, the lawyer *may* reveal information relating to the representation to persons outside the organization, but only if and to the extent necessary to prevent substantive injury to the organization.[54] This permissive right to reveal client information does not apply in two circumstances: (i) where the lawyer was engaged by the organization to investigate an alleged violation of law or (ii) where the lawyer was engaged to defend the organization or an officer against a claim arising from an alleged violation of law. Because such disclosure may reveal client information otherwise protected under Model Rule 1.6(a), Amended Model Rule 1.13 imposes strict conditions that must exist before reporting outside the organization is allowed. The lawyer must have "a heightened level of certainty as to the violation of law, and the actual or threatened violation must be clear."[55] Moreover, there is no permissive right to report out when the organization governance failure involves a violation of a legal duty to the organization and is not otherwise a violation of law.

b. Model Rule 1.16

Model Rule 1.16 prohibits a lawyer from representing a client if the representation will result in a violation of the rules of professional conduct or other law. Model Rule 1.16 permits, but does not require, an attorney to withdraw if his services were used to effect *past* fraudulent conduct on behalf of a client. A lawyer is not obligated to decline or withdraw representation simply because the client suggests an improper course of conduct. A decision to withdraw should only be made on the basis of compelling circumstances. After withdrawal, the lawyer is required to refrain from making disclosure of the client's confidences, except as otherwise

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[51] Model Rules of Prof'l Conduct R. 1.13 cmt 3 (1983) (amended 2003). The terms "reasonable" and "reasonably" imply a range within which the lawyer's conduct will satisfy the requirements of Amended Model Rule 1.13. According to Amended Model Rule 1.13, Comment 3, such circumstances may include, among others, the lawyer's area of expertise, the time constraints under which the lawyer is acting, and the lawyer's previous experience and familiarity with the client.

[52] Model Rules of Prof'l Conduct R. 1.13 cmt 3 (1983) (amended 2003). This standard is similar to the standard used to trigger the reporting up obligation under Final Rule Sections 205.3(b)(2) and 205.2(e).

[53] American Bar Association Task Force on Corporate Responsibility, Report to the House of Delegates, *available at* http://www.abanet.org/leadership/2003/journal/119b.pdf [hereinafter *Rule 1.13 House of Delegates Report*].

[54] *Rule 1.13 House of Delegates Report, supra* note 54, at 14. The ABA Task force believes that the policy interest in protecting the organization from substantive injury outweighs the organization's general interest in protecting the confidentiality of information. In most cases, the limitation would permit communication only with persons outside the organization who have authority and responsibility to take appropriate preventative action.

[55] *Id*.

permitted by Rule 1.6. The Model Rules do not prevent the lawyer from giving notice of the fact of withdrawal, and the lawyer may also withdraw or disaffirm any opinion, document, affirmation, or the like. Disaffirmance should be a last resort and should go no further than necessary to avoid assisting the client's fraud.[56] Prior to amendment, Comment 14 to Model Rule 1.6 directed that if the lawyer's services will be used by the client in materially furthering a course of *ongoing* criminal or fraudulent conduct the lawyer *must* withdraw, as stated in Rule 1.16(a)(1). However, after the amendments to Model Rule 1.6, Comment 14 has been deleted in its entirety.

c. Model Code

In addition, Model Code Disciplinary Rule 2-110(B)(2) prohibits a lawyer from representing a client if she knows or it is obvious that her continued employment will result in a violation of a Disciplinary Rule. Model Rule 1.2 (d) and Model Code Disciplinary Rule 7-102 prohibit a lawyer from assisting the client in conduct that the lawyer knows to be illegal or fraudulent. In the event of client fraud, an attorney who has created work product, such as an opinion letter, in connection with a securities matter, may be required to disaffirm that work product so as not to further facilitate the fraud.[57] If the lawyer reasonably believes that the lawyer's silent withdrawal will be ineffective to prevent the client from using the lawyer's work product to accomplish its unlawful purpose, the lawyer may disaffirm his or her work product with the expectation that such action will prevent reliance on that work product by future victims of the client's continuing fraud.[58] Both the Model Code and the Model Rules emphasize that a lawyer should not withdraw without considering carefully and attempting to minimize the potential adverse effect on the rights of her client and the possibility of prejudice to her client as a consequence of her withdrawal.[59]

2. Effect of the Sarbanes Oxley Act: "Reporting Up" and "Reporting Out"

a. The Congressional Mandate: Section 307 of the Sarbanes Oxley Act

Section 307 of the Act provides that the Commission shall issue rules setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission. The standards must include a rule requiring an attorney to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the company or any agent thereof to the chief legal counsel or the chief executive officer of the company (or the equivalent); and, if such persons do not respond appropriately to the evidence,

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[56] *Id*.

[57] The Association of the Bar of the City of New York has maintained that, generally, it is unethical for a lawyer to provide an opinion letter that is factually and legally correct if it will be used for a fraudulent transaction. Association of the Bar of the City of New York, *Report by the Special Committee on Lawyers' Role in Securities Transactions*, 32 Bus. Law. 1879, 1887 (1977).

[58] ABA Comm. On Ethics and Professional Responsibility, Formal Op. 92-366 (1992).

[59] Model Code of Prof'l Responsibility Canon 2 (1980). Model Rule 1.16(b).

requiring the attorney to report the evidence to the audit committee, another committee of independent directors, or the full board of directors.[60]

While the Commission has opined on a case by case basis that lawyers appearing and practicing before the Commission have an obligation to report corporate misconduct to appropriate officers and directors, it had not adopted comprehensive standards directing attorneys to report instances of misconduct.[61] The Commission reassured the bar and other interested parties that the Proposed Rules "do not attempt to articulate a comprehensive set of standards regulating all aspects of the conduct of attorneys who appear and practice before the Commission."[62]

b. Scope and Trigger for Rule Application

(1) "Attorney Appearing and Practicing"

To be subject to rules promulgated pursuant to Section 301, an individual must be an "attorney" and be considered to be "appearing and practicing" before the Commission. Final Rule Section 205.2(c), identical to the Proposed Rule, identifies an "attorney" subject to the requirements of the ruleas any lawyer who is admitted, licensed, or otherwise qualified to practice law in any jurisdiction, domestic or foreign. The rule applies whether such individual is employed directly by the issuer or engaged to perform legal work on the issuer's behalf. Final Rule Section 205.2(a) narrows the definition of "appearing and practicing" from the exceptionally broad proposed rule.[63] The Final rule includes within the definition only those persons who provide legal services, and who are in an attorney-client relationship with the issuer, and who have notice that documents they are preparing will be filed with or submitted to the Commission.[64] The Commission stated that this narrower definition should clarify that it does not intend to include within the ambit of the rule business people who happen to be lawyers.

[60] 15 U.S.C. §7201 (2002).

[61] *Proposed Rules, supra* note 12, at 6 (citing e.g. *Matter of William R. Carte, Charles J. Johnson, Jr*., 22 S.E.C. Docket No. 292, 1981, WL 384414 (Commission announced that in the future it would interpret Rule 102(e) to require an attorney who learns that a client is "engaged in a substantial and continuing failure to satisfy" disclosure requirements prescribed by the federal securities laws to "take prompt steps to end the client's non compliance" in order to avoid violating professional standards); *Matter of Keating, Muething, & Klekamp*, 1979 SEC LEXIS 1186 (July 2, 1979) at *27 (Commission opined that "a law firm has a duty to make sure that disclosure documents filed with the Commission include all material facts about a client of which it has knowledge as a result of its legal representation of that client); *Matter of John H. Gutfreund, Thomas W. Strauss and John W. Meriwether*, 51 S.E.C. 93 (Dec. 3, 1992) (Commission concluded that legal and compliance officers are "obligated to take affirmative steps to ensure that appropriate action is taken to address the misconduct," including "disclosure of the matter to the entity's board of directors, resignation from the firm, or disclosure to regulatory authorities.").

[62] *Proposed Rules, supra* note 12, at 7.

[63] The definition of "appearing and practicing" contained in the proposed rules covers almost any form of representation, counsel, or advice that should be sufficient to make an attorney subject to the professional responsibility rules, whether it be in connection with a Securities Act of 1933 registration, the filing of an Exchange Act Report, the review of a press release, or a request for a no action letter.

[64] *Final Rules, supra* note 13, at 4.

The extension of the application of the rules to lawyers licensed solely by foreign countries, as contemplated by the proposed rule, has been called an "extraordinary assertion of extraterritorial jurisdiction overriding foreign professional standards"[65] and has led the Commission to carve out an exception in the Final Rules for some foreign licensed attorneys. In a roundtable discussion sponsored by the SEC to discuss the Proposed Rules, foreign lawyers expressed concerns about the many problems associated with extraterritorial application of the rules.[66] Many of those present articulated concerns that the Proposed Rules conflict with the rules of professional conduct in their foreign jurisdictions.[67] A range of exceptions for foreign licensed attorneys were suggested, ranging from a blanket exception exempting all foreign attorneys from the application of the rules, to exempting foreign attorneys who consult with a U.S. attorney.[68] U.S. attorneys feared that a blanket exemption for all foreign attorneys would lead issuers to choose foreign lawyers and law firms over those in the U.S. in order to avoid the application of the rules. Rejecting a blanket exception, the Commission, in the Final Rules, limits the application of the rules to non-U.S. attorneys who counsel clients as to U.S. law to the extent to which they are appearing and practicing before the Commission, unless they provide such advice in consultation with U.S. counsel. Foreign lawyers deemed to be "non-appearing foreign attorneys" are not considered to "appear and practice" before the Commission for the purposes of the rule and therefore not subject to the requirements of the rules.[69]

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[65] Letter from Edward Fleischman, former SEC Commissioner, to SEC (Nov. 25, 2002), available at http://www.sec.gov/rules/proposed/s74502/ehfleischman1.htm.

[66] Rachel McTague, *Foreign Lawyers Raise Concerns About Reporting Rule Proposed by SEC*, Sec. Reg. & L., Dec. 23, 2002.

