

Boston University School of Law

Scholarly Commons at Boston University School of Law

Faculty Scholarship

2004

Legal and Ethical Duties of Lawyers After Sarbanes-Oxley

Susan P. Koniak

George M. Cohen

Roger C. Cramton

Follow this and additional works at: https://scholarship.law.bu.edu/faculty_scholarship



Part of the [Legal Ethics and Professional Responsibility Commons](#)

Recommended Citation

Susan P. Koniak, George M. Cohen & Roger C. Cramton, *Legal and Ethical Duties of Lawyers After Sarbanes-Oxley*, in 49 Villanova Law Review 725 (2004).

Available at: https://scholarship.law.bu.edu/faculty_scholarship/2133

This Article is brought to you for free and open access by Scholarly Commons at Boston University School of Law. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of Scholarly Commons at Boston University School of Law. For more information, please contact lawlessa@bu.edu.





DATE DOWNLOADED: Fri Sep 2 13:44:48 2022

SOURCE: Content Downloaded from [HeinOnline](#)

Citations:

Bluebook 21st ed.

Roger C. Cramton, George M. Cohen & Susan P. Koniak, Legal and Ethical Duties of Lawyers after Sarbanes-Oxley, 49 VILL. L. REV. 725 (2004).

ALWD 7th ed.

Roger C. Cramton, George M. Cohen & Susan P. Koniak, Legal and Ethical Duties of Lawyers after Sarbanes-Oxley, 49 Vill. L. Rev. 725 (2004).

APA 7th ed.

Cramton, R. C., Cohen, G. M., & Koniak, S. P. (2004). Legal and ethical duties of lawyers after sarbanes-oxley. Villanova Law Review, 49(4), 725-832.

Chicago 17th ed.

Roger C. Cramton; George M. Cohen; Susan P. Koniak, "Legal and Ethical Duties of Lawyers after Sarbanes-Oxley," Villanova Law Review 49, no. 4 (2004): 725-832

McGill Guide 9th ed.

Roger C. Cramton, George M. Cohen & Susan P. Koniak, "Legal and Ethical Duties of Lawyers after Sarbanes-Oxley" (2004) 49:4 Vill L Rev 725.

AGLC 4th ed.

Roger C. Cramton, George M. Cohen and Susan P. Koniak, 'Legal and Ethical Duties of Lawyers after Sarbanes-Oxley' (2004) 49(4) Villanova Law Review 725

MLA 9th ed.

Cramton, Roger C., et al. "Legal and Ethical Duties of Lawyers after Sarbanes-Oxley." Villanova Law Review, vol. 49, no. 4, 2004, pp. 725-832. HeinOnline.

OSCOLA 4th ed.

Roger C. Cramton, George M. Cohen & Susan P. Koniak, 'Legal and Ethical Duties of Lawyers after Sarbanes-Oxley' (2004) 49 Vill L Rev 725

Provided by:

Fineman & Pappas Law Libraries

-- Your use of this HeinOnline PDF indicates your acceptance of HeinOnline's Terms and Conditions of the license agreement available at

<https://heinonline.org/HOL/License>

-- The search text of this PDF is generated from uncorrected OCR text.

-- To obtain permission to use this article beyond the scope of your license, please use:

[Copyright Information](#)

VILLANOVA LAW REVIEW

VOLUME 49

2004

NUMBER 4

Articles

LEGAL AND ETHICAL DUTIES OF LAWYERS AFTER SARBANES-OXLEY

ROGER C. CRAMTON,* GEORGE M. COHEN** & SUSAN P. KONIAK***

TABLE OF CONTENTS

I. INTRODUCTION	727
A. <i>Setting the Stage</i>	727
B. <i>A Situation to Ponder: The Spiegel Case</i>	733
II. "REPORTING UP": REPORTING MATERIAL VIOLATIONS OF LAW UP THE CORPORATE LADDER	736
A. <i>Reporting Duties of a Corporation's Lawyer Under State Law</i>	736
B. <i>Required Reporting Under Section 307 of Sarbanes-Oxley</i>	740
1. <i>Which Lawyers Are "Appearing and Practicing" Before the SEC Under Part 205?</i>	741
a. Application of the SEC Rules to Lawyers Who Do Not Specialize in Securities Law	742
b. Application of the SEC Rules to Lawyers Who Do Not Sign Documents Filed with the SEC ...	744
c. The Exclusion of Lawyers Not in a Lawyer- Client Relationship with the Issuer	746
d. The Partial Inclusion of Foreign Lawyers	748
e. Law Firms as Legal Persons Who "Appear and Practice"	750
2. <i>What Triggers the Lawyer's Initial Duty to Report?</i>	751
a. The Troublesome Double-Negative Standard ...	752
b. The Ambiguity of "Reasonably Likely"	754
c. "Becomes Aware" and the Duty of Inquiry	755

* Roger C. Cramton is the Robert S. Stevens Emeritus Professor of Law at Cornell Law School, Ithaca, New York. Correspondence concerning this Article should be addressed to him at rccl0@cornell.edu.

** George M. Cohen is the Edwin Howrey Research Professor of Law at the University of Virginia School of Law.

*** Susan P. Koniak is a Professor of Law at Boston University School of Law.

	d. Imputed Knowledge	759
	e. Conclusion: The Importance of the Initial Trigger	763
3.	<i>Obligations of the Reporting Lawyer After the Initial Report</i>	764
	a. The SEC's Legitimate Concerns and Their Proper Resolution	766
	b. The Mistaken Transplanting of Colorable Defense from the Litigation Context to the Counseling Context.....	769
	c. Other Problems with the SEC's Third "Appropriate Response" Option	771
4.	<i>Obligations of Other Lawyers After the Initial Report: The Wrongheaded Exemptions for Advocates and Investigatory Lawyers</i>	775
III.	"REPORTING OUT": DISCLOSURE OF CONFIDENTIAL INFORMATION OUTSIDE THE CORPORATION	779
	A. <i>Permissive Disclosure Under State Ethics Rules</i>	779
	1. <i>Some Relevant History</i>	779
	2. <i>Current State Law on Disclosure of Confidential Information and Related Issues</i>	782
	3. <i>Effect of Lawyer Disclosure of Confidential Information on the Client's Attorney-Client Privilege</i>	784
	B. <i>Permissive Disclosure Under SEC Part 205</i>	786
	C. <i>The Validity and Preemptive Effect of Permissive Disclosure Under Section 205.3(d)(2)</i>	788
	1. <i>Validity of the SEC Permissive Disclosure Rule</i>	789
	2. <i>The SEC's Authority to Preempt State Law</i>	792
	3. <i>The Irrelevance of Federalism Concerns</i>	795
	4. <i>Does Section 205.3(d)(2) in Fact Preempt State Law?</i> ...	797
	5. <i>The SEC and the State Bars Square Off</i>	799
	a. Round One: The Washington State Bar Interim Opinion	799
	b. Round Two: The Response from the SEC.....	801
	c. Round Three: The California Bar Committee's Retort	802
	d. Let's Get Real	808
	6. <i>State Rules That Go Further Than Those of the SEC</i>	808
IV.	"NOISY WITHDRAWAL": REQUIRED DISCLOSURE OF WITHDRAWAL TO THE SEC.....	809
	A. <i>Required Withdrawal and Disaffirmance of Tainted Opinions Under State Law</i>	809
	B. <i>The SEC's Noisy Withdrawal Proposal</i>	810
	1. <i>The Original Proposal: Reporting Out by the Issuer's Attorney</i>	810
	2. <i>The Alternative Proposal: Reporting Out by the Issuer</i> ...	812

C.	<i>Does Noisy Withdrawal Undermine Confidentiality and Adversely Affect the Lawyer-Client Relationship?</i>	814
V.	THE SPIEGEL CASE	817
A.	<i>Reporting Up in the Spiegel Case</i>	817
1.	<i>The Relevant Facts</i>	817
2.	<i>Did Kirkland Perform Its "Up the Corporate Ladder" Reporting Obligations?</i>	820
B.	<i>Lawyer Conduct in the Spiegel Case: Withdrawal and Disclosure</i>	820
1.	<i>Facts Reported by the Examiner in the Spiegel Case</i>	820
2.	<i>Kirkland's Failure to Withdraw, Disaffirm Filings and Notify the SEC</i>	822
3.	<i>Was White & Case Required to Withdraw, Disaffirm Documents or Disclose to the SEC?</i>	826
C.	<i>The Spiegel Case Indicates Why the SEC Should Require Noisy Withdrawal</i>	828
VI.	CONCLUSION	830

I. INTRODUCTION

A. *Setting the Stage*

IN the first years of this new century a succession of massive corporate frauds dominated the business sections and front pages of major newspapers, shaking public confidence in the integrity of corporate America.¹ Those scandals raise serious questions about the integrity, acuity and prudence of the accountants and lawyers who structure and document business transactions, approve required financial disclosures and, in the case of accountants, certify the accuracy of required reports.²

Congress responded by enacting the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), which became effective on July 30, 2002.³ Sarbanes-

1. See Charles P. Kindleberger, *Corruption, Crime, Chicanery: Business Through the Ages*, N.Y. TIMES, Dec. 16, 2002, at C3 (stating that scandals surrounding highly regarded companies have caused confidence crisis in America).

2. See generally John C. Coffee, Jr., *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293, 1300-07 (2003) (commenting on gatekeeper role of lawyers and accountants both before and after corporate scandals of 1990s); Susan P. Koniak, *Corporate Fraud: See, Lawyers*, 26 HARV. J.L. & PUB. POL'Y 195, 198-210 (2003) [hereinafter Koniak I] (describing role of lawyers in perpetuating recent fraudulent transactions by large corporate clients); Susan P. Koniak, *When the Hurly-burly's Done: The Bar's Struggle with the SEC*, 103 COLUM. L. REV. 1236, 1239-43 (2003) [hereinafter Koniak II] (discussing lawyers' role in wave of corporate fraud).

3. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 784 (codified as amended in scattered sections of 11, 18, 28 and 29 U.S.C.). Section 307 of the Act deals specifically with the rule of professional responsibility governing lawyers practicing or appearing before the SEC. Several other provisions of the Act apply to lawyers but are not considered in this Article. Section 602 codifies part of Rule 102(e) of the Commission's Rules of Practice, which establishes standards for disciplining professionals, including prohibiting those professionals from practic-

Oxley makes many changes in the securities regulation process to improve corporate governance and reporting.⁴ It imposes harsh penalties on violators, creates an elaborate system for governing and regulating auditors for public companies and requires the securities industry's self-regulatory organizations to adopt rules to prevent conflicts of interest and enhance the independence of securities analysts.⁵ Even casual observers of the political reaction to the stunning disclosures about Enron's, WorldCom's and Tyco's deceitful financial practices might have predicted some such legislative response. But little public attention had focused on what the lawyers for fraud-ridden corporations had been doing while shareholders and the investing public were being duped. Thus, even careful observers were surprised by Section 307 of Sarbanes-Oxley. Section 307 directed the Securities and Exchange Commission (SEC or the "Commission") to promulgate "minimum standards of professional conduct for attorneys appearing in practice before the commission."⁶

Moreover, Section 307 did more than require the SEC to issue standards for lawyers; it specified that one of those rules require lawyers to "report evidence of a material violation of the securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal or the chief executive officer of the company (or the equivalent thereof)."⁷ If the chief legal officer (CLO) or chief executive officer (CEO) fails to provide an "appropriate response" to the evidence, the rule required the lawyer to "report the evidence to the audit committee . . . or to another committee of the board of directors comprised solely of [independent] directors . . . , or to the full board."⁸ This requirement is typically referred to as "up-the-ladder" reporting, or simply "reporting up," a phrase we will use here.

On January 29, 2003, the SEC adopted the statutorily mandated rule, which became effective on August 5, 2003.⁹ But that's getting ahead of the story. We will come back to that. First, some attention is due another player in this drama, the organized bar.

ing before the SEC. Section 806 provides whistle-blower protection for employees of public companies in fraud-related matters. Section 3(b) provides sanctions for violations of the Act or related rules.

4. *See id.* (stating that this is "[an act to] protect investors by improving the accuracy and reliability of corporate disclosures to the securities laws, and for other purposes").

5. *See* 15 U.S.C. §§ 7241-7266 (2003) (listing rules on corporate responsibility and enhanced financial disclosures).

6. *Id.* § 7245.

7. *Id.*

8. *Id.*

9. *See* Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 33-8185, 68 Fed. Reg. 6296 (Feb. 6, 2003) (codified at 17 C.F.R. pt. 205) [hereinafter SEC Final Rule] (providing disclosure and withdrawal standards for securities attorneys practicing before SEC).

The organized bar was against the enactment of Section 307. It lobbied Congress, arguing that the federal government should stay out of lawyer regulation because state regulatory authorities could be counted on to enact and implement appropriate reforms to address the question of lawyer acquiescence or involvement in corporate fraud.¹⁰

Congress, however, had good reason to be skeptical of such claims. Since 1974, when the American Bar Association (ABA) changed Disciplinary Rule 7-102(B)(1) of the Model Code of Professional Responsibility, abandoning language that required lawyers to disclose client fraud in which the lawyers' services had been used when the client refused to rectify the fraud in favor of language that required lawyers to keep quiet about client fraud, the organized bar had steadfastly refused to rethink its attitude toward client wrongdoing.¹¹ Periodically, the ABA's House of Delegates had considered proposals to amend Model Rule 1.6, the rule on lawyer-client confidentiality, to allow lawyers to disclose substantial frauds, at least those in which the lawyer's services had been used, but time after time the House of Delegates refused, albeit by relatively slim majorities.¹² Most damning, the ABA House of Delegates rejected just such a reform proposal in August 2001, a few months before the disclosure of Enron's massive frauds.¹³

After the Enron disclosures, in February 2002, while Congress was considering what type of reform legislation to enact, the ABA House of Delegates effectively refused to reconsider its stance on client fraud. The ABA voted to accept the package of changes to the Model Rules it had approved six months earlier,¹⁴ which included no exception to disclose client fraud, unless that fraud was committed against a tribunal.¹⁵

Instead, the ABA created a Task Force on Corporate Responsibility to consider whether to recommend changes to the law of corporate governance and to the ABA's Model Rules, particularly the rule on confidentiality, Model Rule 1.6, and the rule on representing organizations, Model

10. See Koniak I, *supra* note 2, at 220 (discussing ABA's efforts to eliminate Section 307).

11. See MODEL RULES OF PROF'L CONDUCT R. 1.6 (1983) [hereinafter MODEL RULES 1983]. In 1983, when the Model Rules were adopted, Rule 1.6 provided no exception for disclosures to prevent or rectify client crime or fraud. The ABA rejected proposals from the Kutak Commission, which drafted the Model Rules, that would have permitted such disclosure. A majority of states, however, declined to adopt the ABA's version of Rule 1.6. See *infra* note 19 and accompanying text.

12. See Irma S. Russell, *Client Confidences and Public Confidence in the Legal Profession: Observations on the ABA House of Delegates Deliberations on the Duty of Confidentiality*, 13 A.B.A. PROF. LAW. 19 (2002).

13. See *id.*

14. See *id.* at 21.

15. See *id.*

Rule 1.13.¹⁶ While that Task Force was studying those questions, Congress enacted Sarbanes-Oxley and that law went into effect.¹⁷

The bar argued to Congress that it could take care of any problem by changing its model ethics rules and insisted that state regulatory authorities could handle misconduct by securities lawyers. The bar's position was that federal regulation was unnecessary as well as inappropriate, given that lawyer-regulation was a matter entrusted to the states (generally state courts) in our federalist system.¹⁸

What about the states? The states had not passively accepted the ABA's position of no disclosure of client fraud under any circumstances. On the contrary, by 2002 most states had rules in force that allowed lawyers to disclose client fraud in certain circumstances, particularly when the lawyer's services had been used by the client to perpetrate the fraud.¹⁹ On the other hand, the states had, and continue to have, a dismal record of enforcing ethics rules against big firm lawyers. Indeed, despite a multitude of cases involving big firm securities lawyers that demonstrate, in our opinion, clear violations of numerous ethics rules, most notably the rule against assisting a client in unlawful conduct (Model Rule 1.2(d)), the authors of this Article know of only a few instances of bar disciplinary action against a big firm securities lawyer who had not first been convicted of a criminal offense. State regulatory authorities simply lack the resources and expertise to take on a major securities law firm. Thus, to argue for exclusive state jurisdiction over securities lawyer misdeeds is, as a practical matter, to argue that securities lawyers remain beyond the reach of discipline. Congress sensibly rejected the bar's states' rights argument. The bar, however, continued that theme in its comments to the SEC with assistance, as we shall see, from the Conference of Chief Justices.

After Congress passed Sarbanes-Oxley, the scene of action shifted to the SEC. The SEC had 180 days under Sarbanes-Oxley in which to pro-

16. See Christina R. Salem, *The New Mandate of the Corporate Lawyer After the Fall of Enron and the Enactment of the Sarbanes-Oxley Act*, 8 *FORDHAM J. CORP. & FIN. L.* 765, 780-83 (2003).

17. See *id.* at 779 (noting that Task Force issued report just days before President Bush signed Sarbanes-Oxley bill); see also ABA Task Force on Corp. Responsibility, *Report of the American Bar Association Task Force on Corporate Responsibility*, 59 *BUS. LAW.* 145, 148-49 (2003) [hereinafter *Final Report*]. A preliminary report of the Task Force had startled the corporate bar by recommending that lawyers be required to disclose corporate fraud in some circumstances. See ABA Task Force on Corp. Responsibility, *Preliminary Report of the American Bar Association Task Force on Corporate Responsibility*, 58 *BUS. LAW.* 189, 205-06 (2002) [hereinafter *Preliminary Report*]. The ABA Task Force dropped the "required" recommendation and substituted permissive disclosure standards before the final report was issued. See *Final Report, supra*, at 172-73.

18. See Koniak I, *supra* note 2, at 220.

19. See *id.* at 214. The state rules are discussed in some detail in *infra* Part III.A.2.

mulgate an up-the-ladder reporting requirement.²⁰ On November 21, 2002, the Commission published proposed rules for comment.²¹ Bar associations and prominent corporate lawyers and law firms were aghast. The rules were drafted quite broadly, seeming to apply to virtually any lawyer in any way associated with the representation of an issuer, including foreign lawyers. Even more troubling to the bar was that, instead of a mere up-the-ladder reporting requirement, the rules went further, proposing to require “noisy withdrawal” in certain situations, that is, withdrawal from representation of the issuer and notice to the Commission of that withdrawal.²² Letters from lawyers, law firms and bar associations came pouring into the Commission—letters strenuously objecting to any form of “reporting out” to the Commission (including any form of required noisy withdrawal) and arguing against the breadth of the proposed rules.²³ The battle was on and the bar was now fully engaged.

At this point the assist from the Conference of Chief Justices came into play. On August 1, 2002, the Conference of Chief Justices, apparently influenced, at least in part, by a desire to derail any larger federal involvement in lawyer regulation, unanimously recommended that all state high courts adopt a confidentiality rule allowing disclosure of client fraud in cases in which the client had used the lawyer’s services to commit the fraud. This was the proposal made by the ABA’s Ethics 2000 Commission that the ABA’s House of Delegates rejected just a year before.²⁴ As discussed earlier, by the time the Conference adopted this resolution, most states already allowed lawyer disclosure of some client frauds, which is one of the reasons we see the Conference’s move as part of a strategy to encourage minimal regulation of the bar by the SEC. But more telling are the comments the Conference submitted to the SEC. The Conference explicitly referred to the states’ traditional roles as exclusive regulators of the bars and opposed the SEC’s proposed “permissive disclosure” and “noisy withdrawal” rules.²⁵ The Conference took this position, despite the

20. See 15 U.S.C. § 7202(a) (2001) (instructing SEC to promulgate regulations consistent with Sarbanes-Oxley); see also 148 CONG. REC. S6552 (daily ed. July 10, 2002) (statement of Sen. Edwards) (“This amendment is about making sure those lawyers, in addition to the accountants and executives in the company, don’t violate the law and, in fact, more importantly, ensure that the law is being followed.”).

21. See Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 33-8150, 67 Fed. Reg. 71,670 (Dec. 2, 2002) (providing SEC proposed rule regarding attorney conduct).

22. See *id.*

23. See Koniak II, *supra* note 2, at 1270-74 (discussing general tenor of comments submitted by associations and law firms regarding SEC proposed rules).

24. See Conference of Chief Justices, Resolution 35: In Support of Rule 1.6(b)(2) and 1.6(b)(3) of Ethics 2000 (Aug. 1, 2002), at <http://ccj.ncsc.dni.us/resol35RuleOneptSixEthics2000.html>.

25. See Letter from Judith S. Kaye, President, Conference of Chief Justices, to Jonathan G. Katz, Secretary, SEC (Dec. 13, 2002), at <http://www.sec.gov/rules/proposed/s74502/jskaye1.htm> (commenting on SEC proposed rule).

resolution calling for all states to permit disclosure of client fraud in certain circumstances and the fact that the comments to the ethics rules in many states already authorize noisy withdrawal without explicit limitation on the circumstances in which the "noise" may be made.²⁶

On January 29, 2003, the SEC adopted a rule implementing Section 307 to take effect on August 5, 2003.²⁷ As Section 307 mandates, the rule requires up-the-ladder reporting in certain circumstances.²⁸ The rule also follows the ethics rules of most states by permitting a lawyer in some circumstances to disclose client fraud to the SEC without the issuer's consent (an action often referred to as permissive "reporting out" in contrast to the required "reporting up" the corporate ladder).²⁹ On the other hand, the SEC took no action on its proposal to require noisy withdrawal in some circumstances. Instead, the SEC proposed an alternative to its initial noisy-withdrawal proposal, albeit saying at the same time that it would continue to consider that first proposal too.³⁰

The SEC's alternative would, like its first proposal, require lawyers to withdraw from representing an issuer when the issuer's board did not "respond appropriately" to a lawyer's prior report of a material violation of law, but instead of the lawyer having to tell the SEC of that withdrawal, the alternative put that responsibility on the issuer itself.³¹

In August 2003, the ABA House of Delegates amended model Rules 1.6 and 1.13 substantially as recommended in the Task Force on Corporate Responsibility's final report.³² Rule 1.6 was changed to allow disclosure of client fraud in certain situations.³³ Rule 1.13 was amended to make it clear that a lawyer is required: first, to inform the highest authority of an organization when lower-level officers fail to take action to address a law violation (Rule 1.13(b)); and second, to inform the organization's

26. See Koniak I, *supra* note 2, at 229 (noting that at time of proposed SEC rule, "noisy withdrawal was allowed by the ethics rules of almost every state and already required in certain instances by the newest Comments to the ABA's Model Rules").

27. See SEC Final Rule, *supra* note 9, at 6296.

28. See *id.* For a further discussion of the reporting up requirement of Part 205, see *infra* Part II.

29. See *id.* For a further discussion of the reporting out aspect of Part 205, see *infra* Part III.B.

30. See Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 33-8186, 68 Fed. Reg. 6324, 6328 (Feb. 6, 2003) (soliciting comments on both proposals).

31. See *id.*

32. See MODEL RULES OF PROF'L CONDUCT R. 1.6, 1.13 (2003) [hereinafter MODEL RULES 2003] (providing ABA Model Rules as amended); *Final Report, supra* note 17, at 172, 175 (recommending adoption of revised Rule 1.6 and Rule 1.13).

33. See MODEL RULES 2003, *supra* note 32, R. 1.6. The vote in the ABA House of Delegates permitting disclosure in the case of client fraud was a close one (218-201). See Jason Hoppin, *Put Aside Privilege in Post-Enron World, ABA Urges*, NAT'L L.J., Aug. 18, 2003, at 5 (noting that vote to amend reporting up requirement of Rule 1.13 was also close).

highest authority of a lawyer's discharge or withdrawal for fulfilling the up-the-ladder reporting duties of the rule (Rule 1.13(e)).³⁴ A third change added a new provision permitting disclosure of confidential information outside the organization when the highest authority of the organization fails to address a law violation that was reasonably certain to result in substantial injury to the organization (Rule 1.13(c)) even if the lawyer's services were not used to commit the violation.³⁵

The ABA's change of position was influenced by a growing feeling within the organization that its leadership in the legal ethics field was threatened by the degree to which its confidentiality provisions departed from the actions taken by the high courts of most of the states. Also important was the ABA's desire to keep the SEC and the rest of the federal government at bay.

This Article examines the legal and ethical duties of lawyers after Sarbanes-Oxley, focusing on the application, interpretation and ambiguities of the SEC rule implementing Section 307. Although our primary frame of reference will be on the SEC's new rules as an aspect of lawyer regulation, those rules are part of federal securities laws and should be considered in that aspect, i.e., whether they advance the purposes of the federal securities laws. The rules affecting lawyers should not be assessed in a vacuum as a mere turf war between federal regulators on the one hand and the organized bar and its state regulators on the other, although that is one relevant aspect.

Federal securities laws exist to protect investors, largely through compulsory issuer disclosure. The SEC exists for this purpose. Its rules, including the rules governing lawyers, must be evaluated in light of this overarching purpose. In our view, this purpose, and the SEC's rules, are largely consistent with what a prudent lawyer, representing an entity client, would do both for the good of the client and for the lawyer's own risk management. The bar's discomfort with the rules measures in large part the degree to which everyday corporate practice deviates from what one would expect from a prudent and faithful entity agent.

B. *A Situation to Ponder: The Spiegel Case*³⁶

In March 2003, several months before the SEC's rules implementing Section 307 became effective, the SEC filed a partially settled securities fraud complaint that brought into sharp focus the concerns that animated

34. See MODEL RULES 2003, *supra* note 32, R. 1.13.

35. See *id.* R. 1.13(c) (stating that when highest organizational authority fails to address action that is clearly violation of law, lawyer may "reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization").

36. The discussion that follows contains a number of quotations from Jonathan Weil & Cassell Bryan-Low, *Report Bolsters SEC's Proposal for Attorneys*, WALL ST. J., Sept. 15, 2003, at C1.

the legislation requiring those rules.³⁷ The defendant was Spiegel, Inc. ("Spiegel"), a retailer that operates a mail order business and the Eddie Bauer clothing chain, and had just filed for Chapter 11 bankruptcy protection.³⁸ The SEC civil complaint charged Spiegel with fraudulently withholding public disclosure of the company's 2001 annual report, as well as subsequent quarterly reports, to conceal the fact that its auditor, KPMG, had rendered an opinion in early 2002 expressing the accounting firm's substantial doubt about Spiegel's ability to remain in business.³⁹ Although Spiegel neither admitted nor denied wrongdoing, the settlement terms included the court's appointment of Stephen J. Crimmins, a partner in the Washington office of Pepper Hamilton LLP, as an examiner to review Spiegel's accounting regularities and financial condition.⁴⁰

Six months later, in September 2003, Mr. Crimmins filed his examiner's report (the "Crimmins Report") with the district court.⁴¹ The report details "numerous accounting violations at Spiegel, which hit the skids after it began issuing easy credit to unqualified customers as a way to boost revenues."⁴² Among other topics, the report addresses the conduct of Spiegel's lawyers. The report concludes that the lawyers initially behaved appropriately. The report states that the law firm responsible for approving Spiegel's securities disclosure, Kirkland & Ellis LLP ("Kirkland") "had plainly advised Spiegel that it was violating the law by not filing" its 2001 annual report with the SEC.⁴³ Kirkland also warned the company's management and top directors that "this illegal act could have serious consequences, including action by the SEC."⁴⁴

37. See Litigation Release, United States Securities and Exchange Commission, SEC Charges Spiegel, Inc. with Fraud for Failing to Disclose Auditor's "Going Concern" and Related Reporting Violations (Mar. 7, 2003), at <http://www.sec.gov/litigation/litreleases/lr18020.htm> [hereinafter Spiegel Litigation Release] (announcing SEC's suit against Spiegel for violation of federal securities laws).

38. See *In re Spiegel*, 292 B.R. 748, 749 (Bankr. S.D.N.Y. 2003).

39. See Spiegel Litigation Release, *supra* note 37.

40. See *id.*

41. See Indep. Exam'r Report, SEC v. Spiegel, Inc., No. 03C-1685, 2003 U.S. Dist. LEXIS 17933 (N.D. Ill. Sept. 5, 2003), at <http://www.sec.gov/Archives/edgar/data/276641/000094787103002136/0000947871-03-002136.txt> [hereinafter Crimmins Report]. Mr. Crimmins based his reports on documents provided by Spiegel, its law firm (Kirkland) and its auditor (KPMG) relating to Spiegel's disclosures to the SEC and interviews with Spiegel's officers, directors, lawyers and accountants. Spiegel waived its attorney-client privilege with respect to a number of matters, including those related to Spiegel's disclosures to the SEC.

42. Weil & Bryan-Low, *supra* note 36, at C1.

43. Crimmins Report, *supra* note 41, at 80.

44. *Id.* Kirkland spokesman and partner, Jack Levin, echoing the examiner's comment, told the *Wall Street Journal* that the law firm "repeatedly advised the company to file its SEC reports, and we repeatedly told the company that the failure to file was a serious matter," adding, "[t]he examiner's report confirms that we gave our advice loudly and clearly." Weil & Bryan-Low, *supra* note 36, at C1.

When Spiegel refused to file the report,⁴⁵ however, the lawyers faced a critical choice. They chose to continue the representation. A Kirkland spokesman and partner, Jack Levin, later told the *Wall Street Journal*: “There are no rules that say you must resign if the client doesn’t take your advice.”⁴⁶ He also noted that “[t]he SEC, of course, is debating whether it should adopt such rules, and the debate is ongoing.”⁴⁷

The Crimmins Report states that Kirkland continued to prepare and file forms to the SEC, notifying it of the reasons for Spiegel’s filing deficiencies for months after the March 2002 deadline for Spiegel’s 2001 annual report. Spiegel’s late-filing notices all recited that the company was “not in a position to issue financial statements” on the grounds that Spiegel was in default on its loan covenants and “currently working with its bank group” to amend its credit agreements.⁴⁸ According to the Crimmins Report, these representations were materially misleading, and Kirkland knew it.⁴⁹ The report states: “As Kirkland & Ellis knew, the real reason why Spiegel was not filing its periodic reports was that it did not want to disclose KPMG’s going-concern qualification and other material bad facts and circumstances threatening Spiegel’s survival.” Kirkland’s response to the Report’s allegations, through Mr. Levin, was: “All the underlying facts—that the company had defaulted on its debt and other financial problems—were disclosed.”⁵⁰

The Crimmins Report offers an excellent opportunity to evaluate lawyers’ responsibilities in the post-Enron world. If the facts recited in the Crimmins Report are taken as true, what did the applicable state ethics rules permit or require the lawyers to do? If the SEC rule implementing

45. Jonathan Weil and Cassell Bryan-Low explain the reasons for Spiegel’s refusal:

According to the report, Spiegel’s executive committee rejected the views of Kirkland, KPMG and Spiegel’s management during the May [31,] 2003 meeting in Hamburg, Germany and directed the company not to file its overdue SEC reports. The executive committee at that meeting consisted of Michael Otto of Hamburg, who along with his family controlled all of Spiegel’s voting shares and an executive of Mr. Otto’s closely held Otto Versand GmbH, the world’s largest mail-order company. The report says the law firm White and Case LLP interpreted Kirkland’s advice for Spiegel’s auditing committee, though Spiegel technically wasn’t a White & Case client. White & Case’s Hamburg partner [Urs Aschenbrenner] strongly challenged Kirkland’s recommendations, the report says. Phillip Schaeffer, White & Case’s general counsel, said any communications the firm may have had on the matter were with its client, Otto Versand, not Spiegel. “We can’t talk about the advice we did or didn’t give a client.”

Weil & Bryan-Low, *supra* note 36, at C1.

46. *Id.*

47. *Id.*

48. *Id.*

49. See Crimmins Report, *supra* note 41. “The report notes that the SEC forms themselves contain this warning just below the signature line: ‘ATTENTION: Intentional misstatements or omissions of fact constitute Federal Crime Violation.’” Weil & Bryan-Low, *supra* note 36.

50. Weil & Bryan-Low, *supra* note 36, at C1.

Section 307 of Sarbanes-Oxley had been in effect at the time Kirkland acted, what would the rules have required or permitted Kirkland to do? The possibilities include:

1. Take the matter to Spiegel's highest authority (the appropriate committee of the board or the full board).
2. Resign from any representation of Spiegel related to its securities filings if Spiegel failed to meet its obligations under the federal securities laws.
3. Correct the prior material false statements its client had made to the SEC and which Kirkland had prepared.
4. Disclose confidential information to the SEC or defrauded persons to rectify the prior fraud or prevent the continuing fraud.
5. Withdraw from its representation of Spiegel, disaffirm the filings it had helped to prepare and notify the Commission of its withdrawal "for professional considerations."⁵¹

In addition to analyzing the SEC rules in detail, this Article considers the *Spiegel* case and the Crimmins Report as a concrete scenario in which to evaluate those rules. A brief conclusion summarizes the three propositions advanced in this Article.

II. "REPORTING UP": REPORTING MATERIAL VIOLATIONS OF LAW UP THE CORPORATE LADDER

A. *Reporting Duties of a Corporation's Lawyer Under State Law*

The Canons of Professional Ethics and the Model Code of Professional Responsibility did not contain disciplinary rules that dealt explicitly with the responsibilities of a lawyer for an organization. Nevertheless, case law in the United States gradually developed propositions that are now well settled.⁵²

First, a lawyer employed to represent an organization owes professional duties of competence and loyalty to the organization (the so-called "entity theory" of organizational representation).⁵³

51. The title of the *Wall Street Journal* article, cited *supra* note 36, was "Report Bolsters SEC's Proposal for Attorneys." The article states that "Mr. Crimmins's findings will likely add pressure on the SEC to adopt its proposed 'noisy withdrawal' rules for corporate lawyers."

52. See RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 96 cmts. b, d, f (2000) [hereinafter RESTATEMENT] (prescribing generally accepted duties owed corporation by corporate counsel); Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, 58 BUS. LAW. 143, 145-58 (2002) (providing review of legal and ethical duties that organization's lawyer owes to organizational entity). The following summary is largely drawn from comments b, d and f of Section 96 of the Restatement.

53. See RESTATEMENT, *supra* note 52, § 96 cmt. b ("The so-called 'entity' theory of organizational representation . . . is now universally recognized in American law,

Second, the persons authorized by law to act for the organization make decisions to retain or discharge a lawyer for the organization, determine the scope of representation and provide direction to the lawyer.⁵⁴

Third, although an organization's lawyer inevitably works closely with the constituents of the organization who provide direction, the lawyer does not thereby form a client-lawyer relationship with the officers or employees who direct its operations or those who own it. Moreover, the organization's lawyer does not owe duties of care, diligence or confidentiality to the organization's constituents unless joint representation of the organization and a constituent is agreed upon and does not involve an impermissible conflict of interest.⁵⁵

Fourth, as part of the duties of care, competence and diligence that an organization's lawyer owes to the organization, the lawyer is required to exercise reasonable care to prevent an organization's constituent from violating a legal obligation to the organization or causing harm to the organization by performing acts on behalf of the organization that will cause injury to it, such as by exposing the organization to criminal or civil liability.⁵⁶ When the lawyer knows that such a situation has arisen, the lawyer must proceed in the best interests of the organization.

Finally, a lawyer is not prevented by rules of confidentiality from acting to protect the interests of the client organization by disclosing within

for purposes of determining the identity of the direct beneficiary of legal representation of corporations and other forms of organizations.”).

54. *See id.* § 96 cmt. d (“Persons authorized to act for the organization make decisions about retaining or discharging a lawyer for the organization, determine the scope of the representation, and create an obligation for the organization to compensate the lawyer.”). Lawyers are obligated to comply with the lawful requests of those authorized to act for the organization. *See id.* (“Unless the lawyer withdraws, the lawyer must follow instructions and implement decisions of those persons, as the lawyer would follow instructions of an individual client [unless unlawful client acts are involved].”).

55. *See id.* § 96 cmt. b (“By representing the organization, a lawyer does not thereby also form a client-lawyer relationship with all or any individuals employed by it or who direct its operations or who have an ownership or other beneficial interest in it, such as its shareholders.”).

56. *See id.* § 96 cmt. e (stating that lawyer “must not knowingly or negligently assist any constituent to breach a legal duty to the organization,” and is required to “act diligently and to exercise care to prevent reasonably foreseeable harm to a client [and must] take action . . . with respect to certain breaches of legal duty to the organization by a constituent”); Cramton, *supra* note 52, at 154-58 (stating that lawyer has duty to first report up corporate ladder and then, if corrective action is not taken, to withdraw and perhaps report out to third parties in order to prevent harm to organization caused by fraudulent or criminal enterprises of organization's constituents); George C. Harris, *Taking the Entity Theory Seriously: Lawyer Liability for Failure to Prevent Harm to Organizational Clients Through Disclosure of Constituent Wrongdoing*, 11 *GEO. J. LEGAL ETHICS* 597, 653 (1998) (“[T]he individual constituents of the organization . . . should know . . . that the lawyer's duty of loyalty is not to them individually and that the lawyer will not be bound to keep their confidences if they are engaged or intend to engage in activities that are not in the interest of the organization.”).

the organization communications gained from constituents who are not themselves clients.⁵⁷ Also, the organization, acting through duly authorized constituents, may assert or waive the duty of confidentiality or the attorney-client privilege to such information.⁵⁸

Today, most of these propositions are stated or are implicit in ABA Rule 1.13, which has been adopted by virtually every state.⁵⁹ Nevertheless, the lawyer's duty of "loyal disclosure" within the organization has not been generally understood although it is plainly stated in Rule 1.13(b): When a lawyer for an organization knows that a constituent of the organization is engaged in wrongful conduct that is likely to harm the organization or embark the organization on an unlawful course, Rule 1.13(b) provides that the lawyer "*shall proceed as is reasonably necessary in the best interest of the organization.*"⁶⁰

Two circumstances explain the widespread failure of lawyers to understand that Rule 1.13, even prior to its amendment in August 2003, requires lawyers for an organization to go up the organizational ladder to prevent law violations that will harm the organization. One emerges from the language and structure of the former rule itself. Former Rule 1.13(b), which is still the governing rule in most jurisdictions, is a lengthy provision that lists four factors to be considered by the lawyer in determining what to do, and then presents three possible remedial measures that the lawyer "may" take, with "referring the matter to higher authority in the organization" coming last. As a consequence, many lawyers have viewed the provision as only giving the lawyer discretion to choose among a number of options, including doing nothing at all.

This uncertainty is compounded by the lack of interpretation of Rule 1.13 and its application to the situations in which an organization's lawyer does nothing to prevent organizational wrongdoing resulting in harm to

57. See RESTATEMENT, *supra* note 52, § 96 cmt. e (noting that disclosure within organization of information gained from constituents may be made "even if disclosure is against the interests of the communicating person, [or] of another constituent whose breach of duty is in issue").

58. See *id.* § 73 cmt. j (discussing authority of those in control of organization, not individual constituents, to waive organization's attorney-client privilege). A successor in interest, such as a bankruptcy trustee, can waive the organization's privilege over the objections of the organization's former directors. See *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 358 (1985) (holding that corporation's bankruptcy trustee had power to waive attorney-client privilege with respect to pre-bankruptcy communications).

59. See MODEL RULES 2003, *supra* note 32, R. 1.13 (establishing duties by organization's lawyer to lawyer's organizational client). Even states such as California and New York, that have not adopted the Model Rules of Professional Conduct as the framework for the state's ethics rules, have adopted provisions concerning the duties of an organizational lawyer that parallel and are largely drawn from the 1983 version of Model Rule 1.13. See THOMAS D. MORGAN & RONALD D. ROTUNDA, 2003 SELECTED STANDARDS ON PROFESSIONAL RESPONSIBILITY 445-47, 509-10 (2003) (reproducing California and New York equivalent of ABA Model Rule 1.13).

60. MODEL RULES 1983, *supra* note 11, R. 1.13 (emphasis added). The quoted language was retained in the 2002 revision.

third persons and ultimately to the organization. Judicial decisions and ethics opinions interpreting and applying Rule 1.13 are virtually nonexistent.⁶¹

As indicated earlier, in August 2003 the ABA amended Rule 1.13 to remedy these flaws. Rule 1.13 now requires a lawyer to inform a higher authority in an organization (and the highest authority "if warranted by the circumstances") when lower levels have failed to take action to address a law violation "[u]nless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so (1.13(b))." Despite this desirable change in Model Rule 1.13, it remains doubtful whether up-the-ladder reporting by an organization's lawyer will become routine and whether departures from the report obligation will be punished. It remains uncertain whether or when state high courts will adopt the amended version of the rule. Even if state high courts adopt the amended Rule 1.13, the rule, despite its mandatory language, contains a number of important limitations and qualifications (or should we say loopholes) that give lawyers wide discretion, making enforcement difficult. These include: (1) the actual knowledge standard as the trigger for the lawyer's duty; (2) a definitive "violation" rather than evidence of a violation or a potential violation; (3) the requirement that the violation be "related to the representation;" (4) the requirement that the violation "is likely to result in substantial injury" rather than simply being "material;" (5) the requirement that the substantial injury be "to the organization," ignoring the situations in which only third persons are harmed by the illegality; (6) the exception to the reporting up duty if the lawyer "reasonably believes that it is not necessary in the best interests of the organization to do so;" and (7) the limitation that lawyers need to report to the "highest authority" only "if warranted by the seriousness of the matter."⁶²

In the past, state disciplinary authorities have not brought disciplinary proceedings against lawyers who failed to take constituent wrongdoing to the highest authority of an organization when doing so was required. Experience under the pre-2003 version of Rule 1.13 suggests that enforcement of "loyal disclosure," within the corporation and to protect its interests, will come only through civil liability actions or SEC enforcement proceedings against securities lawyers for public companies. Some judicial decisions hold that the organization's former lawyer may be liable to the organization for failing to prevent a constituent's breach of a legal obliga-

61. The fifth edition of the *ABA Annotated Model Rules* cites no cases that discuss Rule 1.13(b) or 1.13(c). For a rare case discussing Rule 1.13 and suggesting a weak commitment to enforcing the rule, see *Florida Bar v. Brown*, 790 So. 2d 1081, 1086 (Fla. 2001), in which the Florida Supreme Court stated that the defendant could have taken more steps to alert persons in the corporation of illegal conduct, but there was no evidence that he did not act as reasonably necessary in the best interest of the corporation.

62. See MODEL RULES 2003, *supra* note 32, R. 1.13.

tion to the organization.⁶³ Others hold the organization's lawyer liable for failing to protect the organization against wrongful acts by constituents harming third persons (third-party liability for assisting or participating in the organization's wrongful conduct).⁶⁴ And, even prior to the enactment of Section 307 of Sarbanes-Oxley, a line of SEC enforcement proceedings against lawyers had established that securities lawyers have obligations, flowing primarily from state ethics rules, to take reasonable steps to prevent an organizational client or one of its constituents from violating federal securities laws.⁶⁵

B. *Required Reporting Under Section 307 of Sarbanes-Oxley*

The final rules implementing Section 307 of Sarbanes-Oxley are set forth in new Part 205 of the Commission's rules.⁶⁶ The rules require attorneys "appearing and practicing" before the SEC in the representation of issuers to report evidence of a material violation of law or breach of fiduciary duty by the issuer or its agent up the corporate ladder to the CLO or to both the CLO and the CEO.⁶⁷ If the CLO or CEO fails to provide an "appropriate response" to the evidence, the attorney must re-

63. See, e.g., *In re Am. Cont'l Corp.*, 794 F. Supp. 1424, 1453 (D. Ariz. 1992) (finding complaint alleging law firm failed to take corrective action to prevent serious regulatory violations by those then in control of organization stated claim for relief; lawyer must go to board, urge cessation and withdraw when continued representation will assist ongoing illegality). See generally *Fin. Gen. Bankshares, Inc. v. Metzger*, 523 F. Supp. 744 (D.D.C. 1981) (finding lawyer violated fiduciary duty to organization by assisting a hostile takeover), *vacated*, 680 F.2d 768 (D.C. Cir. 1982) (vacating for lack of jurisdiction).

64. See, e.g., *FDIC v. O'Melveny & Myers*, 969 F.2d 744 (9th Cir. 1992) (finding breach of lawyer's duty to protect corporate client against wrongful acts of constituents giving rise to corporation's liability to third person), *rev'd on other grounds*, 512 U.S. 79 (1994), *aff'd on remand*, 61 F.3d 17 (9th Cir. 1995); see also *FDIC v. Clark*, 978 F.2d 1541 (10th Cir. 1992) (finding substantial evidence supported jury verdict that corporation's lawyers breached duty to make reasonable independent investigation into third-party allegations of fraud on part of corporate officers).

65. See *In re Carter & Johnson*, 47 S.E.C. 471 (1981) (stating prospective rule that "[w]hen a lawyer with significant responsibilities in the effectuation of a company's compliance with the disclosure requirements of the federal securities laws becomes aware that his client is engaged in a substantial and continuing failure to satisfy those disclosure requirements, his continued participation violates professional standards unless he takes prompt steps to end the client's compliance"); see also *In re Gutfreund*, Exchange Act Release No. 31,553 (1992) (lawyer who had legal compliance duties as chief legal counsel of investment banking firm, and who knows or has reason to know misconduct by company trader has not been addressed, must take appropriate steps to ensure that misconduct is adequately addressed, which "may include disclosure of the matter to the entity's board of directors, resignation from the [representation], or disclosure to regulatory authorities").

66. See 17 C.F.R. § 205 (2004) (setting forth new minimum standards for professional conduct for attorneys).

67. See *id.* § 205.3(b)(1).

port the evidence to the audit committee, another independent committee or the full board of directors.⁶⁸

The SEC rules supplement state ethics rules and are not intended to limit states from imposing additional obligations consistent with their purposes.⁶⁹ Section 307 required the SEC to promulgate “minimum” rules of professional conduct, not “maximum” ones.⁷⁰ Where state rules conflict with the SEC rules, however, the federal rules govern.⁷¹ Preemption of state standards is most likely to arise with respect to disclosure of confidential information outside the organization also known as “reporting out.”⁷²

1. *Which Lawyers Are “Appearing and Practicing” Before the SEC Under Part 205?*

The first interpretive question lawyers face under the SEC rules is whether the rules apply to them. Congress cast a potentially wide net in Section 307 by requiring the SEC rules to apply to all “attorneys appearing and practicing before the Commission *in any way* in the representation of issuers.”⁷³ In accordance with this directive, the SEC promulgated Section 205.2(a)(1), which defines “appearing and practicing before the Commission” to include:

- transacting any business with the SEC, including communications in any form;
- representing an issuer in SEC administrative proceedings or in connection with any SEC investigation, inquiry, information request or subpoena;
- providing advice with respect to the federal securities laws or SEC rules thereunder regarding any document that the attorney has notice will be filed with the SEC; and

68. *See id.* § 205.3(b)(3). The rule does not give complete discretion to the lawyer to choose among the higher authorities. As Section 205.3(b)(3) is written, the lawyer must report to the audit committee if one exists. If no audit committee exists, the lawyer must report to a committee of independent directors. Only if there is no such committee is the lawyer required to report to the full board of directors.

69. *See id.* § 205.1. Section 205.1 states:

These standards supplement applicable standards of any jurisdiction where an attorney is admitted or practices and are not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with the application of this part. Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, this part shall govern.

Id.

70. *See* 15 U.S.C. § 7245 (2004).

71. *See infra* notes 282-91 and accompanying text.

72. For further discussion of “reporting out,” *see infra* Part III.

73. 15 U.S.C. § 7245 (emphasis added).

- advising an issuer as to whether information or a statement, opinion or other writing is required to be filed with or submitted to the SEC.⁷⁴

The definition of “appearing and practicing” expressly excludes two types of lawyers.⁷⁵ First, the rules do not apply to lawyers who engage in the above listed activities outside of the “context of providing legal services to an issuer with whom the attorney has an attorney-client relationship.”⁷⁶ Second, the rules exclude some, but not all, foreign lawyers, specifically those who qualify as “non-appearing foreign attorneys.”⁷⁷

Five aspects of this definition have given rise to the most concern and discussion among lawyers: the application of the SEC rules to non-securities lawyers; the application of the SEC rules to securities lawyers who advise on, but do not sign, documents submitted to the SEC; the exclusion of lawyers not in a lawyer-client relationship with the corporation; the exclusion of some foreign lawyers; and the failure to cover law firms.

a. Application of the SEC Rules to Lawyers Who Do Not Specialize in Securities Law

The potential application of the SEC rules to lawyers who do not specialize in securities law comes from Section 205.2(a)(1)(iii), which includes as a lawyer “appearing and practicing” before the SEC, one who:

Provid[es] advice *in respect of* the United States securities laws or the Commission’s rules or regulations thereunder regarding any document that the attorney has *notice* will be *filed with* or submitted to, or *incorporated into* any document that will be filed with or submitted to, the Commission, *including* the provision of *such advice* in the context of preparing, or participating in the preparation of, any such document.⁷⁸

Practicing lawyers have expressed concern about the possibility that this provision inappropriately sweeps lawyers within the SEC rules’ grasp in two general situations.⁷⁹ First, transactional lawyers who are specialists in some area other than securities law—such as tax, labor or environmental law—may prepare a document that will be incorporated by the client’s securities counsel (who may be in the same firm) into an SEC filing. Second, litigators may be asked by a corporation’s auditors to provide infor-

74. 17 C.F.R. § 205.2(a)(1).

75. *See id.* § 205.2(a)(2).

76. *See id.* § 205.2(a)(2)(i).

77. *See id.* § 205.2(a)(2)(ii). For the definition of “Non-appearing foreign attorneys,” *see id.* § 205.2(j).

78. *Id.* § 205.2(a)(1)(iii) (emphasis added).

79. *See, e.g.*, ABA Comments on Initial Proposed Rules, at www.sec.gov/rules/proposed/s74502.html (urging that non-securities specialists who do not in fact practice securities law should not be subject to Section 205).

mation relevant to the question whether the litigation affects the issuer's financial position. The SEC responded to the bar's concerns by adding a requirement that lawyers have "notice" that their documents will be made part of an SEC filing.⁸⁰

In fact, however, Section 205.2(a)(1)(iii) is ambiguous as to whether these non-securities lawyers are covered by the SEC rules. The textual argument that these lawyers are not covered is that even if they have given advice with respect to a document that they have notice will be included in an SEC filing, the "advice" covered by the provision is expressly limited to "advice in respect of the United States securities laws or the Commission's rules and regulations thereunder."⁸¹ If "in respect of" means "about," then lawyers who are not securities lawyers would not be giving the required advice.⁸² On the other hand, if "in respect of" means "relevant to" (such as when the inclusion of materially misleading information in the filed document may constitute a violation of securities laws even if the information itself is not about securities), then these lawyers would be covered.⁸³

Regardless of how a court would interpret the language of Section 205.2(a)(1)(iii), the SEC rules should cover non-securities lawyers in the situations described, and the SEC should either change the language of the rule or clarify its meaning in a formal ruling at the earliest opportunity. Lawyers for a corporation need not be "securities lawyers" providing "securities law advice" either to participate in activity that may be or become a securities law violation, or to become aware of evidence of such activity. The evidence they are most likely to become aware of is evidence related to their own area of practice. If, for example, an environmental lawyer has evidence that the corporation is engaged in material violations of environmental law, yet provides information for an SEC filing suggesting that there is no violation, the lawyer may be assisting, or at least facilitating, a securities law violation. The investing public would certainly take such information into account in making investment decisions. Why should such a lawyer be exempt from a duty to report this evidence?

Some lawyers are concerned that the coverage sweeps more broadly than the above scenarios suggest. For example, it could be argued that once a lawyer is deemed to be "appearing and practicing" before the SEC, then the lawyer's duty to report applies to everything that lawyer does, not just the advice concerning the document submitted to the SEC, including all material violations of securities law or breaches of fiduciary duty the lawyer becomes aware of, not just evidence within the lawyer's area of expertise. It is true that, unlike Model Rule 1.13, which limits the obligations imposed on a corporation's lawyers to "matter[s] related to the represen-

80. See SEC Final Rule, *supra* note 9, cmt. to 17 C.F.R. § 205.2.

81. See SEC Final Rule, *supra* note 9.

82. See *id.*

83. See *id.*

tation," the duty to report under Section 205.2(b) contains no similar limitation.⁸⁴ The most sensible reading of the duty to report under Section 205.2(b), however, is that it applies only to the extent that the lawyer's activities count as "appearing and practicing."

Even if the SEC rules are interpreted to contain no limitation based on the relationship between the lawyer and the subject matter of the representation, the rules include two other important protections for lawyers who do not generally practice securities law. First, the rules contain an important limitation on the duty to report for "subordinate" lawyers in Section 205.5.⁸⁵ Paragraph (a) of that section defines "subordinate attorney" broadly, as a lawyer who appears and practices before the SEC "under the supervision or direction of another attorney."⁸⁶ Subordinate attorneys do have a duty to report, but satisfy that duty by reporting evidence of a material violation to the supervising attorney without regard to whether the supervising attorney satisfies his or her duties under the rules.⁸⁷ Lawyers who are not securities lawyers have a good argument that, at least with respect to evidence outside their area of expertise, reporting evidence of a material violation to the securities lawyer who is handling the SEC filing would be sufficient because the securities lawyer would be acting in a supervisory capacity.⁸⁸ Second, as a practical matter, the sanctions the SEC can impose on non-securities lawyers are limited.⁸⁹ The SEC can, for example, preclude the lawyer from appearing and practicing before the SEC for a period of time, but if that simply means the lawyer cannot give an opinion about material to be included in an SEC filing, that may not put a large dent in the non-securities lawyer's practice or that of the lawyer's firm.⁹⁰

b. Application of the SEC Rules to Lawyers Who Do Not Sign Documents Filed with the SEC

With respect to lawyers who specialize in securities law, the main coverage question resolved by the SEC rules is whether lawyers who do not sign documents filed with the SEC are covered. One scenario involves

84. *Contra* MODEL RULES 2003, *supra* note 32, R. 1.13(b) (amending Model Rule 1.13(b) to eliminate limitation on reporting duty). For a critique of the SEC rules' failure to limit the reporting duty to matters related to the representation, see Thomas D. Morgan, *Sarbanes-Oxley: A Complication, Not a Contribution in the Effort to Improve a Corporate Lawyer's Professional Conduct*, 17 GEO. J. LEGAL ETHICS 1, 29-30 (2003).

85. *See* 17 C.F.R. § 205.5 (2004).