[67] *Id*, at 1-2. Akira Kawamura, immediate past chairman of the Council on International Activities of the Japan Federation of Bar Associations, explained that the noisy withdrawal provision is "absolutely inconsistent" with Japanese law and ethics rules. The SEC would not be able to enforce this provision against Japanese infringers, he asserted. Moreover, Kawamura urged that the SEC would "probably destroy a part of the market in the international arena" if it finalized this part of the rule. Stephen Revell, member and immediate past chair of the SBL Capital Markets Forum of the International Bar Association, said that nobody has a problem with the up the ladder reporting requirement, but that the noisy withdrawal provision would force breach of client confidentiality. He noted that the SEC has no power to take foreign lawyers "off the hook" by deeming the disclosure not to be a breach of attorney client confidentiality. Jose Visoso, partner in the Mexican firm Frank, Galicia y Robles, like several others, said that the rule should only extend to attorneys who directly participate in preparing client documents and who have knowledge that the material will be used in an SEC filing. Further, he pointed out that even if a foreign attorney were subject to the rule, it would be difficult for the foreign attorney to determine whether there is evidence of a material violation under US laws.

[68] Thomas Joyce, a partner in the London based firm Freshfields Bruckhaus Deringer, reported that six London based firms submitted a comment letter suggesting the creation of an exception for foreign lawyers who consult with a US attorney (even within the same firm). *Id*. The International Bar Association, urging the SEC to exempt foreign attorneys from the Proposed Rules, argued that "the extension of the rules to lawyers outside the U.S. would create a series of practical difficulties that would affect the ability of non U.S. lawyers – and their client companies to become involved in transactions in the U.S., and would interfere and conflict with the regulation of the legal profession in other countries." See *International Bar Association Seeks Exemption from SEC,* BNA Corp. Couns. Dec. 14, 2002.

[69] A "non-appearing foreign attorney" means an attorney: (1) who is admitted to practice law in a jurisdiction outside the United States; (2) who does not hold himself or herself out as practicing, and does not give legal advice regarding, United States federal or state securities or other laws (except as provided in 205.2(j)(3)(ii); and (3) who: (i) conducts activities that would constitute appearing and practicing before the Commission only incidentally to, and in the ordinary course of, the practice of law in a jurisdiction outside the United States; or (ii)

In addition, the definition of "appearing and practicing" contained in the proposed rules was extremely broad in its application; however, the Commission believes that the revised definition will address the concerns brought forth by commentators. For example, former SEC Commissioner Edward Fleischman urged that the Commission not include within the ambit of the rule those attorneys merely rending legal advice or opinion about a company's obligation to file a given document with the SEC.[70] In addition, the ABA suggested a more functional approach that would subject to the requirements of the rules only those lawyers with "significant responsibility for the issuer's compliance with U.S. securities law or with overall responsibility for advising on legal compliance and corporate governance matters under U.S. law." The ABA further urged, "it is fundamental fairness to impose regulatory obligations only on those in a position to know that they are subject to the obligations and those who are in a position to comply.[71] The revised definition recognizes that attorneys interact with the SEC in a number of ways on behalf of issuers[72] while adding a new subsection clarifying particular circumstances in which an attorney will not be considered to be "appearing and practicing" before the Commission. Final Rule Section 205.2(a)(2) provides that appearing and practicing before the Commission does not include (i) conducting Commission related activities other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship, or (ii) acting as a non-appearing foreign attorney.

(2) Triggering Application of the Rules

The Commission confirmed that it intended an objective standard to trigger the application of Part 205 and recognized that the standard in the Final Rules should be substantially higher than the hair-trigger that could have been read into the rules as proposed. Under proposed Section 205.3(b), the attorney's duty to report the evidence of a "material violation" would have been triggered when the attorney became aware of information that would lead a reasonable attorney to believe that that a material violation harmful to investors has occurred, is occurring, or is about to occur.[73] The lawyer would not have to *know* that a violation has been committed in order to trigger application of the rules. Alan Beller, director of the SEC's Division of Corporate Finance, described the standard for triggering the rule as "an objective standard for a lawyer of reasonable competence … an analysis in deciding if a material violation is about to occur is whether the SEC would win the Section 13(a) case."[74]

Final Rule Section 205.3(b) provides that an attorney's "reporting up" obligation is triggered when the attorney becomes aware of evidence of a material violation by the issuer, or

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is appearing and practicing before the Commission only in consultation with counsel, or other than a non-appearing foreign attorney, admitted or licensed to practice in a state or other United States jurisdiction.

[70] *Former SEC Commissioner Urges SEC to Modify Lawyer Standards of Conduct*, SEC Today, Dec. 2, 2002.

[71] Comment on Proposed Rules from American Bar Association to the SEC (Dec. 18, 2002), *available at* http://www.sec.gov/rules/proposed/s74502/apcarlton1.htm.

[72] CCH Editorial Staff, *SEC's Attorney Conduct Proposal is Subject to Debate,* Fed. Sec. L. Rep. Report Letter No 2054, Dec. 11, 2002.

[73] *Proposed Rules, supra* note 12, at 24.

[74] CCH Editorial Staff, *SEC's Attorney Conduct Proposal is Subject to Debate,* Fed. Sec. L. Rep.. Report Letter No 2054, Dec. 11, 2002.

by any officer, director, employee, or agent of the issuer. Evidence of a material violation is "credible evidence from which it would be unreasonable, under the circumstances[75] for a prudent and competent attorney not to conclude that it is reasonably likely[76] that a material violation[77] has occurred, is occurring, or is ongoing or about to occur."[78] Like the Proposed Rules, the Final Rules do not require that the attorney be certain that a violation has occurred, is occurring, or is about to occur.

c. Obligation to Report Evidence of Material Violation: "Reporting Up"

The cornerstone of the SEC Final Rules is Section 205.3(b) providing for, as mandated by Section 307, an "up the ladder" reporting system. Under the up-the-ladder reporting scheme, the attorney would be initially directed to make the report of evidence a material violation to the issuer's Chief Legal Officer ("CLO") (or the equivalent thereof), or to both the issuer's CLO and Chief Executive Officer ("CEO").[79] However, if the attorney reasonably believes that it would be futile to report evidence of a material violation to the CLO and/or CEO, the attorney may report directly to the issuer's audit committee, another committee of independent directors, or to the full board.[80]

Upon receipt of a report of evidence of a "material violation" the issuer's CLO becomes obligated, under Final Rule 205.3(b)(2), to conduct a reasonable inquiry into the reported material violation and determine whether a violation has occurred, is occurring, or is about to occur. A CLO who reasonably concludes that there has been no material violation must notify the reporting attorney and advise the reporting attorney of the basis for such determination. A CLO who concludes that a material violation has occurred, is occurring, or is about to occur is required to take all reasonable steps to cause the issuer to respond appropriately.[81] In addition,

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[75] The "circumstances" are the circumstances at the time the attorney decides whether he or she is obligated to report the information. These circumstances may include, among others, the attorney's professional skills, background and experience, the time constraints under which the attorney is acting, the attorney's previous experience and familiarity with the client, and the availability of other lawyers with who the lawyer may consult. *Final Rules, supra* note 13, at 12.

[76] To be reasonably likely, a material violation must be more than a mere possibility, but need not be more likely than not. *Final Rules, supra* note 13, at 13.

[77] Final Rule 205.2(i) provides that a material violation means material violation of any US federal or state law, including securities law, or a material breach of fiduciary duty arising under US federal or state law.

[78] Press Release, Securities and Exchange Commission, SEC Adopts Attorney Conduct Rule Under Sarbanes-Oxley Act (Jan. 23, 2003).

[79] *Final Rules*, *supra* note 13, at 22. The proposed rule required that the attorney take reasonable steps under the circumstances to document the report and the response thereto and to retain such documentation for a reasonable time. In addition the CLO would have been required to document when he received an appropriate response to his report. In the Final Rules, the Commission has eliminated all requirements that report and responses be documented and maintained for a reasonable time.

[80] *Final Rules, supra* note 13, at 25.

[81] The corresponding proposed rule required that the CLO take reasonable steps to ensure that the issuer adopts appropriate remedial measures and/or sanctions, including appropriate disclosures.

the CLO must advise the reporting attorney of his or her conclusions.[82] Based on the findings by the CLO, the issuer must adopt appropriate remedial measures or sanctions to prevent future violations, redress past violations, and stop ongoing violations and consider the feasibility of restitution.[83]

If a reporting attorney reasonably believes the CLO or the CEO of the issuer has not provided an appropriate response[84] within a reasonable time,[85] the attorney must report the evidence of a material violation to the issuer's audit committee, another committee of independent directors, or to the full board of directors of the company.[86] The Final Rules expand the definition of what is considered an "appropriate response" to permit an issuer to assert as an appropriate response that it has directed its attorney, whether employed or retained by it, to undertake an internal review of the reported evidence of a material violation and has substantially implemented the recommendations made by an attorney after reasonable investigation and evaluation of the reported evidence.[87] Further, the Final Rule permits an attorney to take into account, and the Commission to weigh, all attendant circumstances when determining the reasonableness of the attorney's belief that a response was appropriate.[88] SEC attorney, Samuel Forstein, warns that there must be a case by case determination of how long a lawyer who has reported evidence of a material violation up the ladder to the CLO must wait before the lack of an appropriate response warrants going over the CLO's head. Forestein asserts that, irrespective of time, an appropriate response would do one of two things: (i) provide

[82] *Final Rules, supra* note 13, at 24.

[83] *Final Rules, supra* note 13, at 9.

[84] The definition of appropriate response contained in Final Rule 205.2(b) provides that "appropriate response" means a response to an attorney regarding reported evidence of a material violation as of result of which the attorney reasonably believes: (i) that no material violation has occurred, is ongoing, or is about to occur; (ii) that the issuer has adopted appropriate remedial measures; or (iii) that the issuer or a QLCC has retained or directed an attorney to review the reported evidence and either: (a) has implemented any remedial recommendations or (b) has been advised that such attorney may assert a colorable defense on behalf of the issuer. This revised definition emphasizes that an attorneys evaluation of, and the appropriateness of an issuer's response to, evidence of material violations will be measured against a reasonableness standard. The Commission's intent is to permit attorneys to exercise their judgment as to whether a response to a report is appropriate, so long as their determination of what constitutes an "appropriate response" is reasonable.

[85] A reasonable time period after which a reporting attorney is obligated to report further up the ladder would include a reasonable period of time for the issuer to complete its ongoing remediation. *Final Rules, supra* note 13, at 10.

[86] *Final Rules, supra* note 13, at 24-25.

[87] The attorney retained or directed to conduct the evaluation must have been retained or directed with the consent of the issuer's board of directors, a committee thereof to whom a report could be made, or a qualified legal compliance committee.