86. *Id.*

87. *See id.*

88. *See id.* § 205.5(c) ("A subordinate attorney complies with § 205.3 if the subordinate attorney reports to his or her supervising attorney under § 205.3(b) evidence of a material violation of which the subordinate attorney has become aware in appearing and practicing before the Commission.").

89. *See id.* § 205.6.

90. *See id.*

securities lawyers who advise that documents need not be filed at all or that certain information need not be included in filed documents. Section 205.2(a)(1)(iv) expressly includes lawyers who:

[Advise] an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the Commission's rules and regulations thereunder to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission.⁹¹

The securities laws are as concerned with failures to make required disclosures as they are with affirmative misstatements in required disclosures. Thus, lawyers who advise against disclosure should not be excluded from the duty to report evidence of a material violation.

Lawyers who advise or draft, but do not sign, documents filed with the SEC are covered by Section 205.2(a)(1)(iii).⁹² The SEC's decision to include these lawyers should be applauded. Any other rule would facilitate circumvention of Part 205 by encouraging corporate managers and corporate counsel to confine lawyer signatures on Commission documents or filings to a bare minimum to ensure no up-the-ladder reporting of wrongdoing by non-signing lawyers. That would risk gutting the SEC rules and Section 307. Lawyers and corporate managers already have an incentive to employ this strategy in an attempt to avoid primary liability for violating the securities laws in civil suits, now that secondary liability for aiding and abetting a securities violation—the assistance that lawyers most commonly provide to risk-taking clients—is no longer available to third parties in private suits for damages because of the decision in *Central Bank of Denver v. First Interstate Bank of Denver*.⁹³

The argument that lawyers should have no responsibility for client illegality, short of signing documents, is an embarrassment to the legal profession. The law rejects this hamstrung vision of lawyer ethics. At a minimum, it is malpractice for a lawyer whether negligently, recklessly or intentionally, to sit by silently or passively and advise a client that legally required documents need not be filed or that certain required information need not be disclosed when a reasonable lawyer in the same circumstances would advise otherwise.⁹⁴ In *SEC v. National Student Marketing Corp.*,⁹⁵ the court found that in some circumstances, such conduct is more

91. *Id.* § 205.2(a)(1)(iv).

92. See *supra* notes 78-83 and accompanying text (discussing Section 205.2(a)(1)(iii)).

93. 511 U.S. 164, 192 (1994).

94. In *FDIC v. O'Melveny & Myers*, 969 F.2d 744, 746-47 (9th Cir. 1992), the law firm, knowing that the client's auditing and law firms had recently resigned, went ahead with a client's securities offering without making any inquiry as to the circumstances of resignation.

95. 457 F. Supp. 682 (D.D.C. 1978).

than malpractice; it amounts to aiding and abetting securities fraud.⁹⁶ Most recently, *In re Enron Corp. Securities, Derivative & ERISA Litigation*⁹⁷ held that lawyers can be primary violators of the securities laws even if they do not sign the relevant documents.⁹⁸

Civil liability, however, insufficiently deters those kinds of lawyer misconduct. First, under *Central Bank*, private parties can no longer bring civil suits for aiding and abetting.⁹⁹ Second, investors cannot rely on malpractice actions by corporations to deter such behavior. Until and unless a corporation is forced into bankruptcy and a trustee has been appointed, experience teaches that corporations are unlikely to bring malpractice actions against their lawyers. Absent a hostile change of control, corporate managers usually prefer to keep such matters private. With the law already labeling such conduct as malpractice or sometimes more and civil actions unlikely to be brought due to either the limits of law or what economists call an “agency” problem, Congress was right to require the Commission to regulate behind-the-scenes assistance, which is precisely what the SEC rules do.

In introducing and debating Section 307, the amendment’s sponsors were absolutely clear that the conduct at which Section 307 was directed had nothing to do with who signed what documents and everything to do with lawyers failing to advise and insist that the law’s requirements be met, including disclosure of all required information to the Commission and filing all necessary paperwork.¹⁰⁰ The argument that advising as described in Section 205.2(a)(1)(iii) and (iv) should not be covered by these rules is implausible and unsound.

c. The Exclusion of Lawyers Not in a Lawyer-Client Relationship with the Issuer

After the SEC circulated its initial proposed rules, many lawyers expressed concern that the rules could be read to cover corporate employees who are trained and licensed lawyers but who do not practice law within the company. In response, the SEC adopted Section 205.2(a)(2)(i), which excludes from coverage lawyers who engage in the activities described in Section 205.2(a)(1), “other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship.”¹⁰¹

96. *See id.* at 712-15.

97. 235 F. Supp. 2d 549 (S.D. Tex. 2002).

98. *See id.* at 582 (concluding that lawyers are responsible for violations even without signing questionable documents).

99. *See Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 190-91 (1994).

100. *See* 148 CONG. REC. S6555 (July 10, 2002) (insisting attorneys meet disclosure requirements).

101. 17 C.F.R. § 205.2(a)(2)(i) (2004).

It is not clear that the exemption in Section 205.2(a)(2)(i) was necessary at all. First, the duty to report under Section 205.3(b) is limited to an attorney “appearing and practicing before the Commission *in the representation of an issuer*.”¹⁰² The phrase “in the representation of an issuer” is defined in Section 205.2(g) to mean “providing legal services as an attorney for the issuer, regardless of whether the attorney is employed or retained by the issuer.”¹⁰³ That definition seems to resolve the problem of lawyers who are employed by issuers but do not practice law. Even without that limiting definition, most of the conduct listed in “appearing and practicing” involves the practice of law, rather than “mere business” activity.

Mere redundancy in regulation, however, is not a large problem. The bigger problem with Section 205.2(a)(2)(i) is that it extends the exemption beyond the stated concern. The source of the problem is the last phrase in the subsection, “with whom the attorney has an attorney-client relationship.”¹⁰⁴ This phrase was not necessary to exempt licensed lawyers who perform only business functions for their corporate employer. The provision of legal services to an issuer is implicit in the SEC’s requirement of an “attorney-client relationship” with an issuer. The requirement of an attorney-client relationship with an “issuer” raises the question whether lawyers for a related corporate entity, such as a subsidiary or a “special purpose entity” (SPE), or for an agent of the issuer, such as the CFO, are excepted. For an example of these lawyers, one need look no further than the *Enron* case, in which the Kirkland firm is alleged to have provided substantial legal advice to Enron while representing only Fastow and the SPEs.¹⁰⁵ There is no reason for the SEC to exempt any lawyer who provides legal advice to an issuer from any of these rules simply because that lawyer may be able to claim that he or she had no “attorney-client relationship” with the issuer.

The rules may address this problem in the definition of “issuer” in Section 205.2(h).¹⁰⁶ “For purposes of [defining ‘appearing and practicing in the representation of an issuer’], the term ‘issuer’ includes any person controlled by an issuer, where an attorney provides legal services to such person on behalf of, or at the behest, or for the benefit of the issuer,

102. *Id.* § 205.3(b) (emphasis added).

103. *Id.* § 205.2(g).

104. *See id.* § 205.2(a)(2)(i).

105. *See Koniak II, supra* note 2, at 1240-42 (providing example of lawyers for related entity).

106. *See* 17 C.F.R. § 205.2(h). An argument could also be made that Section 205(g) solves the problem by defining “representation by an issuer” to mean “providing legal services as an attorney for an issuer, regardless of whether the attorney is employed or retained by the issuer.” The problem with this argument is that the duty to report under Section 205.2(b)(1) applies only to a lawyer “appearing and practicing before the Commission in the representation of an issuer.” Thus, if an attorney is not “appearing and practicing” under Section 205.2(a), it is not sufficient that the attorney is acting “in the representation of an issuer” under Section 205(g).

regardless of whether the attorney is employed or retained by the issuer."¹⁰⁷ This definition could take care of problems like Kirkland's representation of Enron SPEs, depending on how the SEC and the courts interpret the key phrase "controlled by an issuer." It is not clear to us why the SEC added the "control" requirement, which is likely to end up being heavily litigated. Why is it not enough for the lawyer to provide legal services "on behalf of, or at the behest, or for the benefit of the issuer"? Of course, that may be the way the SEC and the courts wind up defining "attorney-client relationship" in Section 205.2(a)(2)(i).¹⁰⁸ The cleaner solution, however, is to drop the "attorney-client relationship" limitation, and substitute the "on behalf of, or at the behest, or for the benefit of the issuer" phrase in Section 205.2(a)(2)(i).

d. The Partial Inclusion of Foreign Lawyers

The SEC's decision to include the regulation of foreign lawyers within its rules resulted in more comments than any other provision, except for the noisy withdrawal proposal.¹⁰⁹ Despite the universal outcry from foreign lawyers, the SEC did not completely back down in its final rules, though it did retreat somewhat, in two separate rules.¹¹⁰ First, Section 205.6(d) provides that any lawyer "practicing outside the United States shall not be required to comply with the requirements of this part to the extent that such compliance is prohibited by applicable foreign law."¹¹¹ Second, Section 205.2(a)(2)(ii) excludes all "non-appearing foreign attorneys," a term defined in Section 205.2(j).¹¹² Section 205.6(d) seems sensible and straightforward, if not sufficient, to address the legitimate concerns of foreign lawyers, as well as American lawyers practicing in foreign countries. Consequently, the comments below focus on Section 205.2(j).

To qualify as a "non-appearing foreign attorney" under Section 205.2(j), a lawyer must meet three criteria. First, the lawyer must be "admitted to practice in a jurisdiction outside the United States."¹¹³ Second, the lawyer must neither "hold himself or herself out as practicing," nor "give legal advice regarding, United States federal or state securities or

107. *Id.*

108. The SEC, in the comment to Section 205.2(a) expresses the view that "whether an attorney-client relationship exists for purposes of this part will be a federal question and, in general, will turn on the expectations and understandings between the attorney and the issuer."

109. According to the comment to Section 205.2(j), the SEC received more than forty comment letters addressing the international aspects of the initial proposed rule.

110. *See* 17 C.F.R. § 205.2(c) (defining "attorney" to include "any person who is admitted, licensed, or otherwise qualified to practice law in any jurisdiction, domestic or foreign").

111. *Id.* § 205.6(d).

112. *See id.* § 205.2(a)(2)(ii).

113. *Id.* § 205.2(j)(1).

other laws," unless done "in consultation with" a lawyer admitted in the United States (a "U.S. lawyer").¹¹⁴ Third, the lawyer's "appearing and practicing" activity within the meaning of the SEC rules is done in either one of two contexts.¹¹⁵ The first context involves "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."¹¹⁶ The alternative context involves activities done "in consultation with counsel, other than a non-appearing foreign attorney, admitted or licensed to practice in a state or other United States jurisdiction."¹¹⁷

Section 205.2(j) essentially gives foreign lawyers the ability to opt out of the SEC rules by associating with a U.S. lawyer. The key question is how "in consultation with" will be interpreted. The requirement is not a problem if it means that the U.S. lawyer is responsible for the representation and for the conduct of the foreign lawyer. This would be an extension of the rules for supervisory and subordinate lawyers outlined in Sections 205.4 and 205.5, except that the foreign "subordinate" would not even have reporting responsibilities to the U.S. "superior."¹¹⁸ If the U.S. lawyer would be held vicariously liable for the foreign lawyer's conduct, the U.S. lawyer would have an incentive to ensure compliance by the foreign lawyer. More likely, however, the phrase "in consultation with" is intended to denote a looser association between the foreign and U.S. lawyer. If so, the exemption would be more troubling. The looser the association, the more foreign lawyers will be able to take advantage of the exemption, and the greater the potential for corporations to use foreign lawyers to circumvent the reporting requirements of the SEC rules. The danger is that foreign-licensed lawyers who practice U.S. securities law in the United States, and who apparently also may be U.S.-licensed lawyers, could take advantage of this opt-out provision. This makes little sense.

If a foreign lawyer does not "appear and practice" before the SEC "in consultation with" a U.S. lawyer, then the foreign lawyer can be exempt only if the lawyer practices or gives advice with respect to foreign law, practices law outside the U.S. and provides advice constituting "appearing and practicing" before the SEC only "incidentally to, and in the ordinary course of" this foreign practice. An example of how a foreign lawyer could be within the "appearing and practicing" definition and yet exempt would be a French environmental lawyer who provides information to a U.S.-listed corporation about that corporation's compliance with French environmental law. The main question here is how "incidentally to, and in the ordinary course of" will be interpreted. Perhaps the idea is that the closer

114. *Id.* § 205.2(j) (2), (3).

115. *See id.* § 205.2(j) (3).

116. *Id.* § 205.2(j) (3) (i).

117. *Id.* § 205.2(j) (3) (ii).

118. *See id.* §§ 205.4, 205.5.

the relationship the foreign lawyer has with the U.S. issuer and the more often the foreign lawyer, as part of his or her regular practice, provides information on foreign law for the purpose of inclusion in a U.S. securities filing, the greater the justification for regulation of the lawyer under the SEC rules.

e. Law Firms as Legal Persons Who “Appear and Practice”

Section 307 refers to “standards of professional conduct for attorneys” without addressing the question whether firms in which attorneys practice are intended to be regulated.¹¹⁹ The SEC rules appear directed at individual attorneys.¹²⁰ The rules should be revised to state explicitly that law firms, not just individual lawyers, “appear and practice” before the SEC. Similarly, the SEC should add a rule permitting the censure or reprimand of a law firm and the assessment of monetary fines when the firm has failed to conform to responsibilities required by the Commission.

The rationale for including law firms within the SEC rules is straightforward.¹²¹ Corporate clients who hire outside counsel usually understand that they are represented by the law firm, not any one individual lawyer within the firm. In matters of any size or complexity, multiple law-

119. See generally 15 U.S.C. § 7245 (2003).

120. The rules mention only the obligations of “an attorney.” Section 205.2(c) defines “attorney” as “any person who is admitted, licensed, or otherwise qualified to practice law in any jurisdiction, domestic or foreign, or who holds himself or herself out as admitted, licensed, or otherwise qualified to practice law.” See 17 C.F.R. § 205.2(c) (emphasis added) (defining attorney without defining whether firms are covered). The comment accompanying Section 205.2 (c) makes no mention of whether firms are covered. One could, perhaps, argue that “person” includes an entity, as it often does in legal definitions. The rules mention law firms, as distinct from attorneys, in only one place. See *id.* § 205.7(a) (“Nothing in this part is intended to, or does, create a private right of action against any attorney, law firm, or issuer, based upon compliance or noncompliance with its provisions.”). The comment accompanying Section 205.7(a) states that “the protection of this provision should extend to any entity that might be compelled to take action under this part.” Although the comment could be read to support the coverage of law firms, Section 205.7(a) is directed at liability rather than the duty to report under the Part 205 rules themselves. Even if only individual lawyers have responsibilities under the SEC rules, law firms could be exposed to vicarious liability for the acts of their lawyers.

121. For a persuasive argument in favor of extending discipline to law firms, see Ted Schneyer, *Professional Discipline for Law Firms?*, 77 CORNELL L. REV. 1, 45-46 (1992) (arguing “that recent developments in legal ethics and disciplinary enforcement have brought us to the point where firm discipline would only be an incremental, not a radical, step forward”). Cf. Elizabeth Chambers & David B. Wilkins, *A New Framework for Discipline*, 11 GEO. J. LEGAL ETHICS 335 (2003). For a critique, of Schneyer’s proposal, see Julie Rose O’Sullivan, *Professional Discipline for Law Firms? A Response to Professor Schneyer’s Proposal*, 16 GEO. J. LEGAL ETHICS 1 (2002). New York and New Jersey now allow discipline of law firms. See N.Y. CODE OF PROF’L RESPONSIBILITY DR 1-104, 5-105(e) (2003) (requiring law firm to make reasonable efforts to ensure that all lawyers in firm conform to disciplinary rules); see also N.J. RULES OF PROF’L CONDUCT R. 5.1(a) (2003) (requiring firms to establish procedures to maximize attorneys’ compliance with Rules).

yers in the firm, not just one partner and a few subordinates, are likely to be involved. Specialized corporate and securities practice involves the participation of a team of lawyers who bring differing skills and knowledge. Responsibility for decisions is often divided or shared in ways that are uncertain or shifting. The diffusion of responsibility and knowledge leads to the argument that no one lawyer or identified group of lawyers can be held responsible for the work done. The law of agency addresses these realities through rules of vicarious liability and imputed knowledge, which are discussed in more detail in the next section. Furthermore, the SEC itself has disciplined law firms in the past in exercising its authority under Rule 102(e) (formerly Rule 2(e)).¹²²

2. *What Triggers the Lawyer's Initial Duty to Report?*

The heart of Section 307, and of the SEC rules, is the lawyer's duty to report. The key question under the duty to report is what circumstances trigger that duty. Section 307 obligated the SEC to adopt a rule requiring a lawyer "to report evidence of a material violation of securities law 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 thereof)."¹²³ The rule implementing this requirement, Section 205.3(b)(1), states:

If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report such evidence to the issuer's chief legal officer (or the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or the equivalents thereof) forthwith.¹²⁴

122. See *In re Keating, Muething & Klekamp*, Exchange Act Release No. 34-15982 (July 2, 1979) (finding that "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," and imposing sanctions on law firm for "fail[ing] to carry out its professional responsibilities").

123. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 15 U.S.C. § 7245(1).

124. 17 C.F.R. § 205.3(b)(1) (2004) (stating rule requiring lawyer to report). The SEC rules provide two alternative first steps to reporting to the chief legal officer (CLO): (1) reporting to a qualified legal compliance committee and (2) reporting directly to the board or relevant board committee. The alternative of reporting to a previously formed "qualified legal compliance committee," is subject to a trigger similar to the general trigger for reporting to the CLO. See *id.* § 205.3(c) (stating trigger for duty to report is when "an attorney, appearing and practicing before the Commission, becomes aware of evidence of a material violation"). The requirements for a qualified legal compliance committee are given in the definition section. See *id.* § 205.2(k). The alternative of bypassing the CLO and going directly to the board requires that the lawyer "reasonably believe[] that it would be futile to report evidence of a material violation to the issuer's chief

The SEC rules define “evidence of a material violation” in Section 205.2(e) as “credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is occurring, or is about to occur.”¹²⁵

In assessing how faithfully and well the SEC rules implement the congressional mandate, it is important to keep in mind the goals of Section 307. In the wake of Enron and other corporate scandals, Congress was concerned that too many corporate lawyers were taking a “see no evil, report no evil” approach to their representations. Any lawyer worth his salt knows that assessing whether the law is actually being violated is no simple task. One extra fact, one nuance, one affirmative defense, one creative ambiguity, and a judgment of “illegality” morphs into something more benign. Unfortunately, as lawyer behavior in the S & L scandal and countless other financial debacles demonstrate, the inevitable “grayness” or uncertainty of all law—a characteristic of all just legal regimes and not a flaw—has become an excuse for ignoring evidence of illegality, no matter how substantial the evidence or harm being wrought has been.

The purpose of Section 307 was to change this corporate legal culture and practice and encourage more reporting of dubious corporate activities. Thus, Congress abandoned the “subjective” approach of Model Rule 1.13(b), which imposes no obligations on a lawyer unless she “knows” that illegal activity is occurring or will occur. Instead, Congress mandated an objective trigger, while at the same time lowering the triggering standard from one of definitive violation to “evidence” of a violation. The hope was that an objective, probabilistic “evidence” trigger would be less subject to manipulation by lawyers inclined not to notice evidence of wrongdoing or to explain such evidence away. The question, then, is whether the SEC rules further this objective. The answer, unfortunately, is no.

There are four deficiencies in the SEC’s triggering standard: the double-negative formulation in the definition of “evidence of a material violation;” the ambiguity of the “reasonably likely” standard in the same definition; the undefined and uncertain meaning of the “becomes aware” trigger; and the failure to address the problem of imputed knowledge.

a. The Troublesome Double-Negative Standard

In deciding whether to act—whether to report what Congress wanted to encourage lawyers to report up the corporate ladder—the lawyer confronting the definition of “evidence of a material violation” in Section 205.2(e) must ask herself whether it would be *unreasonable not to conclude*

legal officer and chief executive officer.” *Id.* § 205.3(b)(4). Reasonable belief is defined as actual belief plus circumstances suggesting that the belief is “not unreasonable.” *Id.* § 205.2(m).

125. *Id.* § 205.2(e). Other relevant definitions are “material violation” in Section 205.2(i) and “breach of fiduciary duty” in Section 205.2(d).

that the evidence before her demonstrates a reasonable likelihood of a material violation of law. This definition, which triggers the up-the-ladder reporting duty, is troublesome because its use of a double-negative formulation makes the standard difficult to understand, interpret or apply.

Law is intended to guide action in the world. Yet it is barely possible to read the SEC's definition out loud without tripping (or, as we have discovered when presenting this definition in various fora, chuckling) over the words, let alone trying to remember the definition without reading it or trying to work out its "logic." Indeed, the provision is a gross violation of the SEC's own "plain English" rules applicable to SEC filings intended for investors. Similar language in a prospectus would not fare well.

Moreover, the SEC's standard fails another critical test of sound rulemaking. It will be a nightmare to enforce.¹²⁶ The Commission has asked its staff to assume the burden of proving not just one negative, but two. To enforce this rule, the Commission would have to show that it was *unreasonable* for a lawyer *not* to conclude that a violation was reasonably likely. We do not believe that this burden is a realistic one to ask the staff to meet.

The SEC's defense of this definition in the Adopting Release is that it "recognizes that there is a range of conduct in which an attorney may engage without being unreasonable."¹²⁷ The idea is that if *any* "prudent and competent" lawyer *might* conclude that the evidence did not support the conclusion that a material violation has occurred, up-the-ladder reporting is not required. But this standard renders the reporting requirement of Section 307 nearly an empty shell. Any good lawyer will almost always be able to conclude that it is not "unreasonable" to conclude that the evidence before her demonstrates legal conduct. Lawyers are trained to re-imagine evidence of illegality as evidence of legality. Not only will lawyers be able to reach this conclusion, they have strong motives to do so. The ethos of lawyers is not to report up the corporate ladder; instead it is to find any possible way to avoid doing so.

The SEC could easily have adopted a rule plainly stating that a lawyer must report when confronted with information that a prudent and competent lawyer, acting reasonably under the circumstances, would conclude was credible evidence of a material violation. In fact, that is precisely the

126. See Floyd Norris, *No Positives in This Legal Double Negative*, N.Y. TIMES, Jan. 24, 2003, at C1 (stating that change from "straightforward" and "reasonably simple definition" to one that is "confusing" makes required reporting up ladder "a lot harder to enforce").

127. SEC Final Rule, *supra* note 9 (discussing Section 205.2(l) and (m)). The SEC used a similar double negative to define "reasonable" in Section 205.2(l) and "reasonably believes" in Section 205.2(m). Both definitions define "reasonable" behavior as behavior that is "not unreasonable," again to emphasize a "range" of reasonable behavior or belief, a range we believe is already inherent in the concept of "reasonable." In fact, the word "unreasonable" appears in the definition of "evidence of a material violation" in Section 205.2(e), making that definition even more confusing and solicitous of lawyer discretion.

triggering standard we proposed in our comments to the SEC, and which we still support.¹²⁸ This clearer and more straightforward definition, incorporating a standard conception of reasonableness, would provide ample recognition of a “range of conduct” and the need for lawyer discretion.¹²⁹ It would also be consistent with Congress’s intent by providing an objective standard (a “prudent and competent lawyer, acting reasonably under the circumstances”) with respect to both the factual question (“credible evidence”) and the legal question (“material violation”).¹³⁰ The fact that the SEC opted for a more convoluted double-negative standard, rather than the more straightforward standard, will be read by many lawyers as an invitation to inaction. The bar needs no such invitation and Congress surely did not intend the Commission to offer one.

b. The Ambiguity of “Reasonably Likely”

As we noted above, Congress, in adopting a duty to report triggered by “evidence” of a material violation, intended to encourage more reporting by corporate lawyers, even when those lawyers could imagine some alternative interpretation of the facts or law that would render innocuous the conduct about which they had information. Yet, the SEC’s trigger, contained in its definition of “evidence of a material violation,” includes the troubling qualification that the evidence must show that a material violation is “reasonably likely.”

The SEC’s intent was apparently to add a substantiality requirement to the evidence trigger. The Adopting Release states: “To be ‘reasonably likely’ a material violation must be more than a mere possibility, but it need not be ‘more likely than not.’” SEC staff members, while disclaiming authority to speak for the Commission, have stated publicly that “reasonably likely” means less than “more probably than not” and that conduct in “the 20%-40% range of likelihood” should trigger a report.¹³¹ If the lan-

128. See Letter from Professors Susan P. Koniak, Roger C. Cramton & George M. Cohen, to Securities and Exchange Commission (Apr. 7, 2003), available at <http://www.sec.gov/rules/proposed/s74502/lawprofs040703.htm> [hereinafter Koniak, Cramton & Cohen Comments] (commenting on SEC’s proposed rule implementing Section 307 of Sarbanes-Oxley).

129. See, e.g., RESTATEMENT, *supra* note 52, § 52 cmt. b (interpreting lawyer’s duty of competence as one of “reasonableness in the circumstances,” which “does not require a lawyer, in a situation involving the exercise of professional judgment, to employ the same means or select the same options as would other competent lawyers in the many situations in which competent lawyers reasonably exercise professional judgment in different ways”). Moreover, our proposed reasonableness standard, by using the word “would” to modify “conclude” rather than “could,” would ensure the recognition of sufficient lawyer discretion without undermining the rule. See generally Koniak, Cramton & Cohen Comments, *supra* note 128 (advocating different reasonableness standard).

130. See 17 C.F.R. §§ 205.2(e), 205.3(b)(1).

131. Simon N. Lorne, *An Issue-Annotated Version of the SOX 307 Rules*, in ALAS LOSS PREVENTION PROGRAMS, A-117, 125 (June 12, 2003); see also Symposium Transcript, *After Sarbanes-Oxley: A Panel Discussion on Law and Ethics in the Era of Corporate*

guage is interpreted that way, it would be consistent with congressional intent by requiring lawyers to report evidence of possible violations, but not requiring the report of evidence that is so vague and insubstantial as not to warrant additional investigation by the corporation.¹³²

Unfortunately, the language used by the Commission is susceptible of other readings. As one comment on this language stated:

The ordinary, commonly understood meaning of the word “likely” is probable or having a high probability of occurring. Most attorneys would understand the phrase “reasonably likely” as used in Section 205.2(e) to mean probably or more likely than not. Nothing in Part 205 itself seems inconsistent with the commonly accepted understanding of “reasonably likely.”¹³³

The comment goes on to state that the sentence in the Adopting Release, quoted above, “muddies the meaning of ‘reasonably likely’ by attempting to assign to that phrase the meaning ‘possible,’ which is counter-intuitive for most attorneys, confusing and contrary to the commonly accepted meaning.”¹³⁴

When the SEC attempts to enforce Part 205, the SEC will face a “plain meaning” attack on its interpretation of “reasonably likely.” The lawyer accused of failing to report will argue that the language used in the text of the rule is a misleading trap on which the SEC cannot base enforcement, because the SEC’s interpretation of “reasonably likely” departs from the common understanding of those words on which the lawyer reasonably relied. The Commission should amend the rule to make “reasonably likely” a defined term and add a definition stating that “‘reasonably likely’ means something less than ‘more probable than not’ but more than a remote possibility.”

c. “Becomes Aware” and the Duty of Inquiry

One of the problems with the subjective “actual knowledge” trigger in Model Rule 1.13(b),¹³⁵ which Congress sought to replace in Section 307,

Scandal, 17 GEO. J. LEGAL ETHICS 67, 83-84 (2003) (statement of Richard Hershey, Associate General Counsel, SEC).