[88] *Final Rules, supra* note 13, at 9. The circumstances a reporting attorney might weigh include: (i) the amount and weight of the evidence of a material violation; (ii) the severity of the apparent material violation; and (iii) the scope of the investigation into the report. The Commission notes that this information, while certainly relevant to the determination of whether an attorney could reasonably believe that a response was appropriate, cannot be dispositive on the issuer. However, it is anticipated that an attorney, in determining whether a response is appropriate, may rely on reasonable and appropriate factual representation and legal determinations of persons on whom a reasonable attorney would rely.

evidence that there has not been a material violation or breach; or (ii) show that an attorney who has investigated the matter has found that the client has a colorable defense to the violation.[89]

Final Rule Section 205.3(b)(8) provides that if a reporting attorney receives what he or she reasonably believes is an appropriate and timely response to a report of a material violation, the attorney has met his or her obligations under the rule and need do nothing more with respect to his or her report.[90] Final Rule Section 205.3(b)(9) provides that an attorney who does not reasonably believe that the issuer has made an appropriate response within a reasonable time to his or her report must explain his or her concerns therefore to the CLO, the CEO and directors to whom the attorney reported the evidence of a material violation.

Some members of the bar believe that portions of the rule requiring that attorneys make judgment calls would impair attorneys' ability to render independent legal advice.[91] However, the Commission contends, "reporting up the ladder would constitute—not chill – zealous advocacy."[92] The national up the ladder reporting requirement, which would override Model Rule 1.13 for lawyers appearing and practicing before the Commission, rests on the understanding that the highest authority, typically the board of directors, is capable of performing and in fact will perform its responsibilities.[93] The Commission believes that the Model Rules, as in effect at the time of the adoption of the Final Rules, set too high a standard for reporting within an issuer evidence of a material violation, both in requiring an attorney to know of the violation and in requiring that material violation to result in a substantial injury to the issuer. "Such a high threshold for internal reporting would be inconsistent with Section 307's emphasis on the public interest and protecting investors."[94] Amended Model Rule 1.13 is more in line with Section 307's requirements and tracks many of the standards set forth in the Final Rules.[95]

d. Exceptions to Obligation to Report for Investigating Attorneys

The Final Rules adopt two new sections providing some attorneys with exceptions from the general up the ladder reporting obligation. Final Rule Sections 205.3(b)(6) and 205.3(b)(7) exempt from the rule attorneys retained or directed to investigate a report of a material violation or to litigate whether a violation has occurred.[96] These new rules narrow considerably the

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[89] Rachel McTague, SEC Attorney Says Conduct Rule Flexible On When Lawyer Can Go Over CLO's Head, Corporate Counsel Weekly, Vol. 18 No. 30 (Jul. 30 2003).

[90] *Final Rules, supra* note 13, at 27.

[91] Letter from Edward Fleischman, former SEC Commissioner, to SEC (Nov. 25, 2002), available at http://www.sec.gov/rules/proposed/s74502/ehfleischman1.htm.

[92] *Proposed Rules, supra* note 12, at 28.

[93] Comment on Proposed Rules from American Bar Association to SEC (Dec. 18, 2002), *available at* http://www.sec.gov/rules/proposed/s74502/apcarlton1.htm.

[94] *Proposed Rules, supra* note 12, at 26.

[95] See II(B)(1)(a) infra, for a discussion of Amended Model Rule 1.13.

[96] *Final Rules, supra* note 13, at 26.

instances when it is likely to be necessary for such an attorney to report up the ladder. Section 205.3(b)(6) addresses the responsibilities of attorneys retained or directed to investigate or litigate reported violations by the CLO (or the equivalent thereof). In these circumstances, the attorney has no reporting obligation where the results of the investigation are provided to the CLO and the attorney and the CLO agree no violation has occurred and report the results of the inquiry to the issuer's board of directors or to an independent committee of the board. Section 205.3(b)(7) addresses circumstances where attorneys are retained or directed to investigate or litigate reported violations by a qualified legal compliance committee ("QLCC"). An attorney retained or directed by the CLO to litigate a reported violation has no reporting obligation so long as he or she is able to assert a colorable defense on behalf of the issuer and the CLO provides reports on the progress and the outcome of the litigation to the issuer's board of directors. An attorney retained or directed by a QLCC to investigate a reported violation has no reporting obligations. Similarly, an attorney retained or directed by a QLCC to litigate a reported violation has no reporting obligation provided he or she may assert a colorable defense on behalf of the issuer.

e. An Alternative Reporting Scheme: the Qualified Legal Compliance Committee

Under Final Rule Section 205.3(c), as an alternative scheme of reporting evidence of material violations, an issuer's board of directors may, but is not required to, establish a QLCC. Such a committee may be newly formed or formed from an existing committee of the issuer.[97] The QLCC must include at least one member of the issuer's audit committee[98], and two or more independent board members.[99] Where established, the QLCC would be charged with investigating reports of evidence of a material violation made by attorneys. The QLCC must have written procedures for the confidential receipt, retention, and consideration of any report of evidence of a material violation.[100] Both in house and outside counsel, as well as the CLO are permitted to make reports to the QLCC. Upon receipt of a report of evidence of a material violation, the QLCC must decide whether an investigation[101] is necessary to determine whether the material violation described in the report has occurred, is occurring, or is about to occur, and notify the audit committee or the full board of directors of such material violation. Further, the QLCC is responsible for carrying out the steps required by Section 307 of the Act: notifying the CLO of the report of evidence of a material violation; causing an investigation where appropriate; determining what remedial measures are appropriate where a material violation has occurred, is ongoing, or is about to occur; reporting results of the investigation to the CLO, the

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[97] *Final Rules, supra* note 13, at 17.

[98] Where the issuer does not have an audit committee, the requirement to appoint at least one member of the audit committee to the QLCC may be met by appointing instead a member from an equivalent committee of independent directors.

[99] Usually, a director who is *not* "employed directly or indirectly by the issuer" is an independent director of the issuer. *Proposed Rules, supra* note 12, at 34.

[100] *Final Rules, supra* note 13, at 18.

[101] The investigation may be conducted either by the CLO or by outside attorneys.

CEO and the full board of directors, and notifying the Commission if the issuer fails in any material respect to take any of those appropriate remedial measures.[102]

An attorney who reports to the QLCC has satisfied his reporting obligation under the rule and is not required to assess the issuer's response to the reported evidence.[103] The Commission believes that this alternative may encourage attorneys to report evidence of a material violation more promptly, since the reporting attorney's obligations under the rule would be met by doing so. Many commentators see the institution of a QLCC as a safe harbor because a report to the QLCC relives the reporting attorney of any further obligation under the rule.[104] However, Alan Beller, director of the SEC's Division of Corporate Finance, has noted that the QLCC is not intended to be a safe harbor, but an "alternative."

f. Noisy Withdrawal: "Reporting Out"

In addition to the up the ladder reporting requirement, the Proposed Rules included several corollary provisions in 205.3(d) that are not explicitly required by Section 307, but that the Commission considered potentially important minimum standards for attorneys appearing and practicing before the Commission in the representation of issuers. Under certain circumstances, these provisions would have permitted or required attorneys to withdraw from representation of an issuer, to notify the Commission that they have done so, and to disaffirm documents filed or submitted to the Commission on behalf of the issuer (i.e. noisy withdrawal).[105] As expected, the bar resisted the reporting out provisions from concern that the provisions would undermine the attorney-client privilege and the duty of confidentiality owed to clients. Some commentators flatly rejected the proposal, while others, including former SEC Commissioner Edward Fleischman and the D.C. Bar Association, urged the Commission to defer taking action on provisions, such as the noisy withdrawal provision, that go beyond the mandate of the Act.[106] Commissioner Harvey Goldschmid, in his remarks to the ABA Federal Regulation of Securities Committee, told a group of securities lawyers that their client confidentiality concerns about an SEC rule proposal to mandate the reporting of corporate malfeasance can be

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[102] *Final Rules, supra* note 13, at 29.

[103] *Final Rules, supra* note 13, at 28.

[104] *See e.g.* Hearing of the Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee of the House Financial Services Committee, February 4, 2004, comments of Richard Painter, "it's an opt-out rule. If you don't like it, under the SEC rules you'd simply set up a qualified legal compliance committee and then all the reporting goes to the committee and there's no noisy withdrawal requirement any more."

[105] Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release Nos. 33-8186; 34-47282, (proposed January 29, 2003) (to be codified at 17 C.F.R. pt. 205), *available at* http://www.sec.gov/rules/proposed/33-8186.htm [hereinafter *Noisy Withdrawal Proposal*].

[106] Letter from Edward Fleischman, former SEC Commissioner, to SEC (Nov. 25, 2002), available at http://www.sec.gov/rules/proposed/s74502/ehfleischman1.htm.; Comment on Proposed Rules from the D.C. Bar Association to the SEC (Dec. 18, 2002), *available at* http://www.sec.gov/rules/proposed/s74502/dcbar1.htm. Not all commentators opposed the provisions, some, such as Richard Painter, a professor of securities law and professional responsibility at the University of Illinois School of Law and a leading advocate of tightening lawyer's professional responsibilities, believe that the noisy withdrawal provision does not go beyond the statute. Painter argues that the noisy withdrawal provision is a default rule because it can be avoided by the issuer having a QLCC. Commissioner Harvey Goldschmid announced on November 22, 2002 that the SEC reserves the right to drop the noisy withdrawal provision – the alternative proposal has done just that.

outweighed by the need to arrest an ongoing financial fraud.[107] Moreover, the Proposed Rule's assurance that such a withdrawal and disaffirmation is not a breach of any attorney-client privilege did not silence critics of the provisions.[108]

On January 23, 2003, in announcing the adoption of the Final Rules, the Commission announced that it would defer the adoption of a rule requiring noisy withdrawal pending additional comments received during the extended 60-day comment period. The Commission indicated concern that a "reporting out" provision could inhibit discussions between attorneys and clients and explained that there had not been a sufficient opportunity for comment on the provision. In addition, the Commission announced an alternative noisy withdrawal proposal. No further action was taken on the alternative proposal. The original proposal and the alternative proposal are discussed below.