132. In our first set of comments to the SEC, we recommended a “probable cause” standard for handling this concern. See Koniak, Cramton & Cohen Comments, *supra* note 128, at 6-10, 15-16.

133. Comment of Attorneys’ Liability Assurance Society, Inc., on the SEC Proposed Rule (Mar. 28, 2003), available at <http://www.sec.gov/rules/proposed/s74502.html>.

134. *Id.*

135. Under Rule 1.13(b) of the 2003 Model Rules, a lawyer for a corporation has no duty to act unless he “knows” that a violation is occurring or about to occur. See MODEL RULES 2003, *supra* note 32. “Knows” is defined in Model Rule 1.0(f) as “actual knowledge,” which “may be inferred from circumstances.” The actual knowledge trigger remains in Model Rule 1.13, even after the changes adopted by the ABA’s House of Delegates based on the ABA Task Force’s recommendations.

is that it creates an incentive for lawyers not to “know” that wrongdoing is occurring or may occur. An examination of corporate failures and frauds often shows that information that should have led lawyers to inquire was ignored, handled by taking the word of the agents accused of wrongdoing without more or given only a perfunctory review. Many of these cases involved a number of suspicious circumstances over time, some eye-opening enough to be characterized as red flags.¹³⁶ In situations of this type, law firms have frequently ended up settling malpractice or third-party liability claims for large amounts of money.

Prevailing state and federal law on aiding and abetting fraud addresses the problem of “willful blindness” by adopting a standard—usually labeled a scienter of “recklessness”—under which a lawyer’s knowledge of client fraud can be inferred from a failure to report or act on suspicious circumstances.¹³⁷ The law of malpractice goes even further and recognizes a duty to investigate in some cases. A growing number of decisions impose liability when the lawyer relied on the word of the alleged wrongdoer without further inquiry;¹³⁸ failed to inquire when a number of suspicious circumstances would have stimulated action by a prudent and competent lawyer;¹³⁹ failed to report illegal activities by the client’s man-

136. See, e.g., Report of the Trustee, *In re OPM* (S.D.N.Y. 1983). In the OPM fraud, the largest in American history at the time it occurred, the law firm that documented and closed all of OPM’s lease transactions continued to represent OPM after learning that the two managers of OPM were guilty of check-kiting involving a bank they owned, engaged in numerous and unusual transactions with a particular vendor and received a letter from OPM’s former chief financial officer, just resigned, stating that many of the transactions with that vendor were fraudulent.

137. The Model Rules appear to adopt the “willful blindness” standard and the comments to the newly revised version of Model Rule 1.13 interprets the knowledge standard to include willful blindness. See MODEL RULES 2003, *supra* note 32, R. 1.13 cmt. 3 (“As defined in Rule 1.0(f), knowledge can be inferred from circumstances, and a lawyer cannot ignore the obvious.”); see also MODEL RULES 2003, *supra* note 32, R. 4.2 cmt. 8; RESTATEMENT, *supra* note 52, § 94, reporter’s note to cmt. g (“In the Reporter’s view, the preferable rule is that proof of a lawyer’s conscious disregard of facts is relevant evidence, which, together with other evidence bearing on the question, may warrant a finding of actual knowledge.”).

138. See, e.g., *FDIC v. Clark*, 978 F.2d 1541 (10th Cir. 1992) (affirming jury’s verdict against law firm when firm’s lawyers, after receiving plausible allegations that bank’s president had defrauded bank, accepted president’s explanation without making further inquiry or informing bank’s board of allegations).

139. See, e.g., *FDIC v. O’Melveny & Myers*, 969 F.2d 744 (9th Cir. 1992) (reversing summary judgment when law firm, knowing of recent resignation of its client’s prior auditors and outside law firm, made no further inquiry before giving legal opinions and doing other work that assisted client in selling securities that turned out to be fraudulent). In *Loyd v. Paine Webber, Inc.*, 208 F.3d 755, 760 (9th Cir. 2000), *O’Melveny* was distinguished as limited to “the ‘high specialty field’ of securities offerings [where] counsel has an automatic duty to make a ‘reasonable, independent investigation to detect and correct false or misleading materials.’” The court dismissed the legal malpractice suit for failure to allege that the law firm knew or should have known of the fraud. Cf. *Tush v. Pharr*, 68 P.3d 1239, 1246 & n.14 (Alaska 2003) (interpreting *Loyd* as finding no duty to independently investi-

agers to its board of directors;¹⁴⁰ turned a blind eye to facts that were plain to see;¹⁴¹ or failed to take steps to prevent a continuing violation of law.¹⁴² Moreover, in situations in which the outside law firm has provided legal opinions as part of representation involving compliance with federal securities laws, a number of decisions hold that lawyers have a duty to investigate when they have reason to know that the factual assumptions of the legal opinion may be unreliable.¹⁴³

It is unclear how the SEC rules handle the willful blindness problem. Section 205.3(b) imposes a duty to report on a lawyer who “becomes aware of evidence of a material violation.”¹⁴⁴ By lowering the trigger from “violation” to “evidence,” Section 307 and the SEC rules in effect shift much of the burden of a duty of inquiry to the CLO to whom initial reports are made.¹⁴⁵ There could still remain some level of evidence that is not strong enough to trigger a duty to report but could trigger some kind of

gate whether clients were engaged in fraudulent conduct where situation was “unambiguous” in failing to present facts suggesting fraud); *see also* Chem-Age, Inc. v. Glover, 652 N.W.2d 756 (S.D. 2002) (following *O'Melveny*).

140. *See, e.g., In re Am. Cont'l Corp.*, 794 F. Supp. 1424, 1452 (D. Ariz. 1992) (finding failure to report illegal activity of client's managers to its board of directors could not be excused because thought to be futile).

141. *See, e.g., United States v. Benjamin*, 328 F.2d 854, 863 (2d Cir. 1964) (finding that lawyer who “deliberately closed his eyes to facts he had a duty to see” or “recklessly stated as facts things of which he was ignorant” satisfies scienter requirement of mail fraud conviction for securities fraud); *see also* SEC v. Frank, 388 F.2d 486, 488-89 (2d Cir. 1968) (“[A] lawyer, no more than others, can escape liability for fraud by closing his eyes to what he saw and could readily understand,” though whether securities laws “require a lawyer . . . to run down possible infirmities in his client's story of which he has been put on notice, and if so what efforts are required of him, is a closer question”).

142. *See, e.g., SEC v. Nat'l Student Mktg. Corp.*, 457 F. Supp. 682, 714 (D.D.C. 1978) (holding that lawyers who closed merger transaction knowing that proxy solicitation contained materially false information were required “to speak out at the closing” and “to take steps to ensure that the information would be disclosed to the . . . shareholders”); *In re Gutfreund*, 51 S.E.C. 93, 112-14 (1992) (establishing that CLO of public company must take affirmative steps to ensure that misconduct by company trader is adequately addressed); *In re Carter & Johnson*, 47 S.E.C. 471, 511-12 (1981) (indicating lawyer's continued representation knowing of client's ongoing securities fraud “violates professional standards unless he takes prompt steps to end the client's noncompliance”).

143. *See, e.g., Kline v. First W. Gov't Secs., Inc.*, 24 F.3d 480, 488 (3d Cir. 1994) (concluding that facts relied on in legal opinion must be investigated when firm had notice they might not be accurate); *Ackerman v. Schwartz*, 947 F.2d 841, 843-44 (7th Cir. 1991) (noting that knowledge of suspicious circumstances makes further inquiry necessary); *Breard v. Sachnoff & Weaver, Ltd.*, 941 F.2d 142, 144 (2d Cir. 1991) (stating that firm's knowledge that client's principal had been convicted of mail fraud required it to conduct independent investigation).

144. 17 C.F.R. § 205.3(b) (2004).

145. The duty of inquiry for the CLO as a result of a “report” of evidence of a material violation is made explicit in Section 205.3(b)(2) (requiring CLO to “cause such inquiry into the evidence of a material violation as he or she reasonably believes is appropriate to determine whether the material violation described in the report has occurred, is ongoing, or is about to occur”).

duty to inquire. And, the higher the threshold of “evidence” needed to trigger the duty to report, for example, due to a strict reading of “reasonably likely” as discussed in the previous section, the more important the meaning of “becomes aware” becomes.

“Becomes aware,” which is not defined in the rules, sounds like a subjective standard. It could, however, be interpreted to incorporate at least the “recklessness” standard from the case law. We think it should be so interpreted, or better yet, the phrase should be changed or specifically defined to incorporate the recklessness standard.¹⁴⁶ One reason is that lawyers are likely to view compliance with the SEC rules as a kind of “safe harbor” against liability, although the rules themselves do not directly speak to this issue.¹⁴⁷ We do not think the rules should be interpreted to

146. One possibility would be to use a “reason to know” standard. The law of agency distinguishes “reason to know” from “should know.” The latter standard contemplates a duty of inquiry; the former generally does not. See RESTATEMENT (SECOND) AGENCY § 9 cmts. d, e (current through June 2003); see also Deborah A. DeMott, *When Is a Principal Charged with an Agent’s Knowledge?*, 13 DUKE J. COMP. & INT’L L. 291, 300-02 (2003). According to the Restatement comment d:

A person has reason to know of a fact if he has information from which a person of ordinary intelligence, or of the superior intelligence which such person may have, would infer that the fact in question exists or that there is such a substantial chance of its existence that, if exercising reasonable care with reference to the matter in question, his action would be predicated upon the assumption of its possible existence. The inference drawn need not be that the fact exists; it is sufficient that the likelihood of its existence is so great that a person of ordinary intelligence, or of the superior intelligence which the person in question has, would, if exercising ordinary prudence under the circumstances, govern his conduct as if the fact existed, until he could ascertain its existence or non-existence. The words “reason to know” do not necessarily import the existence of a duty to others to ascertain facts; the words are used both where the actor has a duty to another and where he would not be acting adequately in the protection of his own interests were he not to act with reference to the facts which he has reason to know. One may have reason to know a fact although he does not make the inference of its existence which would be made by a reasonable person in his position and with his knowledge, whether his failure to make such inference is due to inferior intelligence or to a failure properly to exercise such intelligence as he has. A person of superior intelligence or training has reason to know a fact if a person with his mental capacity and attainments would draw such an inference from the facts known to him. On the other hand, “reason to know” imports no duty to ascertain facts not to be deduced as inferences from facts already known; one has reason to know a fact only if a reasonable person in his position would infer such fact from other facts already known to him.

147. The SEC in its comments refers to Section 205.7(a) as creating a “safe harbor,” but that rule merely says that the SEC rules do not *create* any causes of action; it does not address the relationship between the rules and *existing* causes of action. With respect to existing liability, the rules speak only to the relationship between the rules and “standards” of other state or federal *jurisdictions*, which presumably refers to specific standards of lawyer conduct such as ethics rules, rather than the relationship between the rules and substantive law of general applicability. See 17 C.F.R. § 205.1 (“These standards supplement applicable *standards* of any *jurisdiction* where an attorney is admitted or practices and are not intended to limit

provide such a safe harbor, because the SEC should not be adopting minimum standards for lawyers that are lower than the prohibitions against securities fraud that are part of the larger regulatory scheme. If they are interpreted to create a safe harbor, however, at least the rules should not provide weaker protection for investors than the general rules of liability under the securities laws and related law. On the other hand, if the rules do not provide a safe harbor, then lawyers who mistakenly believe that they do risk falling into a trap for the unwary.

Of course, prudent lawyers will investigate suspicious, credible information in any event.¹⁴⁸ The likelihood of an adverse outcome in a subsequent proceeding in which the trier of fact knows that a large fraud was involved and the lawyer ignored suspicious circumstances should lead a prudent lawyer to the view that “it depends on the circumstances” and err on the side of caution in examining those circumstances. The CLO can go a long way toward creating an atmosphere of candor and openness, at least for inside counsel, and to some extent even for outside counsel. In addition, for outside counsel, the partner in charge of the relationship with the issuer can set a similar tone within her firm to ensure that she may be fully informed and serve a function analogous to that of the client’s CLO in determining what inquiry is necessary or prudent and how it should be carried out.

In our view, however, the thrust of Section 307 is that reliance on the prudence of most lawyers as well as the threat of liability is not a sufficient deterrent to corporate wrongdoing. The SEC rules should implement that vision.

d. Imputed knowledge

A question related to the duty of inquiry and willful blindness, but not addressed in the rules, is the extent to which knowledge within firms will be “imputed” from one lawyer to another. Lawyers often cite the desire to avoid imputation as a key reason for supporting the “actual knowledge”

the ability of any *jurisdiction* to impose additional *obligations* on an attorney not inconsistent with the application of this part. Where the *standards* of a state or other United States *jurisdiction* where an attorney is admitted or practices conflict with this part, this part shall govern.” (emphasis added); *id.* § 205.6(c) (“An attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under inconsistent *standards* imposed by any state or other United States *jurisdiction* where the attorney is admitted or practices.”) (emphasis added). In our comments to the SEC, we argued that these rules should be revised to make clear that compliance with them does not ensure that the lawyer has complied with all requirements of the securities laws.

148. Simon Lorne, a former SEC general counsel, opposes regulatory language that would impose a broad duty of investigation. Nevertheless, he recommends that prudent corporate counsel encourage reporting of possible problems: “Nothing, of course, prevents corporate counsel from establishing their own, lower, standards for reporting; it may well be that a fairly low standard is the right approach when the power of the SEC enforcement division stands behind a failure to meet that standard.” Lorne, *supra* note 131, at A-117, 126.

standard in Model Rule 1.13. If the SEC rules are revised to make explicit the coverage of law firms, as we recommended above, some form of imputation is necessary, because there must be some way to determine the "knowledge" and "intent" of the firm, which can act only through its agents.

The concept of imputed knowledge comes from the law of agency and partnership. In general, an agent's knowledge is imputed to the agent's principal in two situations: (1) if the knowledge concerns a matter in which the agent's own actions bind the principal; or (2) if the agent has a duty to give the principal information.¹⁴⁹ Similarly, under partnership law, "the knowledge of the partner acting in the particular matter, acquired while a partner or then present to his mind, and the knowledge of any other partner who reasonably could and should have communicated it to the acting partner, operate as . . . knowledge of the partnership."¹⁵⁰ The first situation involves cases in which the agent (or partner) makes contracts on behalf of the principal (or partnership) or commits a tort, including misrepresentation, in the course of representing the principal (or partnership). Although lawyers can certainly be involved in such activity, the situation more relevant to the SEC rules is the second one, in which the lawyer has a duty to disclose to the lawyer's firm. In particular, the question is whether a law firm might have "evidence of a material violation" as a result of information possessed by lawyers in the firm, even if that information is not disclosed to the firm.¹⁵¹

When the agent has a duty to disclose information to the principal, the imputation of knowledge depends on the standards of conduct applicable to the principal. If the principal is subject to an "actual knowledge" standard, then an agent's knowledge is not imputed to the principal unless the agent is acting for the principal in the transaction. On the other hand, if the standard applicable to the principal is "reason to know," the agent's knowledge is imputed even if the agent is not acting for the princi-

149. See RESTATEMENT (SECOND) AGENCY § 272 (current through June 2003).

150. UNIFORM PARTNERSHIP ACT § 12 (2001). The Uniform Partnership Act defines "knowledge" as actual knowledge, as well as "knowledge of such other facts as in the circumstances shows bad faith." *Id.* § 3(1). This definition incorporates the "willful blindness" standard or the agency law "reason to know" standard discussed at *supra* note 136 and accompanying text. The Revised Uniform Partnership Act, now adopted by a majority of U.S. jurisdictions, broadens the concept of partnership imputation to any "fact relating to the partnership" of which a partner has "knowledge," REVISED UNIFORM PARTNERSHIP ACT § 102(f) (1997), but narrows the definition of knowledge to actual knowledge, *id.* § 102(a). Limited liability companies, a form used by many law firms, are also subject to imputation rules, but the statutes governing these entities do not take a uniform position on the question. See generally UNIFORM LIMITED PARTNERSHIP ACT § 303 (2001).

151. A lawyer's knowledge could also be imputed to the lawyer's other principal, the client. But for our purposes in interpreting the SEC rules' duty to report, this potential imputation is not relevant.

pal in the transaction.¹⁵² Moreover, if the principal has a duty to a third party, such as a duty to disclose, and the principal entrusts the matter to an agent, the knowledge that the agent would have acquired had the agent exercised due care is also imputed to the principal.¹⁵³ These principles have led courts to adopt a doctrine of “composite knowledge,” which attributes to an entity the collective knowledge of its individual agents even if no one agent had all the knowledge.¹⁵⁴ The SEC has previously endorsed the composite knowledge idea in exercising its disciplinary authority against law firms under Rule 102(e) (formerly Rule 2(e)).¹⁵⁵

In our view, not only should the SEC rules apply to law firms, but the application to law firms should include the concept of composite knowledge. Absent such an imputation rule, law firms would have an incentive to decentralize legal work to minimize the number of lawyers with access to sufficient client information to bring them within the purview of these rules. As a result, the quality of legal work done in securities matters as well as compliance with the securities laws would decline, perhaps in dramatic ways.¹⁵⁶ Moreover, we would not expect a composite knowledge rule to add significantly to legal costs. Firms often have good economic

152. See Restatement (Second) Agency § 275 cmt. b (current through June 2003).

153. See *id.* § 277 cmt. b.

154. See, e.g., *United States v. T.I.M.E.-D.C. Inc.*, 381 F. Supp. 730, 738 (W.D. Va. 1974).

[K]nowledge acquired by employees within the scope of their employment is imputed to the corporation. In consequence, a corporation cannot plead innocence by asserting that the information obtained by several employees was not acquired by any one individual employee who then would have comprehended its full import. Rather, the corporation is considered to have acquired the collective knowledge of its employees and is held responsible for their failure to act accordingly.

Id. But cf. *Woodmont v. Daniels*, 274 F.2d 132, 137 (10th Cir. 1959) (“[W]hile in some cases, a corporation may be held constructively responsible for the composite knowledge of all its agents, whether acting in unison or not, . . . we are unwilling to apply the rule to fix liability where, as here, intent is an essential ingredient of tort liability as for deceit.”).

155. See *In re Keating, Muething & Klekamp*, Release No. 34-15982, 1979 WL 186370 (July 2, 1979). In that case, the Commission found that the firm “collectively had knowledge” of questionable transactions, but had imposed “a division of authority among the partners within the firm concerning client matters which significantly impaired communications within the firm . . . due in part to the lack of comprehensive internal procedures within the firm to gather and evaluate such information in connection with the preparation of [the client’s] filings with the Commission.” The Commission faulted the firm for failure to have in place “a system which assured that the knowledge of the members of the firm was communicated to the persons responsible for preparing disclosure documents so that adequate disclosure of material information—which was within the firm’s knowledge—was made.”

156. One of the purposes of the disclosure regime of the federal securities laws is to force issuers to aggregate material information and disclose it, which avoids needlessly redundant investigation by analysts and investors. A composite knowledge standard for law firms furthers this regulatory objective.

reasons for dividing up legal work (in particular, benefits from specialization), and so they already have a need to coordinate and monitor the work and information of various lawyers. A failure to coordinate is itself likely to result in duplication of legal work that alone would unnecessarily escalate fees, as well as increase the risk of malpractice. Finally, the increased risk on law firms as a result of the composite knowledge rule could be mitigated by adopting a system of reduced penalties for firms with effective compliance programs and procedures reasonably designed to prevent violations of the SEC rules.

The question of imputation may be important even if law firms as entities are not covered by the rules. In theory, multiple lawyers or multiple law firms could be in an agency relationship with each other, in which case, the agency rules of imputation would apply to the lawyer in the position of principal. In most cases, however, the multiple lawyers involved in representing the corporation will be co-agents of the lawyer's two principals, the law firm and the client. For example, an individual partner is not the principal of an associate whom the partner supervises. If the firm is not subject to sanctions, there is no principal to which information can be imputed. But even if the rules do not adopt "imputation" of knowledge in the sense of a conclusive presumption based solely on an agency relationship, the actual relationship between lawyers may give rise to an inference or presumption of knowledge depending on the circumstances.¹⁵⁷

There is, of course, one area in which the law does impute knowledge to sanction individual lawyers within a firm: conflicts of interest. Conflicts of interest are different from client fraud problems in that conflicts of interest involve situations in which the concern is that lawyers will disclose information that they should not; the rules presume that a conflicting interest will lead them to do so. In the case of client wrongdoing, the concern is that lawyers will fail to disclose information that they should disclose. But it is not clear why that difference should matter. The more important difference is that the result of imputation in the conflict of interest case is disqualification of the firm, whereas the result of imputation in the client fraud situation in the absence of firm sanctions is discipline of an individual lawyer.

An alternative way to handle the problem that imputed knowledge is meant to solve would be through the rule concerning the responsibilities of supervisory attorneys. Under Section 205.4(b), "a supervisory attorney shall make reasonable efforts to ensure that a subordinate attorney . . .

157. See RESTATEMENT, *supra* note 52, § 94 cmt. g ("If the facts warrant, a finder of fact may infer that the lawyer gained information possessed by other associated lawyers, such as other lawyers in the same law firm, where such an inference would be warranted due to the particular circumstances of the persons working together. Thus, for example, in particular circumstances it may be reasonable to infer that a lawyer who regularly consulted about a matter with another lawyer in the same firm became aware of the other lawyer's information about a fact.").

that he or she supervises or directs conforms to this part.”¹⁵⁸ The rule as adopted does not quite solve the problem because the “evidence of a material violation” may become apparent only after the supervisory attorney gathers information from multiple subordinates. Thus, a supervisory attorney who sought to discourage or diffuse the transmission of bits of information that in themselves did not amount to evidence of a material violation would not run afoul of Section 205.4(b).

Section 205.4(b), however, should be modified to include a responsibility on supervisory attorneys who supervise multiple subordinates to adopt reasonable measures for collecting and coordinating information from those subordinates to facilitate compliance with the rules. In addition, we recommend clarifying that the CLO of the corporation, who is defined as a supervisory attorney under Section 205.4(a), is a supervisor not only of inside counsel, but of all outside counsel, or must appoint one outside counsel to serve as such a supervisory attorney for purposes of the duty of collection and coordination of information from multiple firms, which responsible issuers already do. Just as law firms should not have an incentive to balkanize work among their various lawyers, neither should the issuer have an incentive to balkanize work among its various firms, so that no one firm has sufficient information to trigger the duty to report.

e. Conclusion: The Importance of the Initial Trigger

The triggering standard is the gateway to the entire set of obligations created by the SEC’s rules. If that standard is so weak that lawyers inclined to do so can easily circumvent it, if it is so ambiguous and convoluted that the SEC cannot effectively enforce it, the rules will not have effectuated the statutory objective. We find it disappointing, then, that so little attention has been paid to the triggering standard compared to other issues, most notably noisy withdrawal.

We find it even more disappointing that many lawyers who did pay attention to the trigger, and the SEC, which sympathized with their objections, so strongly resisted a simple, objective standard, stated in affirmative terms and incorporating the willful blindness concept. This simple, objective standard would fully implement congressional intent that lawyers report evidence of a material violation, while at the same time preserving an appropriate degree of lawyer discretion. The resistance is all the more troubling when one considers how little is really being demanded of the lawyer at the initial stage. The lawyer must simply report “evidence of a material violation” to the corporation’s CLO.¹⁵⁹ The “report” is not a formal, detailed document, but can be a simple phone call, e-mail or even a casual water cooler comment.¹⁶⁰ More important, the lawyer is not re-

158. 17 C.F.R. § 205.4(b) (2004).

159. *Id.* § 205.3(b)(1).

160. “Report” is defined in Section 205.2(n) as simply “mak[ing] known to directly, either in person, by telephone, by e-mail, electronically, or in writing.” In

quired to take any further steps without an additional, more demanding trigger being satisfied. The next section considers those further steps and their accompanying triggers.

3. *Obligations of the Reporting Lawyer After the Initial Report*

Aside from the initial duty to report evidence of a material violation to the CLO or CEO, the other key component of Section 307 is the obligation of the reporting lawyer to report the evidence up the corporate ladder to the board or relevant board committee if the CLO or CEO does not “appropriately respond” to the reporting lawyer. The SEC implemented this directive in Section 205.3(b)(3), which states that the reporting lawyer “shall report the evidence of a material violation” to the board or relevant board committee, unless the lawyer “reasonably believes that the chief legal officer or the chief executive officer . . . has provided an appropriate response within a reasonable time.”¹⁶¹ The lawyer who reports up to the board must also “explain his or her reasons” for believing that the issuer has not made an appropriate response to the CLO, CEO and the “directors to whom the attorney reported the evidence of a material violation.”¹⁶² On the other hand, if the lawyer “reasonably believes” that he or she has received “an appropriate and timely response,” he or she “need do nothing more . . . with respect to his or her report.”¹⁶³

The effectiveness of the SEC’s rule implementing the reporting up obligation thus depends crucially on the definition and meaning of “appropriate response.” Section 205.2(b) defines “appropriate response” as “a response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes” any one of three

its initial proposed set of rules, the SEC had required written reports, but even those could have been very informal.

161. 17 C.F.R. § 205.3(b)(3). “Reasonably believes” is defined in Section 205.2(m) to mean “that an attorney believes the matter in question and that the circumstances are such that the belief is not unreasonable.” It is important to understand the role of a lawyer’s subjective belief under this standard. If a lawyer subjectively believes that he or she has *not* received an appropriate response, Section 205.3(b)(3) appears to *require* the lawyer to report up, even if the lawyer’s belief is unreasonable. This may not be a bad result (though it may not be a result the SEC intended) because the harm from extra reporting in this situation is likely to be minimal and the likelihood of SEC discipline if the lawyer fails to report in this situation is slim. Still, as we argued in our initial comments to the SEC, we think the lawyer’s obligations to report up should not turn on the lawyer’s subjective belief, and so support a completely objective standard, such as “if a prudent and competent lawyer would conclude.”

162. *Id.* § 205.3(b)(9). The requirement that the lawyer explain his or her reasons to the CLO and CEO, as well as the board, seems unnecessary and, especially in the case of bypassing the CLO and CEO under Section 205.3(b)(4), overly discouraging of the duty to report in situations in which the CLO and/or the CEO are implicated in the material violation.

163. *Id.* § 205.3(b)(8).

things.¹⁶⁴ First, there is no problem; that is, “no material violation . . . has occurred, is ongoing, or is about to occur.”¹⁶⁵ Second, the issuer is fixing whatever problem exists by adopting “appropriate remedial measures.”¹⁶⁶ Third, “the issuer, with the consent of the issuer’s board of directors” or relevant board committee “has retained or directed an attorney to review the reported evidence of a material violation,” as a result of which one of two further things must happen.¹⁶⁷ Either this “investigatory lawyer”¹⁶⁸ must conduct “a reasonable investigation and evaluation of the reported evidence,” make “remedial recommendations” and have those recommendations “substantially implemented” by the issuer,¹⁶⁹ or the “investigatory lawyer” must advise the issuer that he or she “may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer’s officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation.”¹⁷⁰

To the extent that the bar has expressed concern about this definition, it has focused on the second option and the difficulties in determining what counts as “appropriate measures.” Although this phrase creates significant interpretive questions, we think the far more important aspect of the definition concerns what we will call the “third option,” involving

164. *Id.* § 205.2(b). Note that by including the “reasonable belief” of the reporting lawyer in both the definition of “appropriate response” as well as in the reporting lawyer’s follow-up duty in Section 205.3(b)(3), the rules create an unfortunate redundancy that, if read literally, leads to an absurd result. Namely, the lawyer has a duty to report up if the lawyer reasonably believes that he has received a response as a result of which he reasonably believes. In our view, “reasonably believes” should be removed from the definition of “appropriate response.”