(1) Original Proposal for "Noisy Withdrawal"

Proposed Rule Section 205.3(d) set forth the obligation of an attorney who has not received an "appropriate response" from the issuer, and in certain circumstances, requires or permits a noisy withdrawal. "Noisy withdrawal" requires an attorney to "disaffirm" a "tainted" submission to the SEC, thereby breaking confidence with the client issuer ('reporting out"). This proposal distinguished between inside and outside attorneys. The provision also distinguished between material violations that have already occurred and are not ongoing and those which are either ongoing or have not yet occurred. As such, there are four possible scenarios under the original proposed rule:

<u>Outside Attorneys</u>

1. **An outside attorney has reported a material violation and such violation is ongoing or about to occur and is likely to result in substantial injury to the financial interest or property of the issuer or of investors**.[109] Here, the outside

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[107] Rachel McTague, *Goldschmid Says Confidentiality Not Absolute, Urges Lawyers' Duty to Report Ongoing Fraud*, Sec. Reg. & L., Dec. 9, 2002.

[108] Application of the attorney-client privilege is an area that has been principally governed by state courts. Commentators argue that the SEC is "presuming that any administrative agency has the non-specified authority to take away from the courts the determination of what conduct by a lawyer" constitutes waiver. Letter from Edward Fleischman, former SEC Commissioner, to SEC (Nov. 25, 2002), available at http://www.sec.gov/rules/proposed/s74502/ehfleischman1.htm. Attorneys believe that "the Commission requires more explicit authority from Congress before it attempts to preempt state court jurisdiction." Pamela Atkins, *Attorneys Call for Delay, More Discussion of SEC Rule Proposals on Noisy Withdrawal*, BNA Daily Report for Executives, Dec. 19, 2002. However, the Commission reasons that the attorney is not acting as the issuer's agent and accordingly does not waive the issuer's attorney-client privilege in the information disclosed or any other privilege or protection that the issuer is entitled to assert regarding the information. *Proposed Rules, supra* note 12, at 43.

[109] Prior to the adoption of the Model Rules, the existing legal ethics rules contained an exception to the confidentiality rule, allowing attorneys to act to prevent financial harm. The exception disappeared in the Model Rules. More recently, the ABA House of Delegates rejected the Ethics 2000 report that urged a resurgence of the exception. However, 41 states have kept the old rule or declined to adopt the new approach favored by the Model Rules. In July 2002 the ABA Task Force on Corporate Responsibility recommended that Model Rule 1.6 be amended to make disclosure mandatory to prevent serious client crimes using the lawyer's services, including

attorney would be *required* to (i) withdraw from the representation, (ii) within on business day of withdrawing, notify the Commission (in writing) of their withdrawal, indicating that it was based on "professional considerations" and (iii) disaffirm any submission to the Commission that the attorney has prepared or assisted in preparing and that the attorney believes is or may be materially false or misleading.[110]

2. **An outside attorney has reported a material violation that occurred in the past and is likely to have resulted in substantial injury to the financial interest or property interest of the issuer or investors but is not ongoing**. Here, the attorney would be *permitted, but not required*, to take the steps required above.[111]

In-House Attorneys

3. **An in-house attorney has reported a material violation and such violation is ongoing or about to occur and is likely to result in substantial injury to the financial interest or property of the issuer or of investors.** Here, the in-house attorney would be *required* to (i) notify the Commission in writing within one business day, that the lawyer intends to disaffirm some opinion, document, affirmation, representation, etc., filed with the Commission or incorporated into such a document, and (ii) disaffirm in writing any tainted submission that the attorney has prepared or assisted in preparing and that the attorney believes is or may be materially false or misleading. In-house attorneys are not required to resign.[112]

4. **An in-house attorney has reported a material violation that occurred in the past and is likely to have resulted in substantial injury to the financial interest or property interest of the issuer or investors but is not ongoing.** Here, the attorney would be permitted to (i) notify the Commission in writing that he intends to disaffirm some opinion, document, etc., that the attorney has prepared or assisted in preparing and that the attorney believes is or may be materially false or misleading, and (ii) disaffirm to the commission, in writing, any such opinion, document, affirmation, representation, etc.[113]

In all four scenarios, the CLO would have been required to inform any attorney retained or employed to replace the attorney who has withdrawn that the previous attorney's withdrawal was based on professional considerations.[114] While Section 307 of the Act does not mandate a noisy withdrawal provision, the SEC concluded that requiring a reporting attorney to "disaffirm" a "tainted" submission to the SEC "is important to the effective operation of the reporting obligation in those instances where an issuer does not respond appropriately."[115]

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violations of federal securities laws and regulations, where the misconduct is known to the lawyer and is reasonably certain to result in substantial injury to the financial interest or property of another.

[110] Proposed Rule §205.3(d)(1)(i), *Proposed Rules, supra* note 12, at 39.

[111] *Proposed Rules* §205.3(d)(2), *Proposed Rules, supra* note 12, at 42.

[112] *Proposed Rule* §205.3(d)(1)(ii), *Proposed Rules, supra* note 12, at 39.

[113] *Proposed Rules* §205.3(d)(2)(ii), *Proposed Rules, supra* note 12, at 42.

[114] *Proposed Rule* §§205.3(d)(2)(iii) and 205.3(d)(1)(iii), *Proposed Rules, supra* note 14, at 40.

[115] *Proposed Rules, supra* note 12, at 67.

Many commentators argued that the “reporting out” provision conflicts with the confidentiality rules of state bars that have borrowed from Model Rule 1.6. Model Rule 1.6 permits, but does not require, an attorney to disclose confidential material to prevent certain serious client crimes, but not financial wrongdoing.

In addition, many commentators believe that the phrase “professional considerations” is essentially code language that reveals the nature and significance of the disagreement, even if not detailed confidences. However, the Commission argued that utilizing the phrase “professional considerations” to explain the withdrawal “keeps confidential the particular facts underlying the withdrawal,”[116] One commentator argued that the Commission was looking for some sort of “red light” by which it can spot a material lapse in an issuer’s reporting.[117] Forcing the attorney to report out “substitutes the lawyer’s legal judgment – on materiality for instance – for that of the client’s chief internal reviewing officer or organ. Moreover, it substitutes the lawyer’s business judgment on whether management’s objectives further the interest of the company and its shareholders for that of the client’s audit committee or its board of directors.”[118]

(2) Alternative Proposal to “Noisy Withdrawal”

Heeding the pleas by many commentators to defer adoption of final rules relating to noisy withdrawal, the Commission proposed an alternative to the Proposed Rule 205.3(d) (the “Alternative Proposal”). The Alternative Proposal does not contain “noisy withdrawal” or disaffirmation requirements and requires attorney action only where the attorney reasonably concludes that there is substantial evidence that a material violation is ongoing or about to occur and is likely to cause substantial injury to the issuer.

Section 205.3(e) of the Alternative Proposal would require an issuer (rather than its attorney) to report to the Commission an attorney's written notice of withdrawal or failure to receive an appropriate response, as described in section 205.3(d) of the Alternative Proposal. In connection with section 205.3(e) of the alternative proposal, the Commission also proposes to amend Forms 8-K, 20-F, and 40-F to require issuers to disclose publicly an attorney's written notice of withdrawal within two business days of that notice. Section 205.3(f) of the alternative proposal permits (but does not require) an attorney to inform the Commission of his or her withdrawal if the issuer does not comply with paragraph (e).[119] The Commission reasons that this proposed procedure would alleviate potential conflicts with some state bar rules, as well as ethics rules in some foreign jurisdictions that forbid lawyers from disclosing confidential client

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116 *See e.g. Id.*.

117 Charles P. Axelrod, *A View of the SEC’s Proposed Attorney Responsibility Rules Under Sarbanes-Oxley*, 34 Sec. Reg. & L.2053, Dec. 23, 2002.

118 Letter from Edward Fleischman, former SEC Commissioner, to SEC (Nov. 25, 2002), available at http://www.sec.gov/rules/proposed/s74502/ehfleischman1.htm.

119 *Noisy Withdrawal Proposal, supra* note 104, at 10.

information.[120] Critics charge that the Alternative Proposal is essentially the same as the original, but with "cosmetic appeal."[121]

The Alternative Proposal contains three primary provisions:

1. **Requiring an Attorney to Provide Written Notice of Withdrawal to the Issuer When the Attorney Does Not Receive an Appropriate Response to His Report of a Material Violation**[122]

   Outside Attorneys. Alternative proposed section 205.3(d) would require an attorney retained by the issuer who has reported evidence of a material violation and has not received an appropriate or timely response to withdraw from representing the issuer and to notify the issuer, in writing, that the withdrawal is based on professional considerations.[123]

   In-House Attorneys. Faced with the same circumstances, an attorney employed by the issuer would be required to cease participating or assisting in any matter concerning the violation and to notify the issuer, in writing, that he or she believes the issuer has not provided an appropriate response.[124]

2. **Requiring An Issuer to Report An Attorney's Written Notice of Withdrawal**

   Proposed section 205.3(e) would require an issuer who has received notice from an attorney under alternative proposed section 205.3(d) to report the notice and the circumstances related thereto in an appropriate filing with the Commission. Proposed section 205.3(e) would provide that the filing must be made by the issuer on Form 8-K, 20-F or 40-F, as applicable.[125]

3. **Permitting an Attorney to Inform the Commission Where an Issuer Has Not Complied with the Issuer Reporting Requirements**

   Proposed section 205.3(f) would permit an attorney, if an issuer had not complied with paragraph (e), to inform the Commission that he or she had provided the issuer with notice under paragraph (d)(1), (d)(2) or (d)(3). The Commission proposes, in this paragraph, making attorney notification to the Commission permissive, instead of mandatory, in light of the numerous comments it received that were critical of "noisy withdrawal."[126]

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[120] Tamara Loomis and Otis Bilodaueu, *SEC Eases Off on Provisions for Attorneys*, *available at* http://www.law.com/servlet/ContentServer?pagename=OpenMarket/Xcelerate/View&c=LawArticle&cid=1042568712210&t=LawArticleCorp.

[121] *See e.g.* Hearing of the Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee of the House Financial Services Committee, February 4, 2004, comments of Stanley Keller.

[122] Unlike the original proposed section 205.3(d)(1), this proposed paragraph does not require a withdrawing attorney to notify the Commission of his or her withdrawal, and it does not require an attorney to disaffirm documents filed with the Commission. *Noisy Withdrawal Proposal, supra* note 104, at 11.

[123] *Id*.

[124] *Id*.

[125] *Id*. at 13.

[126] *Id*. at 16.

g. The Responsibilities of Supervisory and Subordinate Attorneys

(1) Supervisory Attorney

The Final Rules broadly define a supervisory attorney as an attorney supervising or directing another attorney who is appearing and practicing before the Commission in the representation of an issuer.[127] Final Rule Section 205.4 places three primary responsibilities on supervisory attorneys. A supervisory attorney: (i) must make reasonable efforts to ensure that a subordinate attorney that she supervises complies with the Part 205 rules and other rules administered by the Commission[128]; (ii) must comply with the reporting requirements in Section 205.3 when a subordinate attorney has reported to the supervisory attorney evidence of a material violation;[129] and (iii) may report evidence of a material violation to an issuer's QLCC.[130]

(2) Subordinate Attorney

A subordinate attorney[131] who has reported evidence of a material violation to his supervisor has complied with his reporting obligations under the rule. If the subordinate attorney believes that the supervisory attorney has failed to comply with the reporting requirement under the rule, such subordinate attorney is *permitted, but not obligated* to report the evidence up the ladder. In addition, a subordinate attorney is bound by Part 205 notwithstanding that the subordinate attorney acted at the direction of or under the supervision of another person.[132] The Commission believes that subordinate attorneys should not be exempted from the application of the rule merely because they operate under the supervision or at the direction of another person (who may or may not be an attorney), and the creation of such exemption would seriously undermine Congress' intent to provide for the reporting of evidence of material violations to issuers.

C. Special Issues in Corporate Compliance Programs

1. General Compliance Programs

Special issues arise when a lawyer for a corporation participates in a compliance program that involves reports by company employees of possible wrongdoing within the company,

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[127] *Final Rules, supra* note 13, at 35.

[128] *Id*.

[129] *Id*.

[130] *Id*.

[131] An attorney under the supervision or direction of another attorney is a subordinate attorney. *Final Rules, supra* note 13, at 36.

[132] *Final Rules, supra* note 13, at 73. This rule is based on Model Rule 5.2 which provides that subordinate attorneys remain bound by the Model Rules notwithstanding the fact that they acted at the direction of another person.

because the reports may reveal conflicts of interest between an employee and the corporation. It is the lawyer's obligation, when it appears that a conflict of interest exists, to determine whether the employee is represented by counsel and to provide appropriate advice to the employee regarding the conflict. The New York State Bar Association Committee on Professional Ethics approved the following proposal for lawyers who participate in a "compliance with law" program under which employees are required to report illegal or unethical behavior, and in which lawyers may staff a "help line" and take calls from employees (the opinion is included as Exhibit 2 to this outline):

"When it appears that a caller's interest may differ from, or there is a reasonable possibility that such interests may be 'in conflict' with the Company's interests

Step 1: Determine whether the caller is represented by counsel. If yes, make the following statement:

> 'The Company's policy requires that you report non-compliance with the law or other unethical behavior. However, as you are represented by counsel, I can only talk to you through your counsel. Please have him/her call me or give me his/her name and I would be happy to call him/her.'

Step 2: If the caller is not represented by counsel, please make the following statement:

> 'I want to caution you that I am an attorney for the Company and not for you or other employees. Therefore, while I can record your complaint, I cannot and will not give you legal advice, and you should not understand our conversation to consist of such advice. I do advise you to seek your own counsel, however, as your interests and the Company's may differ. Having said this, I would be happy to listen to your complaint, etc.'"[133]

The *Wall Street Journal* reported on April 13, 2009 that a US District Court judge in Los Angeles threw out portions of the government's criminal case against a former executive of Broadcom Corp., because "a Los Angeles law firm hired by Broadcom to review possibly illegal stock-option grants, failed to explain clearly to the executive that it wasn't representing him. The judge went so far as to refer the law firm to the California state bar for disciplinary action, citing 'ethical misconduct.'"[134]

2. Effect of the Sarbanes Oxley Act: Whistleblower Protection

Section 806 of the Act ("Section 806") provides for certain "whistle blower" protections designed to protect all employees (both internal and external) of public companies against retaliatory action because of any lawful act performed by any an employee in (i) providing

[133] New York State Bar Association Committee on Professional Ethics, Opinion 650 (June 30, 1993), http://www.nysba.org/Content/NavigationMenu/Attorney_Resources/Ethics_Opinions/Committee_on_Professional_Ethics_Opinion_650.htm.

[134] Kara Scannell, "For Corporate Lawyers, There's Just One Client," *Wall Street Journal* (April 13, 2009).

information to or assisting a law enforcement officer in an investigation relating to possible corporate fraud or accounting abuses, or (ii) filing, testifying, participating, or otherwise assisting in any proceeding related to an alleged violation of corporate fraud laws or regulations.[135] Section 806 provides for a non-exclusive civil damage remedy, including attorney's fees, for aggrieved employees, provided they first seek relief from the Secretary of Labor. Thus, an attorney who complies with Section 205.3(d) of the Act, and who is subjected to retaliatory action by an issuer may be accorded a measure of protection and a means of redress under Section 806.

In addition to the protections afforded to whistleblowers by Section 806 of the Act, Section 1107 of the Act ("Section 1107") imposes criminal penalties on any individual who "knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any federal offense."[136] The penalties for a violation of Section 1107 include a fine and/or imprisonment of up to 10 years. Unlike the civil remedies available under Section 806, the criminal penalties created by Section 1107 are not limited to the actions of publicly traded companies, nor are they restricted in scope to matters involving corporate fraud or accounting abuses.[137]

D. Potential Consequences of Counsel's Ethical Violations

In light of the prohibitions against knowing assistance of a client's fraud articulated in the Model Rules and the Model Code, corporate counsel who take no action when confronted with ongoing or planned illegality risk significant liability. Despite the bar's consistent view that disclosure may be made only in limited circumstances, an attorney's failure to disclose client misconduct may result in prosecution by regulatory authorities and civil suits by third parties who have suffered damages as a result of the corporate client's misconduct. By virtue of Section 3(b) of the Act, Section 21(e) of the Exchange Act, and Rule 102(e) of the Commission's Rules of Practice, the Commission could resort to either a judicial or administrative forum or both in seeking remedial relief against an attorney; the former to address the violations under the Act and the latter to address the ability to appear and practice before the Commission.[138]

1. Existing Right of SEC to Discipline Counsel: SEC Rule 102(e)

Rule 102(e) of the Commission's Rules of Practice ("Rule 102(e)") has been the primary vehicle available to ensure the competence of attorneys that appear before the Commission. Current Rule 102(e) permits the Commission to initiate disciplinary proceedings against attorneys who lack integrity or competence, engage in improper professional conduct, or are

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[135] 15 U.S.C. §7201 (2002).

[136] *Id*.

[137] *President Bush Signs into Law New Protections for Corporate Whistleblowers*, Shaw Pittman LLP Employment/Litigation Alert, Number 4, Aug. 2002.

[138] Charles P. Axelrod, *A View of SEC's Proposed Attorney Responsibility Rules Under Sarbanes-Oxley*,34 Sec. Reg. & L., Dec. 23 2053, 2002.

determined to have violated provisions of the federal securities laws. The sanctions available in those proceedings include censure, temporary suspension, and permanent bar. [139] Unlike the rules applicable to accountants, Rule 102(e) gives no guidance with respect to the conduct that would subject an attorney to sanction.[140] Rule 102(e) does not establish professional standards for attorneys. Rather, the rule enables the Commission to discipline professionals who have engaged in improper professional conduct by failing to satisfy the rules, regulations, or standards to which they are already subject, including state ethical rules governing attorney conduct.[141] Until the enactment of Section 307 of the Act, the Commission had never had express statutory authority to promulgate a rule establishing standards of conduct for attorneys representing issuers.[142]

2. Final Rule Section 205.6: Sanctions and Discipline

A violator of Part 205 would be subject to all of the civil penalties and remedies available for a violation of the federal securities laws. The rule does not rescind or supplant Rule 102(e), but a violation of Part 205 would constitute a Rule 102(e) violation.[143] An attorney who violates a provision of Part 205 will have engaged in *improper professional conduct* and may also be subject to administrative disciplinary proceedings that can result in censure, a suspension, or a bar from practicing before the agency.[144] Final Rule Section 205.6 provides that the Commission may impose discipline and sanction an attorney who violates the rule even when the attorney is subject to discipline in the state where he or she practices or is admitted.[145] An attorney who complies in good faith with the provisions of Part 205 will not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other U.S. jurisdiction where the attorney is admitted or practices.[146] The prospect of simultaneous Commission and state disciplinary proceedings for the same misconduct raises questions of the impact of the rule upon state ethical rules and regulation.[147] According to the SEC's General Counsel, Giovanni P. Prezioso, federal law will determine whether an attorney has complied with Part 205. Prezioso argues that "because the issue of whether the attorney has acted in good

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[139] SEC Rules of Practice, 17 C.F.R. §201.102(e).

[140] *Id*.

[141] *Proposed Rules, supra* note 12, at 81.

[142] *Proposed Rules, supra* note 12, at 4

[143] The Commission noted that while Rule 102(e) serves only as a disciplinary rule, Part 205 may serve both an enforcement and disciplinary function. Part 205 will be used only to address misconduct arising under that rule. Rule 102(e) will continue to be used to address the same types of misconduct for which it has traditionally been invoked, except those that would not fall under Part 205.

[144] Improper conduct includes (1) intentional or knowing conduct, including reckless conduct, that results in a violation of Part 205 and (2) negligent conduct in the form of a (i) a single instance of highly unreasonable conduct that results in a violation; or (ii) repeated instances of unreasonable conduct resulting in a violation of Part 205. *Proposed Rules, supra* note 12, at 55. The requirements adopted here are the same state of mind requirements adopted for accountants in the 1998 amendment to 102(e).

[145] *Final Rules, supra* note 13, at 38.

[146] *Id*.

[147] An attorney practicing outside the U.S. shall not be required to comply with the requirements of Part 205 to the extent that such compliance is prohibited by applicable foreign law.

faith requires an interpretation of a Commission rule, states must defer to the SEC's construction." Any conflicting state rule would be preempted by the Commission's rule. Further, the purposes of the Commission's good faith provision would be frustrated by a state-based definition of good faith that is inconsistent with the Commission's interpretation.[148] Part 205 is not intended to impact the disciplinary rules of the jurisdictions in which an attorney is admitted to practice. However, the Commission, through Rule 102(e), may commence an administrative proceeding to censure or temporarily or permanently suspend or bar an attorney from practicing before the Commission.[149]

3. Lawyer Liability for Misstatements

In recent years, the Commission has sought to impose on securities lawyers duties of disclosure that exceed the lawyer's ethical duties.[150] The Commission has utilized administrative proceedings under Rule 102(e) to express the view that a lawyer's representation of a client in the face of the client's false and misleading disclosures or omissions implicates not only the lawyer's professional standards of conduct, but also legal responsibility for the consequences of the client's conduct.[151] A lawyer may therefore be required to take action beyond advising a client to comply with regulatory requirements in order to avoid suspension or disbarment from practice before the Commission.