165. *Id.* § 205.2(b)(1).

166. *Id.* § 205.2(b)(2).

167. *Id.* § 205.2(b)(3). Note that the CLO is obligated to “cause such inquiry into the evidence of a material violation as he or she reasonably believes is appropriate.” *Id.* § 205.3(b)(2). Whether such an inquiry by the CLO qualifies as a “review” by an “attorney” under Section 205.2(b)(3), or whether Section 205.2(b)(3) applies only to reviews by an attorney other than the CLO, is not clear. Under a literal reading, the answer is that a review by the CLO will satisfy Section 205.2(b)(3), though the structure of Section 205.3(b)(2) suggests that an “inquiry” by the CLO is separate from an “appropriate response.” Under Section 205.3(b)(2), the CLO must “cause the issuer to adopt an appropriate response,” unless the CLO “reasonably believes” that there is no material violation. This obligation is mentioned after the CLO’s duty of “inquiry,” which suggests the rule intends that the CLO’s inquiry precedes, and so is distinct from, an “appropriate response.” On the other hand, Section 205.3(b)(2) is somewhat inconsistent with the definition of “appropriate response” because it suggests that there is no need for the CLO to “cause the issuer to adopt an appropriate response” if the CLO determines there is no material violation, whereas Section 205.2(b)(1) includes a determination of “no material violation” as one “appropriate response.”

168. The SEC rules do not use the term “investigatory lawyer.” We use it simply to provide a label for a lawyer serving the investigatory function in this subsection.

169. 17 C.F.R. § 205.2(b)(3)(i).

170. *Id.* § 205.2(b)(3)(ii).

the investigatory lawyer, and in particular the investigatory lawyer's assertion of a "colorable defense." The reason is that Section 205.2(b)(3)(ii) creates a very strong incentive for issuers faced with a "report" to take advantage of this third option. And much like the confusing initial trigger, the third option threatens to undermine Congress's intent in enacting Section 307. In short, the assertion of a colorable defense is not an appropriate response to a report of evidence of a material violation.

To set up our critique of the third option, we explain two legitimate, and related, drafting concerns the SEC faced in implementing Section 307: the problem of lawyers acting as advocates, and the problem of factual and/or legal uncertainty remaining after an investigation of the initial report. We suggest relatively simple ways the SEC could have addressed these concerns. We then analyze how the SEC in fact tried to handle these concerns through the third option and we argue that these provisions do a poor job of handling the SEC's concerns.

a. The SEC's Legitimate Concerns and Their Proper Resolution

In drafting its rules, the SEC faced two concerns that it treated as related, but which in fact are importantly distinct. First, the SEC did not want to interfere with the ability of a corporation charged with a material violation to defend itself in litigation or a similar proceeding. Second, the SEC had to decide what an "appropriate response" to a report of evidence of a material violation would be in situations in which the existence of a material violation, after an investigation of the evidence, remained uncertain. The reason these concerns have a superficial relationship is that litigation often occurs in cases in which the existence of a material violation is uncertain, or at least is contested. But as we shall see, the differences far outweigh the similarities.

The SEC rules, as initially proposed, did not make clear how, if at all, they applied to lawyers acting as advocates in litigation defending their corporate clients against civil or criminal charges alleging material violations of securities law or other related law. Many commentators, including the authors of this Article, expressed the concern that the SEC rules should not chill legitimate advocacy on behalf of issuers.¹⁷¹ The chilling effect could be particularly strong in cases in which the SEC appears as a party, especially in those cases in which the SEC acts as adjudicator and decider as well as prosecutor.

The solution to this problem is straightforward. The SEC could have adopted a simple rule stating that nothing in the rules is intended to interfere with the ability of a lawyer, acting as an advocate for an issuer in litigation or similar proceeding, from zealously presenting all available nonfrivolous arguments on behalf of the issuer.¹⁷² In our system, advo-

171. See Koniak, Cramton & Cohen Comments, *supra* note 128, at 33-34.

172. We argued for such a rule in our comments to the SEC. See *id.* Our proposed rule stated: "Nothing in these rules prevents a lawyer who is acting as an

cates are required to put the other side, particularly if that side is the government, to its proof. They are privileged to put forth all nonfrivolous justifications of their clients' conduct and all nonfrivolous arguments that the law should be read in novel, even unprecedented, ways. When they represent clients charged with civil or criminal wrongs, they may offer "colorable defenses."

The "nonfrivolous" standards applied to advocates under Rule 11¹⁷³ and state ethics rules,¹⁷⁴ and expressly incorporated into Section 205.2(b)(3)(ii),¹⁷⁵ are quite low. These standards suggest that virtually any argument or assertion is permissible if it has the slightest chance of prevailing.¹⁷⁶ At the extremes, these standards may be justifiable in the litigation context, but as we shall argue in the next section, they are not appropriate outside that context.

The SEC's second legitimate concern was what should happen in cases in which the violation remains uncertain after the initial report and subsequent investigation by the CLO. It is important to recall that Section 307 specifically requires that the reporting lawyer take "the evidence" to the board or relevant board committee if the CLO or CEO does not "appropriately respond." Thus, the statute itself mandates reporting up in at least some cases in which the violation is uncertain. This mandate makes sense because a concerned and prudent board would want to know about potential material violations of law. Of course, there is a separate question of what happens if the board itself does not "appropriately respond," a question we address in a subsequent section.¹⁷⁷

The SEC could have responded to the question of uncertain violations simply by including within the definition of "appropriate response" a reporting of the evidence to the board by the CLO or CEO, rather than by the initially reporting lawyer. But the SEC did not take this route, with two exceptions: (1) allowing the CLO to refer the matter to a previously created qualified legal compliance committee (QLCC);¹⁷⁸ and (2) ending the duty to report of a lawyer hired to investigate the evidence after the

advocate in any proceeding or formal or informal investigation by the government from presenting any and all colorable defenses available to the issuer or its agents."

173. FED. R. CIV. P. 11.

174. *E.g.*, Model Rule 3.1, prohibiting a lawyer from making an assertion "unless there is a basis in law and fact for doing so that is not frivolous, which includes a good faith argument for an extension, modification or reversal of existing law."

175. Under Section 205.2(b)(3)(ii), the lawyer asserting a colorable defense must do so "consistent with his or her professional obligations."

176. One experienced litigator has described his own test for "frivolous": "if nobody in the office giggles, it passes muster." See David Margolick, *Lawyer for Striking Air Traffic Controllers Won Back 60 Jobs but Suffered Personal Loss*, N.Y. TIMES, Jan. 20, 1989, at B4 (quoting Harvey Silverglate, a well-known Boston lawyer).

177. The "colorable defense" standard may, in fact, have been drafted with reporting out in mind rather than reporting up. We still believe the standard would be inappropriate in the context of reporting out, but in any case the SEC could have handled the standard for reporting out separately.

178. See 17 C.F.R. §§ 205.3(b)(2), 205.3(c)(2).

initial report.¹⁷⁹ Perhaps the SEC thought that the CLO or CEO could not be trusted to report the evidence to the board or that the statute precluded this possibility, though these explanations seem unlikely.¹⁸⁰ Alternatively, perhaps the SEC did not want the report to the board to end the reporting lawyer's obligations, which is the key consequence of deeming something an "appropriate response." But again this explanation is unsatisfactory because the result of the CLO's or CEO's reporting to the board is exactly the same as if the reporting lawyer reports to the board. If the SEC wanted to create further obligations after that point, it would presumably do so regardless of how the board acquired the information.

The more likely possibility is that the SEC wanted to adopt a graduated approach to reporting up, under which there would be a stricter standard for reporting evidence of a material violation to the board than for the initial duty to report, when the violation remained uncertain after investigation. We supported such a graduated approach in our initial comments.¹⁸¹ But if a graduated approach was the SEC's intent, there were much more direct and less drastic ways to achieve that than the third option under the "appropriate response" definition the SEC drafted. For example, the SEC could have increased the quantum of evidence necessary by adopting a "substantial evidence" standard as triggering a duty to go to the board. Or the SEC could have demanded a higher likelihood of violation than the "reasonably likely" standard it used to define "evidence of a material violation." For example, the SEC could have defined appropriate response to include a determination by the CLO, after investigation, that the risk of a material violation was not significant, or that the absence of a violation was more likely than not. The precise formulation could be debated, as could the appropriate place in the rules to locate the stricter standard.¹⁸²

179. See *id.* § 205.3(b)(6)(i)(B) (stating that lawyer retained or directed by CLO to investigate reported evidence of material violation has no duty of his own to report if CLO "reports the results of the investigation to the issuer's board of directors" or relevant board committee). Actually, as we discuss in the next section, this is not exactly the same as having the CLO reporting "evidence" up to the board.

180. The untrustworthy CLO/CEO case is in part addressed by the bypass rule allowing the reporting lawyer to go directly to the board if the lawyer reasonably believes that reporting to the CLO and CEO would be "futile." *Id.* § 205.3(b)(4). Moreover, why would the SEC deem the CLO more trustworthy in reporting an investigatory lawyer's report under Section 205.3(b)(6)(i)(B) than in reporting an initial report?

181. See Koniak, Cramton & Cohen Comments, *supra* note 128, at 6-17.

182. There are at least three candidates for where the stricter standard could be located: the definition of "evidence of a material violation," Section 205.2(e) (which already includes a "reasonably likely" standard), the definition of "appropriate response," Section 205.2(b), or the triggering rule itself, Section 205.3(b)(3). We do not take a position here on the best place to locate the stricter standard. In our initial comments to the SEC, we argued for using a "substantial evidence" standard in the triggering rule. See Koniak, Cramton & Cohen Comments, *supra* note 128.

The SEC could have adopted a graduated approach to the reporting up trigger without weakening the statutory mandate that “evidence of a material violation” be reported to the board. Nothing in the statute required or even suggested that the SEC use a litigation standard—“colorable defense”—to handle the problem of uncertain violations. Requiring the reporting up of an uncertain violation in no way interferes with a subsequent decision by the board to litigate the issue, asserting all nonfrivolous defenses. Unfortunately, by conflating the SEC’s two legitimate concerns, the third option falls far short of the statutory mandate.¹⁸³

b. The Mistaken Transplanting of Colorable Defense from the Litigation Context to the Counseling Context

The discussion in the preceding section demonstrates the problem with the SEC’s third option in its definition of “appropriate response.” The SEC took a standard, “colorable defense,” that is appropriate to litigation, and unjustifiably transferred it to the counseling context by recognizing the assertion of a colorable defense as an appropriate response to a report of evidence of a material violation. The colorable defense standard will result in too little reporting up of such evidence. Moreover, as a means of addressing the uncertain violation problem, the colorable defense standard sweeps far too broadly.

Litigation standards should not apply to the duty to report. The SEC rules are largely addressed to lawyers acting in a counseling rather than an adversarial role. Their purpose is to enhance compliance with the law. Reporting evidence of misconduct and litigating are two very different legal events, even though they may involve the same conduct. Of course, the reporting of evidence of material violation may lead to litigation over whether a violation has occurred, but it need not.

The bar sometimes speaks as if every lawyer’s job is to behave as lawyers in adversary adjudicatory proceedings are privileged to behave. But that is not so: lawyers who facilitate transactions or advise clients in private on complying with the law perform distinct functions in our democracy

183. It could be argued that by making the reporting up trigger based on “evidence of a *material* violation,” the SEC rules intended to incorporate all aspects of the general securities law standard of “materiality.” The materiality standard in securities law not only incorporates a risk assessment based on the likelihood and magnitude of the potential harm, *Basic v. Levinson*, 485 U.S. 224 (1988), but also whether or not a good defense is available. The problem with this argument is that the standard for reporting up is based on *evidence* of a material violation, which is necessarily a lower standard than the securities requirement of reporting material information. The fact that the SEC added a separate provision discussing the availability of a “colorable defense” as an “appropriate response” supports the conclusion that the SEC did not intend to incorporate into its notion of “materiality” the availability of a good defense. If the SEC did intend to incorporate the availability of a good defense into its “materiality” standard, that combined with the “colorable defense” provision would make matters worse by essentially double-counting the availability of a defense. Such an interpretation would surely contravene the intent of Section 307.

and operate in radically different environments from those inhabited by advocates engaged in adversary proceedings.

Advocates operate in an environment designed to guard against abuses of their broad license to manipulate fact and law. First, there is an adversary party equipped (in almost every case) with a lawyer both armed with information sufficient to challenge vigorously every theory, far-fetched or standard, that the opposing lawyer can make. Second, there is a judge, who is acting as legal umpire (and sometimes as a neutral fact finder), and frequently a separate fact finder, the jury, in addition to the judge—actors obligated to decide with objectivity and neutrality between the contrasting visions of law and fact presented by the battling lawyers. None of those checks is present when, in the privacy of the office and under the protections of lawyer confidentiality, a legal advisor counsels a client or corporate manager that it can act based on some unprecedented vision of what the law requires or some barely plausible interpretation of facts. In short, advocates have much more license to manipulate law and facts than advisors do.

And that is how it should be. Lawyers as advisors are a private sector solution to intrusive government alternatives to ensure that corporations, other entities and individuals operate within and not without the law. It is simply not true that the advisor's job is to stand by the client's position, no matter how implausible as a matter of fact or law, and not judge the client, as lawyers often assert. This is especially true when the client is an entity and the "client's position" may simply be the position of management, which may be acting against the best interest of the entity. Advocates should not judge because there are others charged with that role in the environment in which they operate and they are present to guarantee the clash of positions upon which our adversary system depends. But advisors are relied upon to give advice made on prudent judgments. How else are they to tell anyone what the law requires and what it does not? And that is the role for which they are retained and paid to perform.

Lawyers always seek to fend off regulation by claiming the government is trying to turn them into whistle-blowers or government agents expected to infiltrate and influence private entities from within. They made the same claims with respect to the SEC rules. This is nonsense. The SEC rules on reporting up require no action by lawyers other than those actions they are now permitted or required to take in almost every state. Moreover, the applicable law other than the ethics rules—such as tort law, agency law, corporate law, securities law and criminal law—already provides that advisors who act as advocates in stretching the law and facts risk running afoul of that law. The SEC rules do not change the traditional responsibility and role of lawyer-advisors; they just insist that lawyers properly fulfill that role and not act as advocates in situations where such behavior is not permitted or appropriate.

In light of these general principles, accepting as an “appropriate response” to a report of evidence of a material violation the retaining or directing of a lawyer who may assert a colorable defense in any litigation relating to the reported evidence is indefensible. The fact that a lawyer can advance arguments that would meet the minimum level of plausibility sufficient to avoid sanction in an adversary proceeding does not mean that the conduct is probably legal or somewhere near that middle ground. A public company subject to SEC regulation is guilty of a civil violation of the securities laws when the preponderance of evidence supports a finding of a violation. A lawyer acting as an adviser in transactions and filings subject to SEC disclosure requirements must advise the company on the basis of whether the available evidence indicates that a violation is more likely than not. Indeed, for a lawyer to adopt a litigation stance in the counseling context would, in our view, be a serious breach of the lawyer’s duty of care to the client. Yet the result of a lawyer following the SEC’s rule is that both the firm and the lawyer potentially remain exposed to a significant risk of liability.

The application of the “colorable defense” standard must be limited to the litigation context for which it is appropriate. The existence of a colorable defense allows a lawyer-advocate once a client’s conduct is challenged in a forum as unlawful, to argue that the conduct, even if very likely illegal, is legal. It has no other relevance. The colorable defense standard certainly should not be used to permit lawyers to advise clients, particularly corporate clients with fiduciary obligations to their owner-shareholders, to proceed with conduct that is very likely illegal.

But that is precisely what could happen. The rule as adopted suggests that one alternative to stopping an ongoing fraud or abandoning plans to commit a new fraud is to get an opinion from a lawyer that should the issuer be investigated for the illegal conduct (there is no requirement in the definition that the investigation be underway, pending or even likely to occur), a colorable defense would be available. The SEC should not be suggesting to anyone that the fact that a lawyer can (in good faith and/or reasonably) state that a “colorable defense” would be available, if the action is ever challenged, licenses an issuer to engage in activity that may more likely than not be illegal.

c. Other Problems with the SEC’s Third “Appropriate Response” Option

The SEC’s use of the “colorable defense” standard as an “appropriate response” is bad enough by itself. But the third option contains numerous other provisions that could weaken the reporting up duty even further. Although the SEC or the courts could wind up interpreting some of these provisions in ways that do not weaken the reporting up duty, our fear is that lawyers inclined to avoid reporting up will exploit these ambiguities.

The “colorable defense” prong of the third option in Section 205.2(b)(3)(ii) is written very broadly. First, the provision kicks in if the investigatory lawyer advises the issuer that he or she “may” assert a colorable defense. Why “may,” as opposed to “will”? The provision as drafted appears not to require the investigating lawyer to commit to asserting a colorable defense.¹⁸⁴ The SEC’s intention may have been to avoid tying the hands of the issuer in subsequent litigation. The issuer might, for strategic reasons, forgo a colorable defense that would otherwise be available. If this was the SEC’s concern, however, the SEC could have addressed it by using “can” or “is able to” instead of “may.” The problem with the “may” formulation is that it is susceptible of other meanings. It could be interpreted to mean that an investigating lawyer who is not sure that a colorable defense is available but thinks that one “may” be available (based on the facts and law then known to the lawyer) can, simply by advising that he *may be able to assert* such a defense, provide the basis for an “appropriate response,” which ends the reporting lawyer’s obligations. This problem is exacerbated by the fact that, although we have referred to the lawyer who “may” assert a colorable defense under Section 205.2(b)(3)(ii) as the “investigating lawyer,” in fact that lawyer is not required to do anything more than “review” the reported evidence before rendering an opinion that a colorable defense may be available.¹⁸⁵ Moreover, there is no provision that if the investigating lawyer subsequently discovers facts or law that render the “colorable defense” unavailable, the “appropriate response” is somehow undone.

Another problem created by the use of “may” is a temporal one. “May” suggests not only that present uncertainty exists about the assertion of a colorable defense, but that such assertion could come at any time in the future. Section 205.2(b)(3)(ii) deems an appropriate response to occur when the lawyer “may . . . assert a colorable defense . . . in any investigation or . . . proceeding.”¹⁸⁶ Thus, the provision apparently applies even if there is no investigation or proceeding underway, pending or even likely to occur. If no proceeding is pending, issuers might be tempted to ask lawyers to provide “colorable defense” opinions to a factual and legal situation at an early stage, opinions that would speculate about future proceedings that might occur.¹⁸⁷ The opinions would inevitably have a

184. *Cf.* 17 C.F.R. § 205.3(b)(6)(ii) (providing exemption to duty to report for lawyers “retained or directed . . . to assert . . . a colorable defense”). We discuss this exemption in the next section.

185. Compare the other prong of the third option, Section 205.2(b)(3)(i), which expressly refers to a lawyer making a “reasonable investigation and evaluation of the reported evidence.” *Cf. also id.* § 205.3(b)(6)(i) (providing exemption to duty to report for lawyers retained or directed “to investigate such evidence of a material violation”). We discuss this exemption in the next section.

186. *Id.* § 205.2(b)(3)(ii).

187. Further support for the possibility of “colorable defense opinions” given in advance of any proceeding or investigation comes from the fact that Section 205.2(b)(3)(ii) contemplates that the lawyer retained or directed to “review” the

hypothetical character as distinct from a report based on an existing, or at least imminent, investigation or proceeding in which the issuer must develop a defensive stance. At the extreme, the provision might be used by corporate risk-takers to shop around for a law firm willing to state that a “colorable” defense would be available if a proposed action is ever challenged, giving an issuer an opportunity to engage in activity that may well turn out to be illegal.¹⁸⁸

“May” is not the only small word that creates problems in Section 205.2(b)(3)(ii). An even smaller word—“a”—precedes “colorable defense” and raises similarly troubling questions. The SEC’s likely intent in using “a” is to recognize that the issuer may have more than one colorable defense available. By using the phrase “a colorable defense,” the SEC rule tells us that one of these multiple available colorable defenses is enough. But again, that is not the only possible meaning of “a colorable defense.” In particular, “a colorable defense” could be interpreted to mean a colorable defense that is an *incomplete* defense. Suppose, for example, that a colorable defense to a claim under the federal securities laws exists, but not a defense to a state law claim based on the same evidence. Does an issuer who informs the reporting lawyer that the investigating lawyer may assert “a” colorable defense to the federal claim thereby provide an appropriate response? A similar question arises about procedural, as opposed to substantive, defenses. Would the assertion that a statute of limitations or laches defense “may” be available if litigation is filed be sufficient? It seems crazy to contemplate these possibilities, but a literal reading of Section 205.2(b)(3)(ii) unfortunately supports them. There is no explicit requirement that the “colorable defense” be a *complete* and substantive

evidence of a material violation, rather than a separately retained or directed “advocate,” is the one whose potential assertion of a colorable defense constitutes an appropriate response. Section 205.2(b)(3)(ii) applies if “*such* attorney may . . . assert a colorable defense.” “Such” refers to the attorney retained or directed to “review the reported evidence of a material violation.”

188. We note that a similar, and equally disturbing, problem of potential lawyer-shopping is created by Section 205.2(b)(3)(i), which deems the issuer to have made an appropriate response when an investigatory lawyer conducts a “reasonable investigation and evaluation of the reported evidence” and the issuer “[h]as substantially implemented *any* remedial recommendations made by such attorney.” Note that although the investigating lawyer’s investigation and evaluation must be “reasonable,” there is no similar requirement of reasonableness for the remedial recommendations made by the investigatory lawyer. Compare also the unqualified “remedial recommendations” under Section 205.2(b)(3)(i) with the second “appropriate response” option in Section 205.2(b)(2), which refers to “appropriate remedial measures.” An interpreter of Section 205.2(b)(3)(i) might reasonably ask why that option is there if it merely replicates the remedial standards of Section 205.2(b)(2). Given the apparent absence of constraints on the “remedial recommendations” made by investigating lawyers hired to “review” evidence of a material violation under Section 205.2(b)(3)(i), issuers could be tempted to hire investigatory lawyers known for making light or even no “remedial recommendations.”

defense to *all* possible material violations in all possible proceedings based on the evidence.

Other parts of Section 205.2(b)(3)(ii) create similar problems of incompleteness. For example, the “colorable defense” may be asserted on behalf of the issuer “or the issuer’s officer, director, employee, or agent, as the case may be.” Does this phrase mean that the issuer, simply by hiring a lawyer to represent one of its agents, ends the initially reporting lawyer’s obligations if the hired lawyer asserts a colorable defense for *that agent*, regardless of the liability exposure of the issuer, whether through vicarious liability or otherwise? Similarly, the “colorable defense” may be asserted “in *any* investigation or proceeding *relating to* the reported evidence of a material violation” (emphasis added). Does this phrase mean, for example, that if the issuer has a colorable defense to terminating a whistle-blowing employee in a wrongful discharge suit, the underlying material violation that gave rise to the whistle-blower’s actions need not be reported up? This problem could be avoided if “any” is interpreted to mean “all possible” rather than “any one.” Lawyers should not be left to speculate about such an important matter.

Finally, two further procedural defects contribute to the weakness of the “colorable defense” rule. First, Section 205.2(b)(3)(ii) puts absolutely no qualifications on the lawyer who is “retained or directed” to assert the colorable defense. The rule refers simply to “an attorney.”¹⁸⁹ The phrase “retained or directed an attorney” makes clear that the issuer need not even hire a new outside lawyer, let alone one with any particular expertise, to conduct the “review” of the evidence. An in-house lawyer—even perhaps the CLO¹⁹⁰—could serve the purpose. Equally troubling, especially given the history of Enron, is that an outside law firm whose conduct might be at issue in the potential material violation, might qualify.¹⁹¹

Second, the investigating lawyer must be retained or directed “with the consent of the board.” The SEC views board consent as providing sufficient protection to the issuer.¹⁹² If “consent of the board” required that the board be fully informed of the evidence of the material violation before making a decision, then the SEC would be correct. Under that interpretation, the board could not give “consent” unless it had already

189. “Attorney” is defined broadly in Section 205.2(c).

190. See 17 C.F.R. § 205.2(b)(3).

191. One possible limitation on this practice would be that the colorable defense must be offered “consistent with [the asserting lawyer’s] professional obligations.” These obligations include rules governing conflicts of interest, and a lawyer whose own conduct might be implicated would arguably have a conflict of interest in asserting a colorable defense. See generally MODEL RULES 2003, *supra* note 32, R. 1.7(a)(2). However, apparently many practitioners do not see this as a problem. See Cramton, *supra* note 52, at 163-66 (discussing conflict of interest issues raised by law firm investigating situation in which its own prior legal work, including formal opinions, was at issue).

192. See Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 33-8150, 67 Fed. Reg. 71,670 (Dec. 2, 2002).

been informed, or otherwise already knew, about the evidence—the exact result the reporting up duty is designed to accomplish. But once again, that is not the only possible interpretation, and in this case, it is not even a likely interpretation. For one thing, if the SEC's intent was really to use “consent of the board” as a perfect substitute for reporting up, it could have said so much more clearly than Section 205.2(b)(3) does (as we suggested in a previous subsection). More important, the SEC rules do not define “consent.” In particular, there is no express requirement that the consent be informed, or what “informed consent” might mean.¹⁹³ Thus, even if informed consent were required, that might not mean that the board, before retaining or directing the reviewing attorney under Section 205.2(b)(3), must have full knowledge about the evidence of a material violation. At the extreme, if no informed consent is required, the board could hire the investigating lawyer without knowing *anything* about the evidence. One lawyer has even suggested that blanket advance consent might do the trick.¹⁹⁴ Whether or not that is acceptable under Section 205.2(b)(3), the point is that “consent of the board” is woefully inadequate to redress the deficiencies of the “colorable defense” provision.

4. *Obligations of Other Lawyers After the Initial Report: The Wrongheaded Exemptions for Advocates and Investigatory Lawyers*

Not only do the SEC rules unnecessarily weaken the reporting up obligations of the lawyers who make the initial report through the third option under the definition of “appropriate response” in Section 205.2(b)(3), the rules also provide unnecessarily broad exemptions from the duty to report for lawyers who become involved after the initial report is made. These exemptions appear in Section 205.3(b)(6) and 205.3(b)(7) and involve two types of lawyers: advocates and investigating lawyers.¹⁹⁵ We consider these in turn.

Section 205.3(b)(6)(ii) exempts a lawyer from the duty to report evidence of a material violation if the lawyer is “retained or directed by the chief legal officer . . . to assert . . . a colorable defense . . . in any investigation or . . . proceeding relating to such evidence of a material violation,” so

193. Cf. MODEL RULES 2003, *supra* note 32, R. 1.0(e) (defining “informed consent” to mean “the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct”); *see also id.* cmts. 6, 7.