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[148] CCH Editorial Staff, *SEC General Counsel Says Attorney Conduct Rules Preempt State Regulation*, Fed. Sec. L. Rep., Report Letter No. 2086 (Jul. 30, 2003). The Washington State Bar Association had adopted an interim formal ethics opinion warning corporate counsel in the state not to disclose to the SEC certain information that the Final Rules permit them to reveal unless the disclosure is also allowed by the state's own professional conduct rules. SEC General Counsel, Giovanni P. Prezioso, in a letter to the Washington State Bar Association, noted that the SEC rules prove a safe harbor from discipline and liability under inconsistent state law conduct rules if the attorney complies in good faith with the SEC attorney reporting rules.

[149] The Commission has affirmed that it does not intend that the provisions of Part 205 create any private right of action against an attorney based on his or her compliance or non-compliance with its provisions. *Final Rules, supra* note 13, at 39. *See also* Press Release, Securities and Exchange Commission, SEC Adopts Attorney Conduct Rule Under Sarbanes Oxley Act (Jan. 13, 2002).

[150] *See In re Gutfreund*, Exchange Act Release No. 31,554 [1002 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶85,067 (where the Commission maintained that a corporate legal officer was obligated to take steps (which could include disclosure to the board of directors or regulatory authorities) to address corporate misconduct). *See also SEC v. National Student Mktg. Corp*., [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶93,360 (where the Commission maintained that lawyers for National Student Marketing Corp. should have notified the Commission concerning the misleading nature of their client's financial statements).

[151] *See In re Carter & Johnson*, Exchange Act Release No. 17, 597 [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847 (where, despite evidence that the attorneys advised their client to make certain required disclosures, an administrative law judge found that the attorneys engaged in unethical and improper professional conduct by willfully aiding and abetting their client's securities laws violation. The Commission did not find sufficient evidence of willfulness, however, to sustain the finding of aiding and abetting. The Commission stated that a lawyer who becomes aware of a client's failure to comply with disclosure requirements must take "prompt steps to end the client's non-compliance." These steps include counseling the client, and where violative conduct is continuing, disclosure to senior management or the client's board of directors. Although the Commission included resignation as an option for the lawyer, it did not include among such options, disclosure to the public or to the Commission.

The Commission is not alone in holding attorneys responsible for misleading statements made by or on behalf of attorneys' clients. Courts are interpreting SEC and common law liability principles in new ways to find attorneys liable to non-client plaintiffs.

a. Section 10(b) and Primary Liability for Attorneys

Section 10(b) of the Exchange Act prohibits "manipulative or deceptive acts in connection with the purchase or sale of securities."[152] The Commission's Rule 10b-5, promulgated under the Exchange Act, prohibits knowingly or recklessly making material misstatements or omissions in connection with the sale of securities. Recognizing the rule's principal purpose – to protect investors – the courts have implied into the rule a private right of action against alleged wrongdoers.

Under 10b-5(b), "any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming all of the requirements for primary liability under Rule 10b-5 are met."[153] The Supreme Court left it to the lower courts to determine when the conduct of a secondary actor (e.g. accountants and attorneys) makes such individual a primary violator under the statue.[154] Under the "bright line" test, in order for the conduct of a secondary actor to rise to the level of a primary violation, the secondary actor must not only make a material misstatement or omission, but "the misrepresentation must be attributed to the specific actor at the time of public dissemination," i.e. in advance of the investment decision, so as to satisfy the element of reliance for §10(b) liability.[155]

From 1966 until 1994, private party suits against secondary actors for aiding and abetting primary violators of Section 10(b) had been allowed to proceed in federal court. However, in *Central Bank of Denver v. First Interstate Bank of Denver*, the Supreme Court rejected the notion that secondary civil liability may be imposed for aiding and abetting misstatements.[156] The court added that the absence of Section 10(b) aiding and abetting liability does not mean that secondary actors in securities markets are always free from liability under the Securities Act.

Since *Central Bank of Denver*, a line of cases has emerged which holds that an attorney can be liable under Rule 10b-5 solely as a primary violator.[157] In *Employers Ins. of Wausau v.*

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[152] 15 U.S.C. §78j(b).

[153] *In re Enron Corporation Securities, Derivative & ERISA Litigation,* 2002 U.S. Dist. LEXIS 25211, at 16(S.D. Tex Dec. 20, 2002) (citing Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164,191).

[154] *Id*. at 17.

[155] *Id*. (citing *Wright v. Ernst & Young, LLP*, 152 F.3d 169, 175 (2d cir. 1998), cert. denied, 525 U.S. 1104(1999).

[156] *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994), *superseded in part by statute*, 15 U.S.C. §78t(e) (permitting public prosecution of aiding and abetting violations).

[157] Aiding and abetting has not disappeared, however, from enforcement actions and criminal prosecutions. The Commission still has the authority to pursue aiders and abettors. *See* 15 U.S.C. § 78t(e); Private Securities Litigation Act of 1995, Pub. Law No. 104-67, 109 Stat. 737 (104th Cong. 1st Sess. December 23, 1995). In addition, criminal convictions for aiding and abetting have been recently upheld. *See United States v. Bradstreet*, 135 F.3d 46 (1st Cir. 1998).

Musick, Peeler & Garrett, the Southern District of California held that attorneys who draft a prospectus that contains misrepresentations can be primary violators of Rule 10b-5.[158] In *Klein v. Boyd*, the Third Circuit found that a law firm could be held liable for securities fraud as a primary violator of Rule 10b-5, even where the lawyer did not sign the document(s).[159] The court added, "while the firm did not have an obligation to blow the whistle on its client, it did have a duty to correct its statements."[160]

In *In re Enron Corporation Securities, Derivative & ERISA Litigation,* the Southern District of Texas found that "professionals, including lawyers and accountants, when they take the affirmative step of speaking out, whether individually or as essentially an author or co-author in a statement or report, whether identified or not, about their client's financial condition, do have a duty to third parties not in privity not to knowingly or with severe recklessness issue materially misleading statements on which they intend or have reason to expect that those third parties will rely."[161]

In the *Enron Litigation*, the plaintiff alleged that Enron's lawyers, accountants and underwriters participated with the company in a scheme to enrich themselves, designed to continually draw in more and more investors' funds through the continued sale of Enron securities so that Enron could expand its operations. [162] "Thus, the potential investors were allegedly the intended targets of the reports and documents drafted and issued by the accountants and the attorneys, whether for Enron which they allegedly expected to use the misrepresentations to lure in more investment funds or for the public via SEC filings."[163] The very pattern of action, said the court, undermines claims of negligence and supports allegations of intent to defraud. However, the court was concerned about the danger of "opening the professional liability floodgates to any and every potential investor or foreseeable user of allegedly misleading information who may rely on the statement. Therefore, the court cautioned, a restricted approach with regard to the group to which the attorney and accountant owe the duty should be taken. [164]

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[158] 871 F.Supp. 381 (S.D.Cal. 1994), *amended in part*, 948 F.Supp. 942 (1995).

[159] Fed. Sec. L. Rep. (CCH) ¶ 90,136 (3d Cir. Pa. 1998). The Third Circuit has also held that lawyers may be primarily liable for material misrepresentations and omissions in legal opinions they provide that they know will be relied on by third parties.

[160] *See also Petrillo v. Bachenberg*, 655 A.2d 1354 (NJ 1995). The court concluded that a lawyer may be liable to a third party for professional negligence where it was "reasonably foreseeable" that the attorney's advice would be relied on by third parties. In dicta, the court indicated that "a lawyer reasonably should foresee that third parties will rely on an opinion letter issued in connection with a securities offering." 655 A.2d at 1359.

[161] In Re Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 694 (S.D. Tex. 2002)..

[162] *Id*.

[163] *Id*.

[164] I*d*. at 611. Aiding and abetting has liability may still be an option in enforcement actions and criminal prosecutions. In 1995, the Private Securities Litigation Reform Act ("PSLRA") authorized the SEC to bring enforcement actions against those individuals who "knowingly provide substantial assistance to another person" in the violation of the federal securities law. However, the PSLRA did not create a parallel private right of action. In the *Enron Litigation*, the court noted that the PSLRA must be viewed within the context of the decades-old private right of action granted to defrauded investors injured by corporate management, auditors, outside counsel, and investment bankers when their conduct allegedly violates the federal securities laws.

Another court expanded the universe of scenarios in which attorneys may be liable for fraud, holding a law firm liable for omission of material facts in the firm's statements to opposing counsel in a merger. In *Vega v. Jones, Day, Reavis & Pogue*, a law firm representing an acquiring company voluntarily provided disclosure schedules to its client's target company that described the terms of a third-party investor in the acquiror.[165] The disclosure schedules, however, excluded material terms of financing. These terms represented "toxic" financing provisions that later rendered the target's shareholders' merger compensation essentially worthless. The firm argued that it had no duty to disclose the financing terms to the target company. The court characterized the firm's actions as "active concealment of a material fact in a transaction the lawyers undertook to disclose,"[166] and ruled that the complaint stated a claim for fraud against the law firm.

Other courts have resisted expanding attorney fraud liability, more particularly the *Enron* court's inclusive definition of a primary violator. For example, the court in *In re Homestore.com* defined primary violators as "those who actually employ the scheme to defraud the investors, whereas secondary violators are those who merely participate in or facilitate the scheme," and thus are mere "aiders and abettors."[167] A Second Circuit court found that, within the Second Circuit's definition of a primary violator as one who "participated in the fraudulent scheme," the "participation" standard required that the actions of the violator amount to "orchestration" in order to be considered a primary violation.[168]

In light of the increasingly disparate case law on this primary violation notion and the SEC's continued inclination to exercise its statutory authority to pursue aiders and abettors of securities fraud,[169] corporate counsel should be very cautious and evaluate the characterization their acts could be given under the most plaintiff-friendly standard, "substantial assistance."[170]

A divided Supreme Court, however, in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., et al.*, suggested that courts may be moving in the direction of imposing greater limits on third-party liability in securities cases. The Court ruled in *Stoneridge* that investors can

[165] *Vega v. Jones, Day, Reavis & Pogue*, 17 Cal. Rptr. 3d 26 (Cal. Ct. App. August 2, 2004).

[166] *Id*. at 33-34.