194. *See* Lorne, *supra* note 131, at A-117, 125.

195. These lawyers roughly correspond to the lawyers mentioned in the “third option” under the definition of “appropriate response,” Section 205.2(b)(3), discussed in the previous section. The parallels are far from perfect, however, which is likely to lead to interpretive difficulties. We have already pointed out some of the differences in footnotes in the previous section. For example, advocate lawyers covered by the exemptions in Section 205.3(b)(6)(ii) and 205.3(b)(7)(ii) need not be the lawyers retained or directed to “review the reported evidence of a material violation,” which is what Section 205.2(b)(3)(ii) requires for an “appropriate response” based on the potential assertion of a colorable defense.

long as the CLO “provides reasonable and timely reports on the progress and outcome of such proceeding to the issuer’s board of directors” or relevant board committee.¹⁹⁶ Similarly, under Section 205.3(b)(7)(ii), a lawyer “retained or directed by a qualified legal compliance committee to assert . . . a colorable defense” in a proceeding relating to evidence of a material violation has no reporting duties with respect to such evidence either.¹⁹⁷ These sections exempt advocate lawyers from reporting duties with respect to new evidence of ongoing or potential illegalities that the lawyers might discover as part of their work. Why?

If the Commission meant only to relieve advocate lawyers from reporting evidence already reported to, or otherwise known by, the board, the provisions are written too broadly. Section 205.3(b)(6)(ii) does not ensure that the board will get the new evidence. For one thing, unlike Section 205.2(b)(3)(ii), the “colorable defense” option under the “appropriate response” definition, Section 205.3(b)(6)(ii) exempts the advocate lawyer who in fact asserts a colorable defense from the duty to report even if the advocate lawyer is not retained or directed with the consent of the board; the CLO does the retaining or directing of the advocate lawyer under Section 205.3(b)(6)(ii).¹⁹⁸ In addition, all the board need get to exempt the advocate from the duty to report is “reports on the progress and outcome of such proceeding.”¹⁹⁹ These prog-

196. If the new evidence uncovered by the advocate has no relationship to the proceeding, but involves an unrelated material violation, the advocate attorney would not be exempt from the duty to report, because the advocate is exempt from reporting evidence only when he or she is involved in a proceeding “relating to *such* evidence.” It is likely, however, that in most cases if the advocate discovers new evidence, that evidence will be at least somewhat related to the proceeding or investigation in which the advocate is involved.

197. *Cf.* 17 C.F.R. § 205.3(b)(7)(ii).

198. *Cf. id.* § 205.3(b)(6)(ii) (“An attorney shall not have any obligation to report evidence of a material violation . . . if the attorney was retained or directed by the chief legal officer . . .”).

199. *Id.* This phrase concerning progress reports to the board does not expressly include “investigations” as distinguished from “proceedings.” But Section 205.3(b)(6)(ii) expressly excepts lawyers “retained or directed . . . to assert . . . a colorable defense . . . in any investigation or . . . proceeding.” The omission of “investigations” from the progress report phase could lead to an argument that no progress reports to the board are required as a condition of the exemption for advocates in cases of “investigations” as opposed to “proceedings.” We assume the SEC did not intend this result. Such a result would be particularly unfortunate in that it would provide a broader exemption for advocates involved in investigations, when the argument for any type of exemption for advocates is weaker in cases of investigations. One of the many issues in the Kaye, Scholer incident during the savings and loan crisis was when lawyers may treat an “investigation” as “advocacy.” See generally Quinn, Robert (Moderator), *Panel Two: The Evolving Legal and Ethical Role of the Corporate Attorney After the Sarbanes-Oxley Act of 2002: Panel 2: The Evolution of Corporate Governance*, 52 AM. U. L. REV. 613 (2003). We do not revisit that debate here.

ress reports need not contain information about any newly discovered evidence.²⁰⁰

On the other hand, if the Commission meant to exempt advocate lawyers from reporting new evidence of illegality, that is completely contrary to the point of Section 307, and we can see no legitimate justification for such an exemption. Even advocate lawyers are bound by obligations not to facilitate client wrongdoing. There is no blanket exemption for “advocates” in the ethics rules for participating in, or reporting up, ongoing illegality.²⁰¹ Nor should there be one here. Lawyers acting in an advocacy role should be bound by the duty to report, except with respect to past conduct that is the subject of the litigation and in which the advocate lawyers had no previous role.

It is true that the line between advocating and advising is often uncertain; but it is also true that every legal distinction of any import is subject to the blurry-line critique.²⁰² The line between legal and illegal conduct—which Section 307 and the SEC’s implementing rules employ and with which all lawyers must struggle every day—is also blurry. Lawyers understand these realities and are better equipped to deal with them than are ordinary Americans, who are held to account for crossing legal lines that also are gray at the edges. Ordinary Americans are neither trained nor paid to make these judgments. Securities lawyers, on the other hand, are paid good money for negotiating those grays, including the gray between advocacy and advice. The Commission’s rules do not demand perfection of lawyers in any area, just reasonable conduct, reasonable judgment and reasonable efforts to find the right side of blurry lines.

A similar problem of an excessively broad exemption exists for “investigating lawyers.” Section 205.3(b)(6)(i) states that a lawyer has no duty to report evidence of a material violation if the lawyer is retained or directed by the CLO “to investigate such evidence,” so long as the CLO “reports the results of the investigation to the issuer’s board of directors” or relevant

200. These problems do not exist in Section 205.3(b)(7)(ii), because the QLCC, which stands in for the board, hires and directly monitors the advocate lawyers.

201. See MODEL RULES 2003, *supra* note 32, R. 1.2(d), 1.13, 1.16(a), 4.1. The ABA’s newly adopted version of Model Rule 1.13 does, however, create an exception to the new permissive “reporting out” rule in 1.13(c) for “*information relating to* a lawyer’s representation of an organization to *investigate* an alleged violation of law, or to *defend* the organization or an officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law.” *Id.* R. 1.13(d). It is possible (though we think undesirable) that “information relating to” could be interpreted to include new information about ongoing violations discovered in the context of an investigation or litigation.

202. The distinction between the lawyer’s litigating function (“advocate”) and the lawyer’s advising function (“counselor”) is helpfully discussed in CHARLES W. WOLFRAM, MODERN LEGAL ETHICS ch. 13 (1986), Thomas D. Morgan, *Thinking About Lawyers as Counselors*, 42 FLA. L. REV. 439 (1990), and Murray L. Schwartz, *The Professionalism and Accountability of Lawyers*, 66 CAL. L. REV. 669 (1978).

board committee.²⁰³ And Section 205.3(b)(7)(i) exempts from the duty to report evidence of a material violation any lawyer retained or directed by a QLCC “[t]o investigate such evidence of a material violation,” without any qualification.²⁰⁴ At first blush, the SEC’s interpretations of these exemptions seem reasonable because they seem to contemplate that the investigating lawyer’s report, which presumably would include the evidence of a material violation, would be reported to the board or QLCC.

On further inspection, however, the exemption rules for investigating lawyers provide inadequate assurance that the reporting up demanded by Section 307 will occur. First, the rules do not assure that the evidence of a material violation will be communicated to the board or QLCC when the investigating lawyer is “retained or directed.” Under Section 205.3(b)(6)(i), the CLO, not the board, “retains or directs” the investigating lawyer.²⁰⁵ And under both Section 205.3(b)(6)(i) and Section 205.3(b)(7)(i), an argument could be made that the investigating lawyer could be “retained” in advance of the initial report of evidence of a material violation rather than retained in response to such report. Second, there is no explicit requirement in either Section 205.3(b)(6)(i) or Section 205.3(b)(7)(i) that the investigation be reasonable.²⁰⁶ Indeed, Section 205.3(b)(7)(i) does not require that the investigating lawyer make any investigation at all to be entitled to the exemption. Third, and most important, neither Section 205.3(b)(6)(i) nor Section 205.3(b)(7)(i) explicitly requires that the initially reported “evidence” of a material violation, or any newly discovered evidence, be reported to the board or QLCC as a condition of the exemption. Although one would hope and expect that the report of the “results of the investigation” under Section 205.3(b)(6)(i)(B) would include both types of “evidence,” that is not required. “Results” can include a brief summary with little or no detail. Even worse, the investigating lawyer retained or directed by the QLCC need not make any report at all to qualify for the exemption under Section 205.3(b)(7)(i), though presumably most such lawyers would in fact make a report.

The problems with the exemptions for investigating lawyers are not limited to the question of evidence uncovered during the course of the investigation. The exemptions let the investigating lawyer off the hook if the remedial steps recommended by the investigating lawyer are ignored, thus leaving the material violation unremedied. By contrast, an initially

203. 17 C.F.R. § 205.3(b)(6)(i)(B). The rule does not require the reporting of the results of the investigation to the board if both the CLO and the investigating lawyer reasonably believe that there is no material violation.

204. *See id.* § 205.3(b)(7)(i).

205. *See id.* § 205.3(b)(6)(i) (indicating no obligation to report where issuer’s CLO retains attorney to investigate evidence of material violation).

206. *Cf. id.* § 205.2(b)(3)(i) (referring in third option under “appropriate response” definition to “reasonable investigation and evaluation of the reported evidence”).

reporting lawyer is deemed not to have received an “appropriate response” under Section 205.2(b)(3)(i), and so must report to the board, if a subsequently retained investigating lawyer makes recommendations that the issuer does not “substantially implement.”

As with advocates, there is no basis in Section 307, the securities laws or the law of lawyering for creating a blanket reporting exemption, or even increased solicitude, for “investigating lawyers.” As with advocates, the burden of imposing a duty to report on investigating lawyers seems slight.²⁰⁷ And as with advocates, the SEC could have drafted a narrow exemption for investigatory lawyers to relieve them of reporting duties when the evidence was already known or reported to the board or QLCC, without extending the exemption to the discovery by those lawyers of new evidence or the failure to follow through on remedial recommendations. Instead, the SEC’s adoption of overly broad exemptions for advocates and investigating lawyers threatens to weaken seriously the reporting up mandate of Section 307.

III. “REPORTING OUT”: PERMISSIVE DISCLOSURE OF CONFIDENTIAL INFORMATION OUTSIDE THE CORPORATION

A. *Permissive Disclosure Under State Ethics Rules*

1. *Some Relevant History*

The central ethical tradition of the American legal profession includes four relevant propositions. First, a lawyer is prohibited from counseling or assisting a client in conduct that the lawyer knows is criminal or fraudulent.²⁰⁸ Second, when continued representation of a client would constitute illegal assistance, the lawyer is required to withdraw from the representation.²⁰⁹ Third, a lawyer is permitted to disclose confidential information to prevent a client’s prospective crime or fraud.²¹⁰ And fourth, when the client in the course of the representation has perpetrated a crime or fraud on a person or a tribunal, the lawyer is required to disclose confidential information to the extent necessary to rectify the consequences of the crime or fraud.²¹¹ The last of these propositions echoes

207. As we mentioned in our discussion of the initial trigger of the duty to report, the SEC’s exemptions may have been motivated by concern about the possibility of further duties imposed as a result of the duty to report, in particular, mandatory noisy withdrawal. But since the SEC did not implement that proposal, its concerns with excessive burdens on investigating and advocate lawyers seem overblown.

208. See MODEL RULES 2003, *supra* note 32, R. 1.2(d).

209. See *id.* R. 1.16(a).

210. Canon 37 of the ABA Canons of Professional Ethics permitted disclosure to prevent “[t]he announced intention of a client to commit a crime.” Disciplinary Rule 4-101(C)(3) of the ABA Model Code of Professional Responsibility permitted a lawyer to reveal “the intention of his client to commit a crime and the information necessary to prevent the crime.”

211. Canon 29 required disclosure by a trial lawyer of perjury committed in a case handled by the lawyer. Canon 41 required a lawyer, when the client refused

the crime-fraud exception to the attorney-client privilege. Under evidence law, client communications to a lawyer in furtherance of a client's criminal or fraudulent conduct are not privileged. As Justice Cardozo said many years ago, "The privilege takes flight if the relation is abused. A client who consults an attorney for advice that will serve him in the commission of a fraud will have no help from the law."²¹²

The policies and purposes that justify the attorney-client privilege and its exceptions weigh heavily in favor of a permissive exception to the duty of confidentiality corresponding to the crime-fraud exception of the attorney-client privilege.²¹³ If a lawyer is required to testify to a client communication, otherwise privileged, when the client uses the lawyer's services to perpetrate a fraud on a third person or a tribunal, a parallel discretion to disclose without testimonial compulsion should be recognized under the professional duty of confidentiality. Neither the legal profession nor society as a whole should tolerate a regime in which clients may use lawyers as a means of carrying out a crime or fraud. Permissive disclosure reinforces the lawyer's duty to provide only *lawful* assistance and advice to clients. It also provides the lawyer with a last-resort weapon and increased leverage in dealing with a difficult client or one embarked on an unlawful or fraudulent course of conduct. Moreover, a lawyer's failure to take reasonable steps to prevent or rectify client fraud is likely to lead to civil liability of the lawyer. If insolvency and litigation occur as an aftermath of the fraud, a

to act, "to rectify . . . some [client] fraud or deception . . . unjustly imposed on the court or a party" by "promptly informing the injured person or his counsel, so that they may take appropriate steps." Disciplinary Rule 7-102(B)(1), until amended in 1974, provided:

A lawyer who receives information clearly establishing that: (1) His client has, in the course of the representation, perpetrated a fraud upon a person or tribunal shall promptly call upon the client to rectify the same, and if his client refuses or is unable to do so, he shall reveal the fraud to the affected person or tribunal.

212. *Clark v. United States*, 289 U.S. 1, 15 (1933). See, e.g., Geoffrey C. Hazard, Jr., *An Historical Perspective on the Attorney-Client Privilege*, 66 CAL. L. REV. 1061 (1978).

213. The attorney-client privilege recognized in evidence law applies when a governmental body with power to compel testimony attempts to exercise that power to require a lawyer or the lawyer's client to reveal a communication made to obtain legal advice. A small number of well-established exceptions limit the scope of the privilege. The professional duty of confidentiality is a rule of professional ethics that has a much broader sweep, protecting all information that the lawyer obtains during the representation, subject to limited exceptions stated in state ethics rules. Commentators often confuse the two doctrines. See, e.g., Jason Hoppin, *Put Aside Privilege in Post-Enron World*, ABA *Urges*, NAT'L L.J., Aug. 18, 2003, at 5, the title of which suggests that the ABA action "puts aside privilege." An ABA action recommending that state high courts adopt broadened exceptions to the professional duty of confidentiality would have no effect on the federal and state evidence law governing the attorney-client privilege.

frequent occurrence, the client's confidentiality will inevitably disappear.²¹⁴

The ABA abandoned one of the four principles stated above in 1974 and another in 1983.²¹⁵ In 1974, the fourth proposition was turned on its head.²¹⁶ A rule that required a lawyer to reveal a crime or fraud that a client had perpetrated on a person or tribunal was converted into a prohibition of doing so with the addition of an except clause and a subsequent ABA formal opinion.²¹⁷ In 1983, when the ABA Model Rules of Professional Conduct replaced the Model Code of Professional Responsibility, required disclosure was limited to the situation in which the lawyer, having unknowingly "offered false evidence [in an adjudicative proceeding] . . . comes to know of its falsity."²¹⁸

The third proposition was largely annulled by the failure of the ABA in 1983 to continue the Model Code provision that permitted a lawyer to disclose confidential information to prevent any intended crime of a client or the somewhat narrower client-fraud exception proposed by the Kutak Commission, which had drafted the Model Rules. From 1983 until August 2003, Model Rule 1.6(b) restricted a lawyer's permission to reveal confidential information to prevent a crime or fraud to a client's criminal act "that the lawyer reasonably believes is likely to result in death or substantial bodily harm." Much more common consequences of client misconduct during the representation—those causing economic loss rather than death or personal injury—were eliminated.

The source of the professional concerns that led to the ABA's retrenchment is relevant to today's concern that professional advisers have failed to perform their functions of preventing corporate wrongdoing. The ABA's actions in 1974 and 1983 were heavily influenced by the hostility of important segments of the legal community to the SEC's efforts during the 1970s to apply the third and fourth propositions to securities lawyers who remained silent when they knew or should have known that their client was engaged in a course of conduct that violated federal securi-

214. A public company often desires to cooperate with investigators, and waiving the privilege is often part of successful cooperation; a successor in interest, such as a bankruptcy trustee, is likely to waive any privileges in an effort to recover assets for the insolvent entity, and if these events do not take place, the crime-fraud exception of the privilege may be successfully invoked by an adverse party. Finally, if the lawyer is charged by defrauded persons, the lawyer ordinarily will invoke the self-defense exception to confidentiality.

215. See MODEL CODE OF PROF'L RESPONSIBILITY CANON 4 (1980) (abandoning fourth proposition) [hereinafter MODEL CODE]; MODEL RULES 1983, *supra* note 11, R. 1.6 (abandoning third proposition).

216. See the discussion of the ABA's tortured treatment of disclosure of client fraud in GEOFFREY C. HAZARD, JR., SUSAN P. KONIAK & ROGER C. CRAMTON, *THE LAW AND ETHICS OF LAWYERING* 282-88 (3d ed. 1999) [hereinafter HAZARD, KONIAK & CRAMTON].

217. See Model Code, *supra* note 215, DR 7-102(B)(7) (1980).

218. MODEL RULES 1983, *supra* note 11, R. 3.3(a).

ties laws.²¹⁹ Those propositions had not been viewed as problematic when they were not enforced—state disciplinary authorities had neither the will nor the resources to charge large firm lawyers with assisting a client fraud.²²⁰ But when SEC enforcement came into play with the *National Student Marketing* case,²²¹ the two propositions were attacked and drastically narrowed by the ABA.

2. *Current State Law on Disclosure of Confidential Information and Related Issues*

The ABA is not a lawmaking body but a private organization that recommends professional rules for the consideration of state authorities, usually the highest court of a state. Fortunately, most state courts have rejected the ABA recommendations described above, taking a more public-spirited approach than did the ABA prior to 2002-2003. In 2002, forty-one U.S. jurisdictions permitted a lawyer to disclose confidential information to prevent a client's criminal fraud (four of them required disclosure); forty-four jurisdictions required disclosure of a client's ongoing criminal or fraudulent act when the lawyer knows that the client, in the course of the representation, has made criminal or fraudulent representations.²²²

The ABA's actions have had the greatest effect in emphasizing a distinction between, on the one hand, *preventing* future client crimes or frauds and, on the other hand, *rectifying* past crimes or frauds of which the victims are unaware and that have continuing consequences that are unrectified. In 2002, only eighteen states permitted (two of them required)

219. See Ted Schneyer, *Professionalism as Bar Politics: The Making of the Model Rules of Professional Conduct*, 14 LAW & SOC. INQUIRY 677, 700-20 (1989) (attributing ABA's actions in 1974 and 1983 to opposition of powerful litigator groups (e.g., American College of Trial Lawyers) and concern among some business lawyers about SEC's enforcement of profession's rules in *National Student Marketing* case).

220. See 148 CONG. REC. S6555 (July 10, 2002) (statement of Sen. Enzi). Senator Enzi stated:

I am usually in the camp that believes that States should regulate professionals within their jurisdiction. However, in this case, the State bars as a whole have failed. They have provided no specific ethical rule of conduct to remedy this kind of situation. Even if they do have a general rule that applies, it often goes un-enforced.

Id.

221. 457 F. Supp. 682 (D.D.C. 1978).

222. Attorneys' Liability Assurance Society (ALAS), *Ethics Rule on Client Confidences*, reprinted in THOMAS D. MORGAN & RONALD D. ROTUNDA, 2003 SELECTED STANDARDS ON PROFESSIONAL RESPONSIBILITY 161-72 (2003) [hereinafter ALAS Memorandum]. The memorandum presents a chart indicating the position of the ABA, the states and the District of Columbia on lawyer disclosure of confidential information in eight situations. It is accompanied by footnotes that explain the results in individual states or in groups of states that have similar confidentiality provisions. Column C reports the position of the fifty-one jurisdictions when a client intends to commit a criminal fraud likely to result in injury to the financial interest or property of another; column G reports the disclosure position when a client is engaged in an ongoing criminal or fraudulent act.

an explicit disclosure by the lawyer to disclose confidential information to rectify a client's prior commission of a crime or fraud, using the lawyer's services, resulting in injury to the financial interest or property of another party.²²³ Although communications about such past acts, if made by the client to further a client crime or fraud, are not protected by the attorney-client privilege, rule-makers have been more reluctant to include an explicit provision permitting or requiring a lawyer to disclose confidential information concerning such past acts than to disclose prospective crimes or frauds.

The situation is complicated by two additional considerations. First, a fraudulent misrepresentation that continues to mislead third persons involves a continuing course of conduct that is constantly resulting in new crimes or frauds. In states that permit a lawyer to disclose a prospective crime or fraud, the lawyer may act to prevent harm to new victims (*permissive* disclosure of confidential information).

Second, the combined effect of Rules 1.2(d), 1.16(a), 4.1(b) and 1.6(b) often changes the analysis and requires the lawyer to withdraw and to correct the prior material false statement (*required* disclosure). This result comes in three steps: (1) the lawyer's continued representation related to an ongoing crime or fraud would result in the lawyer assisting the client's criminal or fraudulent act, prohibited by Rules 1.2(d) and 1.16(a), which require the lawyer to withdraw unless the client corrects the prior false statement; (2) because the client's criminal fraud is continuing to deceive new victims, Rule 1.6 (in the form adopted by most states) permits disclosure to prevent these new crimes or frauds, and Rule 4.1(b) requires the lawyer to correct the client's or the lawyer's prior false statement of material fact when failure to disclose would assist the client's crime or fraud and disclosure is permitted under Rule 1.6; and (3) as a result, the permission under Rule 1.6(b) becomes a mandate under Rule 4.1(b).²²⁴

In summary:

- Every state prohibits a lawyer from assisting a client's crime or fraud.²²⁵
- Every state requires a lawyer to withdraw from any related representation when continued representation would assist a client's crime or fraud.²²⁶

223. *Id.* col. D (noting disclosure to rectify consequences of client's prior commission of crime or fraud, using lawyer's services, resulting in injury to financial interest or property of another party).

224. *See id.* nn.3, 4. These notes discuss this issue and include material on the seven states that have retained at least part of the Model Code approach to confidentiality, including Illinois.

225. *See* Model Rules 2003, *supra* note 32, R. 1.2(d); MODEL CODE, *supra* note 215, DR 7-102(A)(7) & (8).

226. *See* MODEL RULES 2003, *supra* note 32, R. 1.16(a); MODEL CODE, *supra* note 215, DR 7-102(B)(2).

- Forty-one states permit (and four of them require) a lawyer to disclose confidential information to prevent a client's criminal fraud.²²⁷
- Eighteen states permit a lawyer to disclose confidential information to rectify or mitigate a past client fraud in which the lawyer's services were used.²²⁸
- Forty-four states permit (and three require) a lawyer to disclose confidential information relating to a client's ongoing criminal or fraudulent act.²²⁹

3. *Effect of Lawyer Disclosure of Confidential Information on the Client's Attorney-Client Privilege*

Articles in the press concerning lawyer disclosure of client confidences frequently contain statements by lawyers to the effect that a lawyer's permitted or required disclosure of client information pursuant to one of the exceptions to confidentiality in a state's ethics rules has the effect of waiving the client's attorney-client privilege as to that information.²³⁰ These statements reflect the fact that a misunderstanding of the privilege and its waiver and of the professional duty of confidentiality is quite common. But repetition of an incorrect statement in the press or by lawyers does not make it the law of the land.

As a leading case states, the ethical propriety of a lawyer disclosing information without the client's consent "tells us nothing about the admissibility of the information disclosed."²³¹ The professional duty of confidentiality and the attorney-client privilege are separate doctrines although they have overlapping objectives. Adverse disclosure by a lawyer in a situation permitted by the ethics rule, but without the client's consent or in pursuit of the client's interest, does not waive the client's attorney-client privilege in the information.²³² Although the information becomes known to those to whom it is revealed and may result in harm to the client, the client retains the right to assert the privilege in any subsequent proceeding whether or not the client is a party.

The Restatement of the Law Governing Lawyers contains an authoritative statement in a comment to Section 78:²³³

227. See ALAS Memorandum, *supra* note 222, at 161-66.

228. See *id.*

229. See *id.*

230. See *supra* note 213.

231. Purcell v. District Attorney, 676 N.E.2d 436, 438 (Mass. 1997). This case is discussed *infra*.

232. See, e.g., CHRISTOPHER B. MUELLER & LAIRD C. KIRKPATRICK, MODERN EVIDENCE 440-44 ("The client is the holder of the privilege, and the attorney cannot waive it over the client's objection."). Actual or implied authority of the attorney to waive the privilege "is determined by the customary rules of the law of agency." Involuntary disclosures do not result in loss of the privilege.

233. RESTATEMENT, *supra* note 52, § 78 cmt. c.

Unauthorized disclosure by a lawyer not in pursuit of a client's interest does not constitute waiver under this Section. For example, disclosure of a client's confidential information . . . to prevent a crime or fraud²³⁴ (§ 67) does not constitute waiver within the meaning of this Section, although another basis for finding the privilege inapplicable may apply [such as the crime-fraud exception to the attorney-client privilege].

In *State v. Macumber*, for example, a lawyer reported to public officials that his client had committed a crime for which another person had been convicted.²³⁵ The disclosure was viewed as permissible under Arizona's ethics rules (i.e., not in violation of the lawyer's duty of confidentiality).²³⁶ Nevertheless, the lawyer's testimony concerning the client's communication was not admissible in a subsequent hearing challenging the allegedly wrongful communication.²³⁷

In *Purcell v. District Attorney*, the Massachusetts Supreme Judicial Court held that a lawyer's permissible disclosure of information that his client planned to set fire to an apartment building did not necessarily lead to the conclusion that the lawyer could be required to testify as to the client's expression of criminal intent in a subsequent attempted arson trial.²³⁸ The client, a maintenance man with an apartment in the building, had consulted the lawyer about matters relating to the loss of the client's job and apartment.²³⁹ Those communications were privileged and the privilege was not waived by the lawyer's permitted disclosure under the ethics code of the intended arson. The harder question was whether the communication concerning the threatened arson was admissible because of the crime-fraud exception to the privilege, a determination that rested on

234. The reference clearly is to the Restatement's provisions permitting or requiring a lawyer to disclose confidential information in certain situations (e.g., rules equivalent to Model Rules 1.6(b) and 3.3(a)(3)). The Reporter's Note on this subject has an explicit statement: "On the rule that a lawyer's permissible disclosure to prevent a client crime does not waive the attorney-client privilege, see *Purcell v. District Attorney*, 676 N.E.2d 436 (Mass. 1997)."

235. See *State v. Macumber*, 544 P.2d 1084, 1087 (Ariz. 1976) (disclosing information after obtaining informal opinion from Committee on Ethics of State Bar, which advised that attorney-client privilege did not apply).

236. See *id.* at 1087-88.

237. See *Macumber*, 544 P.2d at 1084 (holding that lawyer's permissible disclosure to authorities of client's information that he was responsible for crime for which another person had been convicted did not waive client's attorney-client privilege; reversing conviction and remanding for new trial); see also *State v. Macumber*, 582 P.2d 162 (Ariz. 1978) (affirming conviction after second trial). The case is thoroughly discussed in W. William Hodes, *What Ought to Be Done—What Can Be Done—When the Wrong Person Is in Jail or About to Be Executed?*, 29 Loy. L.A. L. Rev. 1547, 1560-81 (1996). See also *State v. Valdez*, 618 P.2d 1234, 1235 (N.M. 1980) (lawyer could not testify that his client had confessed to robbery for which defendant had been convicted).

238. See *Purcell v. District Attorney*, 676 N.E.2d 436, 438 (Mass. 1997) (discussing facts of case).

239. See *id.*

whether the client informed the lawyer of the intention to commit arson "for the purpose of receiving legal advice" concerning the unlawful conduct.²⁴⁰ On remand in *Purcell*, the defense lawyer was not required to testify against his client.²⁴¹ The court held that the client's communication of the proposed arson, unlike those relating to the client's job and housing, was not made for purposes of legal advice.²⁴² "A lawyer can act to save lives [or property], and at the same time avoid being the instrument of the client's conviction."²⁴³

B. *Permissive Disclosure Under SEC Part 205*

Section 205.3(d)(1) of the SEC rule implementing Section 307 of Sarbanes-Oxley provides that an attorney who has reported evidence of a material violation may use that report (and any response to the report) in connection with any investigation, proceeding or litigation in which the attorney's compliance with the rules is at issue. In addition, Section 205.3(d)(2) provides that:

An attorney . . . may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:

- (i) To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;
- (ii) To prevent the issuer, in a Commission investigation or administrative proceeding from committing . . . [or] suborning perjury . . . or committing any act . . . that is likely to perpetrate a fraud upon the Commission; or
- (iii) To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services have been used.

Section 205.3(d)(1) permits something that is permitted under the law of every state: a lawyer may disclose confidential information in a proceeding to defend against allegations or charges that the lawyer, in representing a client, engaged in wrongful conduct.²⁴⁴ The SEC language merely makes clear what is implicit under the language of ABA Rule 1.6(b)(5)—that an official investigation that precedes a formal proceed-

240. *See id.* at 439.

241. *See id.* at 441 (vacating order that denied motion to quash any subpoena issued to *Purcell* to testify).

242. *See id.* at 441 (concluding that client's communication regarding intent to commit arson was not for purpose of receiving legal advice).

243. Susan Martyn, *The Restatement (3d) of the Law Governing Lawyers and the Courts*, PROF. LAW. 115, 124 (Symposium Issue 1997).

244. *See* MODEL RULES 2003, *supra* note 32, R. 1.6(b)(5) (permitting lawyer to disclose confidential information to establish claim or defense).

ing comes within the lawyer's right "to respond to allegations in *any proceeding* concerning the lawyer's representation of the client."²⁴⁵

Section 205.3(d)(2)(ii) permits disclosure to protect the integrity of SEC proceedings.²⁴⁶ This section parallels Model Rule 3.3(a)(4), which requires disclosure to the tribunal when the lawyer learns that the lawyer has offered material evidence that the lawyer now knows is false or, more broadly under Rule 3.3(b), when "[a] lawyer who represents a client in an adjudicative proceeding and who knows that a person intends to engage, is engaging or has engaged in criminal or fraudulent conduct related to the proceeding."²⁴⁷ This is a situation in which the vast majority of states (forty-four, according to the Attorneys' Liability Assurance Society (ALAS) Memorandum), require the lawyer to disclose confidential information to the tribunal.²⁴⁸ In this instance state ethics rules go substantially beyond the SEC's provision vesting lawyers with permission to disclose.

Section 205.3(d)(2)(i) is substantially the same as current ABA Rules 1.6(b)(2) and 1.13(c), as amended in August 2003. To the extent differences exist, the SEC provision generally allows for somewhat more disclosure than the ABA rules. First, Rule 1.6(b)(2) requires that the client has used or is using the lawyer's services to further the crime or fraud, whereas the SEC rule and Rule 1.13(c) contain no such limitation.²⁴⁹ Second, Rule 1.13(c) requires that the matter be "related to the representation," whereas the SEC rule and Rule 1.16(b)(2) do not. Third, the SEC rule allows disclosure whether the harm from the material violation affects the issuer or third-party investors, while Rule 1.13(c) disclosure is limited to preventing injury to the organization, and Rule 1.6(b)(3) disclosure is limited to preventing injury to "another," a term that would not include the issuer client. A fourth difference with uncertain import is that the SEC rule requires that substantial financial harm be "likely," while both ABA rules require substantial injury to be "reasonably certain." As indicated earlier, the ethics rules of about four-fifths of the states permit disclosure to prevent a client's criminal fraud on a third person. Any substantial federal securities law violation would constitute a federal crime and could be disclosed under the ethics rules of at least forty-one states.²⁵⁰

Similarly, Section 205.3(d)(2)(iii) is substantially the same as ABA Rule 1.6(b)(2), as amended in August 2003 (Rule 1.13(c) deals only with prevention, not rectification). The only differences are that this SEC rule, unlike the corresponding ABA rule, does not include prevention or mitigation of harm but only rectification of consequences and requires that the harm be to the issuer or investors rather than "to another." Section

245. *See id.* (emphasis added).

246. *See* 17 C.F.R. § 205.3(d)(2)(ii) (2004).

247. MODEL RULES 2003, *supra* note 32, R. 3.3(b).

248. *See* ALAS Memorandum, *supra* note 222, col. G.

249. *Compare* MODEL RULES 2003, *supra* note 32, R. 1.6(b)(2), *with id.* R. 1.13(c).

250. *See* ALAS Memorandum, *supra* note 222, col. C.

205.3(d)(2)(iii), unlike Section 205.3(d)(2)(i), follows the ABA provision in limiting rectification of past frauds to situations in which the lawyer's services have been used in furtherance of the fraud. As indicated earlier, by providing for rectification of a past fraud by a client in which the lawyer's services were used, the SEC rule permits disclosure to the Commission in a situation in which a substantial minority of states (eighteen) permit disclosure, but most states would prohibit it. Disclosure in this situation is now recommended by the ABA and by Section 67 of the ALI's Restatement of the Law Governing Lawyers.

C. *The Validity and Preemptive Effect of Permissive Disclosure Under Section 205.3(d)(2)*

Reporting out, even if merely permissive, inevitably generates more controversy than mandatory reporting up. Therefore, it should have been no surprise that the first important public challenges to the SEC rules, which occurred during the summer of 2003, involved the validity and preemptive effect of the SEC's permissive disclosure rules. The challenges came from two state's bars: Washington and California. Our view is that the challenges are unconvincing, and that the SEC had authority to, and did in fact, draft rules that preempt state ethics rules that prohibit or restrict disclosure of material violations of law.²⁵¹ Indeed, the fact that state bars are now arguing to the contrary supports our previously expressed concern with "colorable defense" and other standards relating to reporting up, since it shows that some lawyers are willing to argue almost anything to protect their vision of lawyering.

An analysis of the validity and preemptive effect of the SEC's permissive disclosure rules involves several considerations. The first question is whether Congress in Section 307 authorized the SEC to promulgate permissive disclosure rules. The next question is whether Congress intended to allow the SEC to give its rules preemptive force. The Supreme Court has recognized three types of preemption: *express preemption*, based on the express language of a statute; *field preemption*, based on congressional intent to occupy an entire field and leave no room for state regulation; and *implied conflict preemption*, under which federal statutes preempt state law with which the federal statute "actually conflicts."²⁵² Because Section 307 contains no express preemption provision and does not intend to displace all state regulation of lawyers, the type of preemption at issue here is implied conflict preemption.

Under the doctrine of implied conflict preemption, a conflict exists between federal and state law either if it is "impossible for a private party

251. Another recent discussion by an ethics scholar reaches the same general conclusion. See Roy D. Simon, *The Washington State Bar Takes on the SEC* (Sept. 11, 2003) (on file with *Villanova Law Review*).

252. See generally Caleb Nelson, *Preemption*, 86 VA. L. REV. 225, 225-231 (2000) (citing cases setting forth preemption doctrine).

to comply with both state and federal requirements” (sometimes known as “physical impossibility”) or if state law “stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.”²⁵³ The SEC rules do not create situations in which compliance with both the SEC rules and state law is a “physical impossibility.” The SEC rules generally do not require lawyers to do anything that state law prohibits. They do two other things: require something (i.e., reporting up) that some state rules may merely permit; and permit something (i.e., reporting out) that some state rules prohibit or restrict. And, unlike Section 307, the SEC rules contain express preemption provisions. The question is whether these rules involve the kind of “conflict” necessary to create the “obstacle preemption” variant of conflict preemption. Finally, there is the related question of what deference is owed to the SEC’s own interpretations of its rules, in this case interpretations concerning preemption. As a general proposition, courts are likely to give great deference to the SEC’s interpretations of its own rules.²⁵⁴

1. *Validity of the SEC Permissive Disclosure Rule*

We first consider whether Congress in Section 307 authorized the SEC to promulgate a permissive disclosure rule and to give that rule preemptive effect. The language of Section 307 grants broad authority to the SEC.²⁵⁵ It requires the SEC to “issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including” two specific rules, which we have discussed in previous sections.²⁵⁶ Permissive disclosure rules fit comfortably within that legislative mandate. First, Section 307 refers to “minimum standards of professional conduct,” which means that the SEC was required to adopt not simply the two rules referred to, but a set of rules governing the conduct of lawyers who appear and practice before the SEC. Rules concerning disclosure are not unusual, either for “standards of professional conduct” governing lawyers generally or for

253. *E.g.*, *Sprietsma v. Mercury Marine*, 537 U.S. 51, 64 (2002) (quoting *Freightliner Corp. v. Myrick*, 514 U.S. 280, 287 (1995)).

254. *See, e.g.*, *Geier v. Am. Honda*, 529 U.S. 861, 883 (2000) (federal regulations preempt state product liability suits where “Congress has delegated to [the agency] authority to implement the statute; the subject matter is technical; and the relevant history and background are complex and extensive[; thus, t]he agency is likely to have a thorough understanding of its own regulation and its objectives and is ‘uniquely qualified’ to comprehend the likely impact of state requirements”); *Chevron v. Natural Res. Def. Counsel*, 467 U.S. 837, 842-43 (1984) (noting that if statute is silent with respect to specific issue court must sustain agency’s interpretation if it is based on permissible construction of act); *Bowles v. Seminole Rock*, 325 U.S. 410, 413-14 (1945) (agency’s administrative interpretation of its own regulations is controlling unless plainly erroneous or inconsistent with regulation).

255. *See* 15 U.S.C. § 7245 (2003).

256. *Id.*

rules promulgated by the SEC under the securities laws, which of course are all about disclosure of various types. The use of the word “including” reinforces the idea that the two rules mentioned in Section 307 were not the only ones Congress authorized the SEC to adopt. Moreover, there is no language in Section 307 that purports to limit in any way the type of “standards of professional conduct” the SEC is authorized to adopt.

That leaves legislative history. As many lawyers who criticized the SEC’s proposed rules in their public comments pointed out, there are some statements in the legislative history to the effect that Section 307 does not require lawyers to report evidence of a material violation to the SEC. Senator Enzi, one of the co-sponsors of the amendment that became Section 307, stated that the “reporting up” required by the amendment:

[I]s still less onerous than that imposed on accountants under section 10A of the 1934 Securities Exchange Act, which requires an auditor to report, both to the client’s directors and simultaneously to the SEC, an illegal act if management fails to take remedial action.

The amendment I am supporting would not require the attorneys to report violations to the SEC, only to corporate legal counsel or the CEO, and ultimately, to the board of directors.²⁵⁷

Shortly thereafter, the following colloquy occurred between Senator Sarbanes and Senator Edwards, another of the co-sponsors of Section 307:

Mr. SARBANES. It is my understanding that this amendment, which places responsibility upon the lawyer for the corporation to report up the ladder, only involves going up within the corporate structure. He doesn’t go outside of the corporate structure. So the lawyer would first go to the chief legal officer, or the chief executive officer, and if he didn’t get an appropriate response, he would go to the board of directors. Is that correct?

Mr. EDWARDS. Mr. President, my response to the question is the only obligation that this amendment creates is the obligation to report to the client, which begins with the chief legal officer, and, if that is unsuccessful, then to the board of the corporation. There is no obligation to report anything outside the client—the corporation.

Mr. SARBANES. I think that is an important point. I simply asked the question in order to stress the fact that that is the way this amendment works. This has been a very carefully worked out amendment. . . .²⁵⁸

In our view, these statements do not support the proposition that Section 307 prohibits the SEC from adopting rules requiring disclosure,

257. 148 CONG. REC. S6555 (July 10, 2002) (statement of Sen. Enzi).

258. *Id.* S6557 (July 10, 2002) (statements of Sens. Edwards & Sarbanes).

much less rules requiring noisy withdrawal, or rules merely permitting disclosure. First, the statements are directed to the lawyer's obligation to report up to the board if the lawyer does not receive an appropriate response from *management* to the initial report of evidence of a material violation. The statements do not address what is supposed to happen if after reporting to the board, the *board* itself refuses to respond appropriately, perhaps because the senators were being optimistic that reporting up would always work or perhaps because they wanted to duck a politically sensitive issue.²⁵⁹ At most, then, the statements seem to say that the lawyer cannot immediately or simultaneously run to the SEC if management does not appropriately respond to the lawyer's initial report. But permissive disclosure would not be allowed in that situation under Section 205.3(d)(2), which requires that the lawyer "reasonably believe" the disclosure is "necessary."²⁶⁰ It is hard to imagine that the SEC or the courts would find disclosure to the SEC before (or at the same time as) reporting up to the board "reasonably necessary." And the proposed mandatory noisy withdrawal rule, discussed in the next section, does contain such a limitation.

Second, the statements are directed to what the *amendment requires*, not what the *SEC is authorized to do* in the exercise of its discretion pursuant to the amendment. Neither of the statements say *anything* about the SEC's rulemaking authority. Yet the amendment gives the SEC broad discretion to create rules. It is common for legislators to leave technical details or politically sensitive issues to agency rulemaking. That can be part of the "careful working out" of a statute. So the fact that three senators did not want to go on record as requiring outside disclosure in the amendment says nothing about whether the SEC has authority to do so.

Third, to the extent the statements have relevance to the kinds of rules the SEC is authorized to promulgate, they seem to be directed at mandatory reporting to the SEC. Neither the permissive disclosure rule adopted in Section 205.3(d)(2) nor the proposed noisy withdrawal rule involves mandatory reporting to the SEC. Section 205.3(d)(2) does not require the lawyer to do anything, but leaves disclosure to the lawyer's discretion, subject to the "reasonably necessary" limitation. And the proposed noisy withdrawal rule, though mandatory, does not involve the lawyer making a full disclosure of his "report" to the SEC, but rather notifying the SEC of his withdrawal "for professional reasons."

259. In another part of his statement, Senator Enzi expressed the view that a lawyer, "[b]y reporting violations to the board of directors, . . . can avoid being found guilty of aiding and abetting their client." *Id.* S6555 (July 10, 2002) (statement of Sen. Enzi). As we have already discussed, a lawyer would not avoid the risk of aiding-and-abetting liability if the board refused to stop or rectify a material violation. So Senator Enzi's stated concern could be read to support permissive disclosure.

260. *See* 17 C.F.R. § 205.3(d)(2) (2004).

Finally, of course, the weight that courts are likely to give to this legislative history is uncertain. The status of legislative history generally is controversial, especially in the face of statutory language directing the promulgation of "minimum rules of professional conduct" for securities lawyers. And in this case, all we have is the opinion of three senators, albeit including two of the amendment's co-sponsors in the Senate. What, if anything, the other senators or members of the House were thinking when they voted for Section 307 is unknown.

2. *The SEC's Authority to Preempt State Law*

As long as the federal government has authority under the Constitution to regulate in a particular area, the Supremacy Clause of the Constitution makes it clear that state law that conflicts or interferes with federal regulation must yield. In general, an agency's authority to promulgate substantive regulations in an area includes the authority to preempt state law. In the case of Section 307, although the statute makes no explicit reference to preemption, the structure of the statute, as well as the legislative history, both support the inference that Congress intended that the SEC rules would preempt conflicting state rules.²⁶¹

The primary substantive goal of Section 307 was to replace what was perceived to be the inadequate discretionary reporting up standard contained in old Model Rule 1.13 with a mandatory reporting up rule for purposes of disciplining lawyers who appear and practice before the SEC. As we have discussed, old Rule 1.13(b) did require that if a lawyer "knows" of a violation "in a matter related to the representation" that is "likely to result in substantial injury to the organization," the lawyer must "proceed as is reasonably necessary in the best interest of the organization," which "may include" reporting up to the board. And as we have also discussed, Section 307 not only made reporting up mandatory, it also replaced the "actual knowledge" standard with an "evidence" standard, replaced the "substantial injury" requirement with "material violation" and dropped the requirement that the matter be related to the representation. Thus, Congress passed a statute that explicitly required the SEC to adopt rules that clearly differed from state ethical standards because the state standards

261. In contrast, courts uniformly rejected arguments that the "Thornburgh Memorandum," which purported to exempt Department of Justice lawyers from the requirements of Model Rule 4.2, preempted state ethics rules. Rule 4.2 prohibits a lawyer from communicating directly with a represented person (with limited exceptions). Among other things, courts relied on the fact that the Thornburgh Memorandum was not authorized by any federal statute. *See, e.g.,* United States *ex rel.* O'Keefe v. McDonnell Douglas Corp., 961 F. Supp. 1288, 1294 (E.D. Mo. 1997), *aff'd*, 132 F.3d 1252, 1257 n.4 (8th Cir. 1998); United States v. Ferrara, 847 F. Supp. 964, 969 (D.D.C. 1993), *aff'd on other grounds*, 54 F.3d 825 (D.C. Cir. 1995); *In re Doe*, 801 F. Supp. 478, 484-487 (D.N.M. 1992); United States v. Lopez, 765 F. Supp. 1433, 1445-50 (N.D. Cal. 1991), *vacated*, 989 F.3d 1032 (9th Cir. 1993), *amended and superseded*, 4 F.3d 1455 (9th Cir. 1993); *In re Howes*, 940 P.2d 159, 169 (N.M. 1997).

were not sufficiently encouraging of reporting up. If that is not preemptive intent, what is?

The legislative history here supports the view that the primary purpose of Section 307 was to displace the standard of former Model Rule 1.13. The amendment's sponsors repeatedly made reference to the letter from the forty law professors (including us) to the SEC, which argued that the Rule 1.13 standard was inadequate.²⁶² They also argued directly that state standards were inadequate, as well as under-enforced.²⁶³

Moreover, prior to the Senate vote on Section 307, the Senate considered the question of preemption because the opponents of the amendment raised arguments against it. The Senate rejected the arguments.²⁶⁴ While the bill was in conference, the ABA sent a letter to the conferees, arguing, among other things, that federalism either mandated or counseled the legislators to declare that any Commission rules issued under Section 307 would yield to state ethics codes. The conferees rejected the ABA's pleas.²⁶⁵ The same arguments are likely to be presented to courts when they are asked to review an SEC enforcement proceeding under Section 307. The arguments are not meritorious.

262. See 148 CONG. REC. S6554 (July 10, 2002) (statement of Sen. Edwards); *id.* S6555 (statement of Sen. Enzi); *id.* S6557 (statement of Sen. Sarbanes).

263. See *id.* S6555 (statement of Sen. Enzi). Senator Enzi stated:

When their counsel and advice is sought, attorneys should have an explicit, not just an implied, duty to advise the primary officer and then, if necessary, the auditing committee or the board of directors of any serious legal violation of the law by a corporate agent. Currently, there is no explicit mandate requiring this standard of conduct. . . .

. . . .

I am usually in the camp that believes States should regulate professionals within their jurisdiction. However, in this case, the State bars as a whole have failed. They have provided no specific ethical rule of conduct to remedy this kind of situation. Even if they do have a general rule that applies, it often goes unenforced. Most States also do not have the ability to investigate attorney violations involved with the complex circumstances of audit procedures within giant corporations.

Similarly, the American Bar Association's Model Rules of Professional Responsibility do not have mandatory rules for professional conduct for corporate practitioners which require them to take specific action. The ABA merely has a general rule that an attorney must represent the best interests of an organization and suggests a number of ways an attorney could respond, including reporting illegal conduct to a responsible constituent of the organization, such as the board of directors. But this does not mandate action.

Id.

264. Amendment Number S.Amdt.4187 to S.2643 was approved by a vote of ninety-seven to zero, with three senators not voting. The amendment required the SEC to set "forth minimum standards of professional conduct for attorney's appearing and practicing before the Commission." 148 CONG. REC. S6778 (July 15, 2002).

265. See H.R. CONF. REP. NO. 107-610 (2002) (recommending to both Houses of Congress adoption of "Sarbanes-Oxley" Act of 2002, with Section 307 included).

The arguments against preemptive authority made in comments to the SEC emphasize the traditional role of the states in the regulation of the bar.²⁶⁶ It is true that lawyer regulation has traditionally been the province of the states, but so has the regulation of corporations and accountants. Yet, in furtherance of the regulation of securities that trade in interstate commerce, the SEC regulates some aspects of corporate governance and the accounting profession. Moreover, courts have generally rejected claims that state law conflicting with those regulations should somehow trump those regulatory efforts because "traditionally" states, not the federal government, have been the primary regulators of those groups.

Anti-preemption arguments also emphasize the important role an independent bar plays in our constitutional system. We agree, but rhetoric about lawyer independence is no substitute for reasoned argument. If the federal government's power (and thus, the Commission's power) under the Commerce Clause to regulate lawyers is more limited than its power to regulate other groups that are involved in the issuance and trading of securities and that have been traditionally regulated by the states, the limitation can only be due to some other language in the Constitution that provides that singular status for lawyers. Courts often invoke the Sixth Amendment for that purpose, but the Supreme Court has long held that the Sixth Amendment's guarantee of counsel does not generally extend beyond criminal prosecutions.²⁶⁷ The Supreme Court has never held that the Sixth Amendment extends to the provision of legal advice to companies relating to compliance with the securities laws or to regulating the conduct of attorneys in administrative proceedings before the SEC. And no court, of which we are aware, has suggested that any other clause of the Constitution, including the Due Process Clauses of the Fifth and Fourteenth Amendments, performs the function that some commentators try to attribute to the Sixth Amendment.

Assertions that the Commission is going where no arm of the federal government has gone before, and that federal regulation of any lawyer is a novel, alien and dangerous concept are false.²⁶⁸ The IRS regulates tax

266. See, e.g., Comments of the ABA at 32; Comments of 77 Law Firms at 2; Comments of the Association of the Bar of the City of New York at 38 ("There is nothing in Section 307 to suggest that Congress authorized the Commission to preempt state law and rules governing attorney conduct."); Comments of the Conference of Chief Justices at 1 ("[S]tate supreme courts are traditionally the ultimate authority for the promulgation and enforcement of the regulation of lawyers on a day-by-day basis.") (citing McDade Act, 28 U.S.C. § 530B (1998), subjecting attorneys for federal government to ethics rules of state in which federal attorney acts).

267. See, e.g., *Lassiter v. Dep't of Soc. Servs.*, 452 U.S. 18, 26 (1981) (right to appointed counsel applicable to criminal cases does not extend to indigent litigant in civil proceeding involving parental rights); *Wolff v. McDonnell*, 418 U.S. 539, 570 (1974) (holding there is no right to appointed counsel to inmate in prison disciplinary proceeding).

268. See generally Michael P. Cox, *Regulation of Attorneys Practicing Before Federal Agencies*, 34 CASE W. RES. L. REV. 173 (1984) (finding that federal agencies have

lawyers in some respects,²⁶⁹ federal banking agencies have considered the responsibilities of lawyers in bank examinations and filings,²⁷⁰ the Patent and Trademark Office regulates patent and trademark lawyers,²⁷¹ and federal bankruptcy judges regulate bankruptcy lawyers (with rules, by the way, that conflict with the conflict of interest rules in virtually every state),²⁷² to provide five prominent examples. The federal government rightly exercises the right to regulate lawyers in those areas because all the areas involve matters on which the government's power to legislate and regulate are beyond question, just as it is in securities law. There is no basis for singling out the securities bar, among all lawyers engaged in federal practice areas, as being entitled to immunity from federal regulation. In the past, even before the Commission had a specific legislative mandate to regulate the conduct of lawyers appearing or practicing before it, similar arguments against the Commission's discipline of lawyers were rejected by federal courts.²⁷³

3. *The Irrelevance of Federalism Concerns*

Why do many lawyers argue for state regulation of the securities bar, an approach that would involve differing standards and multiple regulatory bodies—an outcome that would be a nightmare for multi-state and multi-national law firms? To speak plainly, bar organizations are not arguing for state or self-regulation in lieu of federal rules—because those are not the choices. They are arguing for no effective regulation of corporate lawyers handling complex securities-related matters versus effective regulation. Viewed in that light, the pleas of some segments of the bar are understandable. Everyone would prefer being free of the law's grasp, although that argument is fraught with irony in the mouths of lawyers and distressing in demonstrating how little faith in law those dedicated to it are willing to display.

The choices are no regulation versus regulation for two reasons. First, the ABA and other voluntary associations of lawyers have no power

authority to regulate attorneys and proposing grant of authority to regulate lawyers to Office of Government Ethics).

269. See BERNARD WOLFMAN, JAMES P. HOLDEN & KENNETH L. HARRIS, STANDARDS OF TAX PRACTICE: PROFESSIONAL RESPONSIBILITY AND ETHICS (CCH 1991).

270. See Lawrence G. Baxter, *Reforming Legal Ethics in a Regulated Environment: An Introductory Overview*, 8 GEO. J. LEGAL ETHICS 181 (1995) (examining how lawyer conduct should be evaluated and controlled within regulatory sphere).

271. See 35 U.S.C. §§ 31-33 (1994) (governing practice before Patent Office); see also 5 U.S.C. § 500e (1999) (excepting patent lawyer from general statute permitting lawyer admitted by any state to practice before U.S. administrative agencies).

272. Practice before bankruptcy courts is governed by federal bankruptcy court rules and the federal bankruptcy statute.

273. See, e.g., *Checkosky v. SEC*, 23 F.3d 452 (D.C. Cir. 1994); *Davy v. SEC*, 792 F.2d 1418, 1421 (9th Cir. 1986); *Touche Ross & Co. v. SEC*, 609 F.2d 570 (2d Cir. 1979). These decisions uphold the SEC's power to promulgate a rule, now Rule 102(e), providing for discipline of accountants and lawyers.

to regulate anyone. Notwithstanding complaints about the bar's independence from the government, the states are empowered to regulate the bar using rules, procedures and proceedings promulgated or supervised by the highest court in each state (with some state legislative participation in a few states). Second, the states have never made any effort to regulate the securities bar and are unlikely to do so in the future.²⁷⁴ This is not because they are unconcerned with lawyer misconduct or the securities laws but because bar counsel's offices lack (and will continue to lack) the expertise, resources and political clout to take on a major law firm for misconduct connected to that firm's securities practice. We are experts in this field and none of us knows of a single instance in which bar counsel has successfully prosecuted (or even brought charges against) a major law firm relating to securities law practice.