[167] *In re Homestore.com, Inc. Sec. Litig.*, No. CV C01-11115 MJP order regarding motions to dismiss at 29-30 (C.D. Cal. Mar. 7, 2003).

[168] *Rich v. Maidstone Fin. Inc.*, No. Civ. 2569, 2002 WL 31867724 (S.D.N.Y. Dec. 20, 2002).

[169] Statement by SEC Chairman William H. Donaldson, Suit Against Merrill Lynch and Four Merrill Lynch Executives for Aiding and Abetting Enron Accounting Fraud (March 17, 2003) available at http://www.sec.gov/news/speech/spch031703whd.htm.

[170] While certain courts have required that the defendant have actually made the statement in order to be held liable as a primary violator, other courts have held that other types of substantial assistance can be sufficient to establish primary liability under the securities laws. *Compare S.E.C. v. First Jersey Securities*, 101 F.3d 1450, 1471 (2d Cir. 1996) (primary liability may be imposed "not only on persons who made fraudulent misrepresentations but also on those who had knowledge of the fraud and assisted in its perpetration") *and Anixter v. Home-Stake Production Co.*, 77 F.3d 1215, 1225 (10th Cir. 1996) (considering that "[t]he critical element separating primary liability from aiding and abetting violations is the existence of a representation, either by statement or by omission made by the defendant, that is relied on by the plaintiff. Reliance only on representations made by others cannot itself form the basis of liability.").

not bring private lawsuits against third parties -- investment bankers, lawyers, accountants and vendors -- in corporate-fraud cases unless the investors relied on the actions of those third parties when making their investment decisions.[171]

The investor plaintiffs accused two suppliers of Charter Communications of colluding with the company to deceive its stockholders and manipulate the price of its stock. The Court held that §10b's "implied private right of action does not extend to aiders and abettors" and that "[t]he conduct of a secondary actor must satisfy each of the elements or preconditions for liability" under §10(b).[172] The Court's majority opinion turned, in large part, on whether the investors had relied on the third parties' statements in making their investment decisions. The Court indicated that, even if a plaintiff can establish some type of deceptive conduct, the plaintiff also must prove that he relied on that conduct, because reliance is "an essential element of the private §10(b) cause of action,"[173] and concluded that, in this case, "the private right of action does not reach the customer/supplier companies because the investor did not rely upon their statements or representations."[174]

One reason the *Stoneridge* plaintiffs failed was that they did not qualify for either of the two rebuttable presumptions of reliance the Court has recognized in the past. First, "if there is an omission of a material fact by one with a duty to disclose, the investor to whom the duty was owed need not provide specific proof of reliance."[175] Second, "under the fraud-on-the-market doctrine, reliance is presumed when the statements at issue become public."[176] These presumptions play a key role in §10(b) cases against lawyers. *In re DVI Inc. Securities Litigation*[177] shows a court confronting a question of class certification after *Stoneridge*. Although the securities class-action plaintiffs were entitled to certification with respect to claims against the officers, directors, independent auditor, and largest shareholder of DVI, the court refused to certify the class with respect to claims against outside counsel even assuming counsel had taken an active part in assisting in a scheme to defraud investors. Since none of the outside counsel's conduct was "publicly disclosed such that it affected the market for DVI's securities" and it owed no duty of disclosure to DVI's investors, there was no presumption of reliance. Absent this presumption, with respect to that defendant individual issues of reliance would predominate over common issues of law and fact, making certification inappropriate.

In *DVI*, counsel had not furnished to investors any public documents other than an opinion letter that itself contained no misstatements or omissions. In another recent case, *Burket v. Hyman Lippitt, P.C.*,[178] there was evidence that the outside law firm had prepared subscription

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171 *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., et al.*, Supreme Court Docket No. 06-43 (January 15, 2008).

172 *Id*. at 7.

173 *Id*. at 8.

174 *Id*. at 1.

175 *Id.* at 8, citing *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153-54 (1972).

176 *Id.*, citing *Basic Inc. v. Levinson*, 485 U.S. 224, 247 (1988).

177 *In re DVI Inc. Securities Litigation*, 2008 WL 1900384 (E.D.Pa. April 29, 2008).

178 *Burket v. Hyman Lippitt, P.C.*, 2008 WL 1837355 (E.D. Mich. April 23, 2008).

agreements that were furnished to investors and that contained misleading information. Explaining that "an attorney involved in a securities transaction has a duty to provide complete and non-misleading information when he or she undertakes to speak on a particular subject whether or not there exists an attorney-client relationship,"[179] the court refused to dismiss the claims against the law firm. Although *DVI* and *Burket* have different outcomes, they stand for the same principle: if an attorney undertakes to speak on a subject, he acquires a duty to provide complete and non-misleading information on that subject, and a violation of this duty will entitle plaintiffs in private actions under §10(b) to a rebuttable presumption that they relied on his conduct.

The distinction between primary and secondary liability was further explored in SEC v. Tambone, U.S.App. LEXIS 5031 (1st Cir., March 10, 2010). In that case, James Tambone and Robert Hussey were senior executives of a registered broker dealer, Columbia Funds Distributor, Inc. The SEC's complaint against the executives alleged that the two men engaged in fraud in connection with the sale of mutual fund shares. The prospectuses for the funds told investors that market timing was not permitted. A number of customers were, however, permitted to market time. According to the SEC, the two defendants were responsible for the false statements in the prospectuses, having commented on the market timing passages prior to their inclusion in the documents.

The prospectuses were not prepared by, or the responsibility of, the broker dealer which employed the two defendants. The defendants were not alleged to have uttered or written direct misstatements, but the SEC brought suit based on an "implied representation" theory. Under this theory, Rule 10b-5 liability could attach to one who was not the actual speaker of an alleged misstatement but used the alleged misstatement to sell securities. In Tambone, the SEC argued that the individuals "made" misrepresentations in two ways: (1) by using prospectuses drafted by others to sell mutual funds that allegedly contained misrepresentations, and (2) by acting on behalf of the underwriter, thus implying they must have had a reasonable basis to believe the statements in the prospectuses were accurate and complete.

The district court granted a motion to dismiss the complaint on the basis that mere participation in the drafting of an offering document is insufficient to establish primary liability. On appeal by the SEC, an en banc panel of the First Circuit affirmed the district court's dismissal. Specifically, the court held that a securities professional cannot be said to "make" a statement in a securities offering document that was prepared by others, and cannot be said to have impliedly represented to investors that the securities professional had a reasonable basis for believing that the statements in the prospectus were truthful and complete. The court concluded that the duty of an underwriter to investigate in Sections 11 and 12 of the Securities Act does not mean that an implied representation is made about the accuracy of the issuer's statements. The court also concluded that the SEC's attempt to broaden the meaning of Rule 10b-5 would undermine the Supreme Court's decision in Central Bank, which had held that aiding and abetting liability does not fall within the text of Section 10(b).

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[179] *Id.*, citing *Rubin v. Schottenstein, Zox & Dunn*, 143 F.3d 263 (6th Cir. 1998)(internal quotation marks removed).

The Tambone decision refused to extend primary liability under Rule 10b-5(b) to securities professionals whenever they use a prospectus drafted by others that fails to disclose material information. Most significantly, it rejects the concept that use of an offering document means the underwriter impliedly vouches for the accuracy and completeness of such document.

b. Duty to Investigate: Due Diligence

Can counsel be liable to its client (in the absence of malpractice) or to third parties for inadequacy of a due diligence investigation? The Securities Act does not directly impose any obligation on counsel to assure the accuracy of a prospectus, and the courts generally have taken a more restrictive view of the responsibilities of counsel than that of the SEC.

Some courts have referred to a "duty" of securities counsel to make a thorough investigation to correct any misleading statements or omissions.[180] In *Federal Deposit Insurance Corp. v. O'Melveny & Meyers*, the court found that securities counsel had such a duty.[181] The FDIC sued the law firm that had prepared certain private placement memoranda for the bank for which the FDIC later became conservator. The FDIC had settled with the disappointed investors and had obtained assignments of any claims the investors had arising from the private placements. The FDIC then sued the law firm, charging the firm with professional negligence, negligent misrepresentation, and breach of fiduciary duty.

The law firm argued that it owed no duty to the bank to discover the bank's own fraud. The Court of Appeals, however, concluded that the law firm owed a duty of care to the issuer to conduct a thorough investigation. The court advised, "part and parcel of effectively protecting a client, and thus discharging the attorney's duty of care, is to protect the client from the liability which may flow from promulgating a false or misleading offering to investors. An important duty of securities counsel is to make a "reasonable, independent investigation to detect and correct false or misleading materials. This is what is meant by due diligence investigation. The [law firm] had a duty to guide the [client]…as to its obligations and to protect it against liability. In its high specialty field, [the law firm] owed a duty of care not only to the investors, but also to its client.[182]

[180] *See Felts v. National Account Systems Ass'n, Inc.*, 469 F. Supp. 54, 67 (N.D. Miss. 1978); *Federal Deposit Insurance Corp. v. O'Melveny & Meyers*, 969 F.2d 744 (9th Cir. l992*), rev'd on other grounds*, 512 U.S. 79 (1994), *reaff'd on remand*, 61 F.3d 17 (9th Cir. 1995) (rejecting the notion that there is federal common law in this area, the Supreme Court reversed and remanded for a decision based on state law. On remand, the Ninth Circuit reaffirmed its previous decision reversing the District Court based on state law).

[181] 969 F.2d at 749.

[182] *See e.g., Loyd v. Paine Webber, Inc.*, 208 F.3d 755, 760 (9th Cir. 2000) ("We decline to impose a similar duty here. The *O'Melveny & Meyers* decision was dependent on the fact that the firm was assisting in a public offering and helped produce some documents which suggested to the investing public that the client was financially sound . . . Nowhere did the court indicate that, *as a general matter*, an attorney who represents corporate clients has an automatic duty to independently investigate whether its clients are engaging in fraudulent conduct."(*emphasis in original*)); *see also Resolution Trust Corp. v. Blasdell*, 154 F.R.D. 675, 687-88 (D. Arizona 1993) ("*O'Melveny* is not directly applicable . . . because it involved the duties of "attorneys retained to give advice and assistance with respect to public offerings." . . . In holding that the attorneys owed a duty of care to the investors and the savings bank, the Ninth Circuit stated: "An important duty of *securities counsel* is to make a 'reasonable, independent investigation to detect and correct false or misleading materials.' "(citations omitted) (*emphasis in original*)).

However, in *Escott v. BarChris Construction Corporation*, while ruling on Section 11 claims,[183] the court specifically rejected such a duty.[184] "To say that the entire registration statement is expertised because some lawyer prepared it would be an unreasonable construction of the statute. Neither the lawyer for the company nor the lawyer for the underwriters is an expert within the meaning of Section 11."[185] Recently, the Western District of Kentucky, in *Lawson v. Advanced Equities*, found that two law firms were not liable for investors' securities fraud claims for the firms' involvement in preparing securities offering documents that allegedly revealed neither felony convictions of the corporation's president nor that the technology the corporation claimed to have developed did not exist.[186] The court found that there is "no case law imposing a duty to investigate on law firms, absent some reason to know that they were making a misstatement."[187]

c. Attorney Malpractice Actions by Non-Clients

Attorneys practicing securities law should be aware of expanded potential liability not only under Rule 10b-5, but also for malpractice. In October 2003 a New York Supreme Court judge ruled that an attorney who issued an opinion letter to an investor in the attorney's client company with respect to a merger could be liable to the investor for harm caused by the attorney's professional negligence, despite the lack of privity between the attorney and the investor.[188] The court listed the requirements for liability as "an awareness that an attorney's statement is to be used for a specific purpose, reliance on that statement, and some conduct linking the attorneys to the non-client evincing their understanding of that reliance." [189] The court described these conditions as "so close as to approach privity."[190] Still, the court acknowledged that a claim by an adverse party would be more difficult to maintain, and recognized that the plaintiff "was not an adverse party, but was a party investing a substantial sum of money in defendant's client based, in some measure, by the advice and opinions rendered by defendant."[191]

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[183] Section 11(a) lists the categories of persons and entities in addition to the issuer which may be liable for misstatements or omissions in the registration statement: (1) all signers of the registration statement … (4) any person whose profession gives authority to statements made by him or her, who has with consent been named in the registration statement as having prepared or certified any part of the filing, or any report or evaluation used in connection with the registration statement . . . 15 U.S.C. § 77(a).

[184] 283 F.Supp. at 683.

[185] *Id*.

[186] *Law Firms Not Liable for Role in Securities Offering Documents*, Corporate Counsel Weekly, Vol. 18 No. 30 (Jul. 30, 2003) (citing *Lawson v. Advanced Equities*, 2003 U.S. DIST. LEXIS 11899 (W.D. Ky.),, 6/19/03).

[187] *Id*.

[188] Order granting in part defendants' motion to dismiss, Reich Family L.P. v. McDermott, Will & Emery, Index No. 101921-03 (N.Y. Sup. Ct. Oct. 17, 2003).

[189] *Id*. at 3.

[190] *Id*. at 4.

[191] *Id*, at 5.

This trend continued through 2005 and 2006. In a 2005 Florida Supreme Court case, *Cowan Liebowitz & Latman v. Kaplan*[192], the court, in the course of permitting the assignment of a legal malpractice case involving the preparation of a private placement memorandum, argued that the role of counsel in a private placement was similar to that of the auditors, because counsel prepared an offering memorandum and other documents that were intended to disclose information about the client to third parties. "Like the independent auditors in [*KPMG Peat Marwick v. Nat'l Union Fire Ins. Co.*, 765 So.2d 36 (Fla. 2000)], the attorneys intended that third parties would rely on the representations made in the memoranda. The legal services at issue, therefore, were not personal but involved publication of corporate information."[193]

III. CONCLUSION

"Not to put too fine a point on it, but what the hell is going on? Have we adequately served the public while serving our clients? How is it that we have all these laws, rules, interpretations, and advice but that we may advise our clients that there is still room for behavior that can only be described as shameful? How is it that so many of us regard the law as infinitely elastic, easily twisted to conform to political, ideological, or economic agendas? And how is it that too many lawyers feel trapped in their jobs? Do too many lawyers feel as if business imperatives had caused them to lose touch with their better professional selves? And if you think I'm overstating the number of lawyers who feel trapped, get a government job and find out how many new friends call.

* * *

"As we do our work, we need to worry about getting it right. At the same time, we need to worry about whether we are doing the right thing. It's true, as we're wont to point out, that lots of times that right thing is very hard to discern. But that hardly frees us from our obligation to do right, it just means that we need to worry about it all the more. We need to worry about whether we are overstepping our roles as lawyers. It is our clients, after all, who discern their own interests, and it is our professional obligation to advance those interests zealously, within the bounds of the law. We should not burden our clients with what may be merely an outsider's fussy fastidiousness. But we should also worry about whether we've defined our role too narrowly. We rightly delimit our assignments to avoid exposure to risks we do not intend to undertake. But we cannot afford to blind ourselves to the larger picture. We are just instruments, all right, but to what ends?"

-- David M. Becker, SEC General Counsel, May 2, 2002.[194]

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[192] 902 So.2d 755 (Fla. 2005).

[193] *Id.* at 759.

[194] http://www.sec.gov/news/speech/spch556.htm.

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EXHIBIT 1

New York State Bar Association

Committee on Professional Ethics
Opinion 650 - 6/30/93 (3-93)

Topic: Lawyer participation in corporate "Compliance With Law" program; conflict of interest; communication with one of adverse interest.
Digest: Lawyers may participate and "Adverse Interest" statement suffices if timely read.
Code: DR 1-102(A)(4), DR 3-101(A); EC 4-4, 4-5; DR 5-109, DR 7-104; Canon 9, EC 9-6

Question:
May a corporate attorney participate in a "compliance with law" program under which employees are required to report illegal or unethical behavior?

Opinion:
Corporate legal department lawyers and paralegals have been asked to participate in the corporation's "compliance with law" program. The program, influenced by the Federal Sentencing Guidelines, requires all employees "to report all instances of unlawful or otherwise unethical behavior by any employee." Employees may satisfy this obligation by speaking with personnel department representatives, management personnel, corporate officers or department heads, or with "any member of the Corporate Legal Department." In addition, and as an alternative reporting device, lawyers and legal assistants will staff and answer a "help line" telephone in the corporate legal department, taking reports from employees. The fruits of these calls will be passed on to the corporation's compliance officer for further investigation and such other responses as may be appropriate.

The corporation's program appears to contemplate at least two separate functions served by lawyers who answer the help line. First, corporation lawyers are accustomed to fielding inquiries from employees about the application of law to corporate business, and employees are accustomed to having such access. Some of the calls on the help line will be of this sort. Second, the help line will receive complaints and reports of misconduct by other employees, and some callers may report on or seek advice respecting their own misconduct.

Because some of the reports received may reveal conflicts of interest or adversity of interests between the caller and the corporation, an adverse interest script has been prepared to be read by the corporate lawyers to a caller who has disclosed such adversity. It provides:

When it appears that a caller's interest may differ from or there is a reasonable possibility that such interests may be 'in conflict' with the Company's interests

1. Determine whether the caller is represented by counsel. If yes, make the following statement:

'The Company's policy requires that you report non-compliance with the law or other unethical behavior. However as you are represented by counsel, I can only talk to you through your counsel. Please have him/her call me or give me his/her name and I would be happy to call him/her.'

2. If the caller is unrepresented by counsel, please make the following statement:

'I want to caution you that I am an attorney for the Company and not for you or other employees. Therefore, while I can record your complaint, I cannot and will not give you legal advice, and you should not understand our conversation to consist of such advice. I do advise you to seek your own counsel, however, as your interests and the Company's may differ. Having said this, I would be happy to listen to your complaint, etc.'

The lawyers who would talk with callers on the help line are employees of the corporation. DR 5-109 provides:

When a lawyer employed or retained by an organization is dealing with … employees …, and it appears that the organization's interests may differ from those of the constituents with whom the lawyer is dealing, the lawyer shall explain that the lawyer is the lawyer for the organization and not for any of the constituents.

The threshold requiring the lawyer to offer an explanation is not high. An appearance of potentially different interests triggers the obligation. Thus, at minimum, compliance with DR 5-109 by help line lawyers requires them to be sensitive to the communication, and to determine as soon as possible whether there is the appearance of potential conflict.

Moreover, DR 5-109 requires the lawyer to *explain* that the lawyer is the lawyer for the corporation and not for the employee. The implicit assumption is that, absent such expressed disclaimer, the employee may believe that the lawyer is the lawyer for the employee. Especially, as on the instant facts, where employees habituated to access and communication with corporate counsel may be inclined to believe that their communications with lawyers on the help line might be held confidential or might insulate them from public or private liability, the Code requires that the lawyer take pains not to be misleading. DR 1-102(A)(4); EC 9-6.

The precise content of the lawyer's explanation as required by DR 5-109 will vary depending on the sophistication of the employee, the nature of prior discussions or understandings between the employee and the lawyer, and the content of the conversation revealing the adversity of interest. In providing the explanation, however, the lawyer must ensure that the employee does not labor under the mistaken belief that what the employee says will be confidential between the employee and the lawyer.

DR 7-104 governs communication with callers after the determination of potential adversity:

DR 7-104. Communicating with one of adverse interest.

During the course of the representation of a client a lawyer shall not:

1. Communicate or cause another to communicate on the subject of the representation with a party the lawyer knows to be represented by a lawyer in that matter unless the lawyer has the prior consent of the lawyer representing such other party or is authorized by law to do so.

2. Give advice to a person who is not represented by a lawyer, other than the advice to secure counsel, if the interests of such person are or have a reasonable possibility of being in conflict with the interests of the lawyer's client.

The proposed "Adverse Impact Statement" correctly requires the attorney to inquire if the caller is represented by counsel in the matter about which the caller is reporting. If so, in addition to the previously described requirement of DR 5-109, the attorney must advise the caller that the attorney can only speak to the caller's counsel about the matter, unless there is prior consent to speak with the caller. DR 7-104(A)(1). If the caller is not represented by counsel in this matter, the attorney cannot give any further advice other than the advice to secure counsel. DR 7-104(A)(2)

In determining that the proposed adverse interest script submitted by the inquirer and reviewed in this opinion satisfies ethical requirements, we do not suggest that use of that script is the only means available to corporate counsel to comply with DR 5-109 and DR 7-104 in the context of a corporate compliance program intended to qualify under the criteria set out in the recently-issued Federal Sentencing Guidelines for Organizations. Indeed, it is possible that other approaches can satisfy ethical requirements without deterring the desired communication to the extent that may occur with implementation of the particular adverse interest script reviewed here.

Conclusion

For the reasons given and subject to the qualifications discussed above, the question is answered in the affirmative.