This absence of state enforcement cannot be attributed to an absence of evidence of serious misconduct by securities lawyers in major law firms. Published cases relying on internal memoranda and testimony of lawyers within a firm provide compelling evidence of misconduct connected to securities work at a substantial number of successful and venerable law firms. The bulk of lawyers in those firms and elsewhere are decent, dedicated and highly competent attorneys. Nevertheless, solid evidence exists that lawyers within many firms at one time or another did things that in any effective regulatory regime would, at a minimum, justify the filing of charges. Yet there has been nothing in the way of formal state proceedings.

We are not blaming the state courts, which do not control state funding of the state's legal system. Bar counsel's offices do not usually pay enough to attract and keep lawyers with securities expertise, and lawyers are unwilling to support the increases in bar dues that would finance higher pay and larger staffs.²⁷⁵ Moreover, unlike the SEC, which also needs more funds to attract and retain top-notch securities lawyers, bar counsel employment does not offer as promising a route to a prestigious career in private practice following government service. Lawyers with considerable expertise in securities law would be required to prosecute disci-

274. See Speech by SEC Chairman: Remarks Before the Annual Meeting of the American Bar Association's Business Law Section, Securities and Exchange Commission (Aug. 12, 2002), at <http://www.sec.gov/news/speech/spch579.htm>. Harvey L. Pitt, then SEC Chairman, in a speech to the ABA Section of Business Law, stated that ethics referrals that the SEC had made to state disciplinary bodies had not resulted in lawyer discipline; see also *supra* note 263 (comments by Senator Enzi) (stating that state regulation is insufficient and often goes unenforced).

275. See HAZARD, KONIAK & CRAMTON, *supra* note 216, at 934-37 (discussing limited funding of state disciplinary bodies and factors that limit its effectiveness). Discipline is primarily applied to serious intentional violations of ethics rules that cause harm to clients (e.g., stealing client's money), and disciplinary proceedings "are rarely directed at practitioners from mainstream firms and organizations." Deborah L. Rhode, *Institutionalizing Ethics*, 44 CASE W. RES. L. REV. 665, 696 (1994) (finding that state agencies have grossly inadequate resources, and that the public is not protected, nor lawyers punished).

plinary violations involving lawyer conduct in connection with complex corporate fraud situations, and such lawyers are lacking in bar counsel offices. The attorneys they would be prosecuting would almost always be from large law firms that have such expertise, not to mention the money and the incentive to fight such charges tooth and nail. Hiring outside counsel to bring disciplinary charges is not a viable option. Contingency fee arrangements are not and should not be available to tempt such lawyers to take those assignments. Ethical and legal prohibitions constrain public prosecutors, even in disciplinary as opposed to criminal proceedings, from working for personal profit.²⁷⁶

It is unrealistic to suggest that bar counsels' offices will suddenly be transformed—infused with enough cash and prestige—to do the regulatory job that the ABA and some state judges would have the Commission leave entirely to the states. Nor does Section 307 permit that approach: the statutory mandate says that “rules” must be promulgated, “including,” not “limited to,” the up-the-ladder rule embodied in the legislation itself. The choice is regulation by the Commission or no effective regulation. The Commission's duty under Section 307 is to adopt appropriate “rules” to protect investors and in the public interest. The Commission's mandate neither assumes nor allows the Commission to yield to state regulatory regimes that have not and cannot do the job.

4. *Does Section 205.3(d)(2) in Fact Preempt State Law?*

Even if the SEC had general authority to promulgate rules preempting state law, it is a separate question whether the SEC in fact promulgated rules with preemptive effect. In particular, does the permissive disclosure rule in Section 205.3(d)(2) have such preemptive effect? We think the SEC did promulgate rules with preemptive effect, and that Section 205.3(d)(2) has as much preemptive effect as the other rules.

The SEC rules include two specific provisions directed at preemption. The very first rule, Section 205.1, states: “Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices *conflict* with this part, this part shall govern.”²⁷⁷ Similarly, one of the last rules, Section 205.6(c), states: “An attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under *inconsistent* standards imposed by any state or other United States jurisdiction where the attorney is admitted or practices.”²⁷⁸ The question, then, is whether an SEC rule that permits, but does not require, disclosure, “conflicts” or is “inconsistent” with state standards that prohibit or restrict disclosure. If “conflicts” or “inconsistent” means that it

276. *See, e.g.,* Young v. United States *ex rel.* Vuitton et Fils S.A., 481 U.S. 787 (1987) (holding that appointment of lawyers who represented plaintiffs in private action from which this contempt prosecution emerged was improper because of their self-interest in matter).

277. 17 C.F.R. § 205.1 (2004) (emphasis added).

278. *Id.* § 205.6(c) (emphasis added).

is not possible for the lawyer to comply with both the SEC and state standard, then Section 205.3(d)(2) does not conflict with state law, because a lawyer can comply with both the SEC and state standards by not disclosing. On the other hand, if "conflicts" or "inconsistent" means that the SEC rules displace any state standards whose enforcement would frustrate the SEC's goals in its rules, then the SEC's permissive disclosure rule preempts state rules prohibiting disclosure in the sense that no state could discipline a lawyer for disclosing what the SEC rules permit. The first meaning of "conflict" corresponds to what the courts have called the "physical impossibility" version of conflict preemption. The second meaning corresponds to what courts have called "obstacle preemption." Most courts recognize obstacle preemption as sufficient, though the concept has its critics.²⁷⁹ So as long as the SEC intended, in using the words "conflicts" and "inconsistent" to incorporate the preemption case law understanding of these terms, Section 205.3(d)(2) should have preemptive effect.

The strongest argument in favor of the "obstacle" interpretation of Sections 205.1 and 205.6(c) is to look at the purpose of Section 205.3(d)(2), the permissive disclosure rule. The key point is that the SEC rules contain no general rule of confidentiality or prohibited disclosure, comparable to Model Rule 1.6, to which Section 205.3(d)(2) is an exception. For example, if a lawyer makes a disclosure under Section 205.3(d)(2) that he does not "reasonably believe necessary," the lawyer does not, in our view, violate the SEC rules (though he would lose any preemptive protection against state discipline or liability). The question then is what possible purpose a permissive disclosure rule could have? It is not possible for a lawyer to violate such a rule by failing to disclose any more than it is possible to violate the rule (for purposes of SEC discipline) by disclosing. Therefore, the only possible purpose of the SEC in adopting a permissive disclosure rule is to preempt state law that prohibits disclosure in situations in which Section 205.3(d)(2) permits disclosure, thus enabling lawyers to avoid aiding and abetting material violations of issuers and encouraging compliance, consistent with the goals of Section 307.²⁸⁰

279. See generally, e.g., Nelson, *supra* note 252.

280. In several recent cases, courts have concluded that California's recently enacted ethics standards for arbitrators are preempted by NASD's arbitration procedures authorized by the SEC under the Securities Exchange Act of 1934, in part on "obstacle preemption" grounds. See *Mayo v. Dean Witter Reynolds, Inc.*, 258 F. Supp. 2d 1097 (N.D. Cal. 2003); *Jevne v. Superior Court*, 113 Cal. App. 4th 486 (2003). The cases provide an example of SEC rules preempting state ethics provisions, with both courts deferring to the SEC's views on whether such obstacles exist. On the other hand, the cases are distinguishable on two grounds from the preemption issue here. First, the cases rely on "physical impossibility" conflicts as well as "obstacle preemption." Second, the state ethics rules were relative newcomers; it was the federal regulation of arbitration that was the established practice.

5. *The SEC and the State Bars Square Off*

a. Round One: The Washington State Bar Interim Opinion

Despite these strong arguments that Section 205.3(d)(2) preempts state ethics rules prohibiting or restricting disclosure, two state bars expressed contrary opinions in 2003. The Washington State Bar fired the first shot on July 26, 2003 by publishing an "Interim" Formal Ethics Opinion entitled "The Effect of the SEC's Sarbanes-Oxley Regulations on Washington Attorneys' Obligations under the RPCs."²⁸¹ The reason for the unusual "interim" designation of the opinion, as explained in a footnote, was "the lack of case law about the extent to which the SEC Regulations addressed in this opinion pre-empt state ethics rules and [the fact that] . . . a WSBA committee is considering changes to RPC 1.6."²⁸²

The real question, however, is why, given the reasons cited by the Washington State Bar, it felt compelled to issue an interim opinion at all.²⁸³ The question is all the more puzzling because Washington's version of Rule 1.6 does not absolutely prohibit disclosure in the case of corporate fraud, but rather allows a lawyer to "reveal such confidences or secrets to the extent the lawyer reasonably believes necessary to prevent the client from committing a crime."²⁸⁴ Of course, as the opinion pointed out, the disclosure permitted by Section 205.3(d)(2) is broader because it includes civil wrongs not also criminal (though violations of the securities laws are often subject to criminal and civil sanctions) as well as rectification of past wrongs.

The opinion begins by boldly stating its conclusion: "It is the opinion of the Board that, to the extent that this SEC regulation [Section 205.3(d)(2)] authorizes but does not require revelation of client's confidences and secrets, the Washington lawyer cannot reveal such confidences and secrets unless authorized to do so under the Washington RPCs."²⁸⁵ How does it reach this conclusion? Not by considering the law of preemption, because that would require the Board to opine on a question of law rather than ethics, which it is not authorized to do. But if the Board did not think it appropriate to consider the law of preemption, it would seem that the whole ethics opinion is a waste of time.

Not wanting to concede its irrelevance to the question it poses, the opinion goes on to discuss the two preemption sections of the SEC rules, Sections 205.1 and 205.6(c). The opinion states that there is no need to consider Section 205.1 because there is no conflict between Section

281. See Wash. State Bar Ass'n Board of Governors, Interim Formal Ethics Op. (July 26, 2003) [hereinafter Interim Formal Ethics Opinion] (discussing effect of SEC's Sarbanes-Oxley regulations on Washington attorneys' obligations under rules of professional conduct).

282. *Id.* at 1 n.1.

283. See *id.*

284. *Id.*; see also WASH. RULES PROF'L CONDUCT R. 1.6(b)(1) (1990).

285. Interim Formal Ethics Opinion, *supra* note 281, at 5.

205.3(d)(2) and Washington's Rule 1.6: a lawyer can comply with both by not disclosing. How the opinion concludes that there is no conflict without "considering" and interpreting the term "conflict" in Section 205.1, thus opining on a question of law (no such concept appearing anywhere in the ethics rules), is nowhere explained in the opinion.²⁸⁶ Not content with this illegitimate assertion of authority to decide legal questions, the opinion goes on to state, in an ironic show of restraint, that "the Board does not at this time reach the question of whether, if there were such a conflict, the SEC laws or regulations would be deemed to have pre-empted the field, such that Section 205 would govern over a Washington RPC to the contrary."²⁸⁷

In the bar's view, a "conflict" already exists between its vision of the primacy of the ethics rules, in particular the rule of confidentiality, and the illegitimate encroachment by the SEC. The bar's resolution of this conflict is to assert its own authority until forced to bow to state power. Thus, the opinion states: "Though the Board recognizes the possibility that Section 205 may ultimately be interpreted as preempting Washington law, a cautious attorney should refrain from making any disclosures in violation of the Washington RPCs until this issue is resolved by the courts."²⁸⁸ The opinion thus fires a clear warning shot to lawyers appearing and practicing before the SEC, saying in effect, "Don't even think about disclosing; we won't hesitate to come after you."

One might think that lawyers would ignore such blustery warnings by the bar. After all, Section 205.6(c) protects a lawyer from discipline if the lawyer "complies in good faith" with Section 205.3(d)(2).²⁸⁹ Yet the Washington State Bar opinion asserts otherwise. It opines on another question of law—the meaning of "good faith" and "complies" under Section 205.3(d)(2).²⁹⁰ While the opinion's interpretation of "conflict" at least had some basis in case law, albeit uncited and not controlling, these interpretations have no basis in anything other than the opinion authors' vivid imaginations. With respect to "good faith," the opinion states:

As a general matter and with the current lack of case law on the pre-emption issue, a Washington attorney cannot . . . fairly claim to be complying in "good faith" with the SEC Regulations, as that

286. For an explanation of this phenomenon, see Susan P. Koniak, *The Law Between the Bar and the State*, 70 N.C. L. REV. 1389 (1992) (analyzing connection between law as upheld by state and ethics codes and "law" maintained by legal profession, and concluding that legal profession's "law" has large influence on lawyers despite ultimate authority of state's law).

287. Simon, *supra* note 251 (referring, somewhat generously, to this statement as "cryptic").

288. Interim Formal Ethics Opinion, *supra* note 281, at 6.

289. See 17 C.F.R. § 205.6 (c) (2004) (protecting lawyer acting in "good faith"); *id.* § 205.3(d)(2) (authorizing disclosure of confidential information).

290. See Interim Formal Ethics Opinion, *supra* note 281, at 6-7.

term is used in Section 205.6(c) of the Regulations, if (s)he took an action that was contrary to this Formal Opinion.²⁹¹

This is a Humpty-Dumpty interpretation of “good faith.” A provision that is clearly intended to preempt state law is instead interpreted as deferring to it. To suggest the SEC intended this rule to preserve the ability of state rules to punish conduct the SEC permits is absurd because it nullifies the very purpose of the permissive rule.

Even more bizarrely, the opinion concludes that the use of the term “complies” in Section 205.6(c) “means that the good faith defense applies only to those provisions which are mandatory in nature and not to discretionary disclosures.”²⁹² This interpretation of “complies” is nonsensical and appears nowhere else in law to the best of our knowledge. In normal usage, people “comply” with non-mandatory laws all the time. For example, getting a driver’s license is not mandatory, but if one wants to get one, one must “comply” with the requirements. Section 205.3(d)(2) sets forth requirements for permissive disclosure.²⁹³ A lawyer who seeks the safe harbor of Section 205.6(c) against state discipline and liability will want to conform his behavior to those requirements. This activity is “complying” in the normal sense of the word. Put another way, one “complies” by seeking the benefits conferred by a permissive rule just as much as by avoiding the costs imposed by a mandatory, prohibitionist rule. Moreover, the phrase in Section 205.6(c) is “complies in good faith with the provisions of this part.”²⁹⁴ This language suggests no limitation to mandatory provisions.

b. Round Two: The Response from the SEC

Before the Washington State Bar Interim Opinion was published, the SEC, through its general counsel, wrote a letter in an ultimately unsuccessful attempt to persuade the Washington State Bar not to go forward with its opinion.²⁹⁵ The brief letter essentially made three points. First, the SEC letter argued that Section 205.3(d)(2) preempts Washington RPC 1.6 to the extent it permits disclosures that 1.6 forbids, and that the Washington State Bar’s argument to the contrary contravened prevailing Supreme Court opinions.²⁹⁶ Second, the letter argued that the meaning of good

291. *Id.* at 1.

292. *Id.* at 7.

293. *See* 17 C.F.R. § 205.3(d)(2).

294. *Id.* § 205.6(c) (looking at plain language section).

295. *See* Letter from Giovanni P. Prezioso, General Counsel, U.S. Securities and Exchange Commission, to J. Richard Manning, President, Washington State Bar Association (July 23, 2003), *available at* <http://www.sec.gov/news/speech/spch072303gpp.htm> [hereinafter Prezioso Letter] (addressing Interim Formal Ethics Opinion).

296. *See id.* (stating “the Proposed Interim Formal Opinion is inconsistent with prevailing Supreme Court precedent”). The letter explains that the Court “has consistently upheld the authority of federal agencies to implement rules of

faith compliance under Section 205.6(c) is a question of federal law in which the SEC's views must be given deference and preempt inconsistent state interpretations.²⁹⁷ Finally, in a thinly veiled and unclear threat, the letter concluded that even the initiation of disciplinary proceedings against a lawyer who in good faith complied with the SEC rules even though the lawyer's conduct violates state ethics rules would "frustrate" the SEC rules and "thwart" their purposes.²⁹⁸

c. Round Three: The California Bar Committee's Retort

Several weeks later on August 13, 2003, the California State Bar Business Law Section jumped into the fray via its Corporations Committee. The California Bar Committee wrote a response letter to the SEC taking issue with the SEC's views on preemption.²⁹⁹ Unlike Washington, California is one of the few jurisdictions with an ethics rule that prohibits all disclosure in cases of corporate fraud.³⁰⁰ The California Bar Committee

conduct that diverge from and supersede state laws that address the same conduct." See *id.* (citing *Sperry v. State Bar of Fla.*, 373 U.S. 379 (1963)). More relevant to the Washington State Bar's argument, the letter cites *Fidelity Federal Savings & Loan Ass'n v. de la Cuesta*, 458 U.S. 141, 155 (1982), for the proposition that if "a conflict arises because a state rule prohibits an attorney from exercising the discretion provided by a federal regulation, the federal regulation will take priority," even if the regulation simply permits what state law prohibits. See *id.* (supporting argument with case law). Although the SEC letter does not specifically refer to obstacle preemption, *Fidelity Federal* relies on this doctrine in finding a conflict. 458 U.S. at 156.

297. See Prezioso Letter, *supra* note 295 (citing *Barnhart v. Walton*, 535 U.S. 212 (2002); *United States v. Locke*, 529 U.S. 108, 110 (2000); and *City of New York v. FCC*, 486 U.S. 57, 64 (1989)).

298. See *id.* (questioning remedy). Perhaps the SEC could bring an injunction action to prevent a state from pursuing discipline against a lawyer. Section 205.7(b) gives the SEC "[a]uthority to enforce compliance with this part," but the only sanctions referred to in Section 205.6 are sanctions against lawyers appearing and practicing before the SEC. See 17 C.F.R. §§ 205.7(b), 205.6 (2004).

299. See Letter from Keith Paul Bishop & Bruce Dravis, Co-Chairs of the Corporations Committee, Business Law Section, The State Bar of California, to Giovanni P. Prezioso, General Counsel, U.S. Securities and Exchange Commission (Aug. 13, 2003) [hereinafter *State Bar of California Letter*] (on file with *Villanova Law Review*).

300. See CAL. BUS. & PROF. CODE § 6068(e) (2004) (stating that attorneys have duty to "maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client"); see also RULES OF PROF'L CONDUCT OF THE STATE BAR OF CAL. R. 3-600(B) (providing rule for "Organization as Client"). Rule 3-600(B) states:

If a member acting on behalf of an organization knows that an actual or apparent agent of the organization acts or intends or refuses to act in a manner that is or may be a violation of law reasonably imputable to the organization, or in a manner which is likely to result in substantial injury to the organization, the member shall not violate his or her duty of protecting all confidential information as provided in Business and Professions Code Section 6068, subdivision (e).

Id. The former version of Model Rule 1.13(b), unlike California's Rule 3-600(B), did not deal with disclosure outside the organization, but left that issue to other

letter warned that a California lawyer who relied on the SEC's assertions of preemption risked harm to their clients and themselves because the courts could disagree with the SEC's position.³⁰¹ The alleged harm to the client would come from the risk of waiver of the attorney-client privilege through "selective disclosure" to the SEC.³⁰² The potential harm to lawyers would be discipline or liability for disclosing client confidences because, unlike the SEC rules, California law contains no "good faith" exception.³⁰³ In fact, the California Bar Committee stated that "[a]n attorney faced with choosing between potentially irreparable harm to a client's interests arising from disclosure of a confidence or the cost of a good faith, well founded objection to the SEC's rules is virtually duty-bound to select the latter."³⁰⁴ The whole basis for this position rests on the assertion that there is a real risk that courts will not find preemption.

The California Bar Committee letter grounds this assertion in the potential claim that the SEC lacked authority to adopt Section 205.3(d)(2) or Section 205.6(c).³⁰⁵ But the arguments the letter marshals in support of this claim are remarkably weak. The letter boldly asserts that "there is no evidence of Congressional intent to preempt state ethics rules," without attempting to examine any of the evidence we discuss above, based on the language of the statute and the legislative history.³⁰⁶ The letter does knock down a few straw man arguments, such as the fact that the "refer-

rules (e.g., Rules 1.6, 3.3 and 4.1). Compare MODEL RULES 1983, *supra* note 11, R. 1.13(b), with RULES OF PROF'L CONDUCT OF THE STATE BAR OF CAL. R. 3-600(B).

301. See State Bar of California Letter, *supra* note 299.

302. See *id.* at 5 n.5. Although the letter noted the SEC's own concern with "selective waiver," the "selective waiver" problem that the SEC is concerned with involves the situation in which a company wants to waive the privilege for information that is clearly protected by the attorney-client privilege as part of cooperating with the government.

303. See *id.* at 5.

304. See *id.* at 6.

305. See *id.* The letter accurately stated that the SEC only has the authority to adopt regulations to carry out the will of Congress as expressed by the statute. It is also true, as the letter states, that courts have on occasion struck down SEC rulemaking for lack of authority. See *id.* Interestingly, the case cited is *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990), in which the SEC had adopted a rule (Rule 19c-4) purporting to regulate shareholder voting requirements (a corporate governance rule requiring one share/one vote). The court vacated the rule because it found that the rule did not further the main purpose of the securities laws, namely disclosure. See *Bus. Roundtable*, 905 F.2d at 417 (vacating rule). Thus, this case is an odd one to cite in support of a position that an SEC rule lacks authority because it permits disclosure. An equally odd citation, made in the letter for the proposition that the SEC lacks "the power to preempt validly adopted regulations of a sovereign state," is *Louisiana Public Service Commission v. FCC*, 476 U.S. 355, 374 (1986). See State Bar of California Letter, *supra* note 299, at 6 (questioning SEC authority to preempt adopted regulation). The statute in *Louisiana Public Service Commission* specifically carved out a role for state regulation with respect to intrastate matters, unlike Section 307, which is designed to redress dissatisfaction with state regulation.

306. See State Bar of California Letter, *supra* note 299, at 6.

ences in Section 307 to 'public interest' and 'protection of investors' are simply too general to evidence any actual intent by Congress to empower the SEC to adopt rules allowing attorneys to divulge client confidences and establish immunity for those who do."³⁰⁷ But of course these are not the only possible phrases in Section 307 that could be relevant. As argued above, the very specific reference in Section 307 to reporting up rules that are designedly more stringent than the extant version of Model Rule 1.13 is strong evidence of preemptive intent, and permissive disclosure fits comfortably within "minimum standards of conduct" that already exist in numerous states, besides being consistent with the disclosure thrust of the securities laws. In addition, the letter argues that the statutes *other* than Section 307 cited by the SEC in support of its rules "do not appear to address Congressional intent to invest the SEC with broad authority to permit lawyers to disclose client secrets and then immunize or otherwise protect those lawyers who do."³⁰⁸ True enough, but again not responsive to the affirmative case we have made.

The letter also draws distinctions between Section 307 and two other statutory provisions. First, the letter distinguishes Section 301 of the Private Securities Litigation Reform Act, which "specifically requires a registered public accounting firm to report to the SEC in specific circumstances."³⁰⁹ Section 205.3(d)(2), however, does not require a lawyer to report to the SEC, or even permit the lawyer to report to the SEC as a general matter.³¹⁰ It permits lawyers to disclose information reasonably believed necessary to prevent or rectify a material violation of law. Continuing the same vein, the letter argues that the Sarbanes-Oxley Act itself "established a comprehensive regulatory scheme for that segment of the accounting profession that deals with issuers, [whereas] the grant of authority to the SEC under Section 307 was limited to 'setting forth minimum standards' for attorneys practicing before it."³¹¹ But in what sense is Section 307 "limited"? Perhaps the California Bar Committee is attempting to read "minimum standards" to mean "*minimal* standards," a reading which in our view has no support in ordinary usage or common sense. The most natural reading of "minimum standards" is "standards that an attorney who wishes to appear and practice before the SEC must meet," not "the SEC should adopt as few rules as possible" or "the SEC should adopt rules that infringe as little as possible on a lawyer's obligations under state law."³¹²

307. *Id.* at n.9.

308. *Id.* at 6.

309. *Id.* at n.9.

310. See 17 C.F.R. 205.3(d)(2) (2004).

311. State Bar of California Letter, *supra* note 299, at n.9.

312. A better argument for the California Bar Committee is that Section 205.3(d)(2) is not a "minimum standard" because it does not require a lawyer to do, or refrain from doing, anything. This may also be what the Washington State Bar was really trying to get at in its discussion of "good faith compliance." Although we believe this argument is stronger, we still do not find it persuasive. One

Next, the California Bar Committee letter seeks to distinguish *Sperry v. State of Florida*,³¹³ which the SEC letter relied on for the proposition that the "Court 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."³¹⁴ In *Sperry*, the Supreme Court vacated, on preemption grounds, an injunction obtained by the State of Florida against a nonlawyer for the unauthorized practice of law before the U.S. Patent Office.³¹⁵

The California Bar Committee letter says *Sperry* is distinguishable in three ways. First, "the power of Congress to establish a patent office is expressly set forth in the United States Constitution," whereas the SEC's rules "do not emanate from authority expressly vested in Congress by the U.S. Constitution."³¹⁶ This distinction is astonishing. Does the California Bar Committee mean to suggest that the SEC is unconstitutional because it is not specifically mentioned in the Constitution? Or is the California Bar Committee "merely" suggesting that patent office rules have more preemptive effect simply because the Constitution contains a patent clause? No Supreme Court case even remotely suggested such a standard.

The second distinction is that "Congress expressly granted the Commissioner of Patents the authority to prescribe regulations, among other things, recognizing agents or other persons before the Patent Office," whereas the "statutory authority cited by the SEC . . . evidences no clear intent by Congress to supercede state laws and ethical rules."³¹⁷ Something seems to have been lost in the parallelism here. Does not Section 307 expressly grant, indeed require, the SEC to prescribe regulations concerning attorneys who appear and practice before the SEC? If so, how exactly is Section 307 distinguishable from the patent statute?

of the benefits of Section 205.3(d)(2) is that it allows lawyers a means of avoiding aiding-and-abetting liability under the securities laws. Compliance with the general requirements of the securities laws would, in our view, count as a "minimum standard," though it is not one specifically mentioned in the SEC rules. As we argued in our comments to the SEC, the rules should have made clear that they do not displace the general obligation under the securities laws not to engage in aiding-and-abetting violations. For a further discussion of the "safe harbor" provision, see *supra* note 147 and accompanying text.

313. 373 U.S. 379 (1963).

314. See Prezioso Letter, *supra* note 295 (using *Sperry v. State Bar of Florida*, 373 U.S. 379 (1963), to support SEC proposition).

315. See *Sperry*, 373 U.S. at 404 (vacating state court order enjoining petitioner, who was registered to practice before U.S. Patent Office, but not admitted to practice law before Florida's or any other bar, because it prohibited him from "performing tasks . . . incident to the preparation and prosecution of patent applications before the Patent Office").

316. See State Bar of California Letter, *supra* note 299, at 7 n.12 (quoting U.S. CONST. art. I, § 8, cl. 8: "Congress shall have the power . . . [t]o promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries").

317. *Id.* (citing 25 U.S.C. § 31, which was subsequently repealed).

The third distinction from *Sperry* is that “the practice by lay patent agents was long-standing at the time that Congress considered the statute,” whereas “the SEC’s rules represent a radical change from historical patterns of state regulation of attorneys.”³¹⁸ As previously discussed, however, given Rule 102(e) as well as other federal statutes already authorizing the regulation of lawyers practicing before federal agencies, the change effected by Section 307 was not so radical. Moreover, the whole point of Section 307 was to redress inadequate state regulation.³¹⁹

Finally, the California Bar Committee letter neatly overlooks the fact that the long-standing practice that supported the preemption in *Sperry* was actually *inconsistent* with the state bar’s having monopoly control over the regulation of the practice of law.

The California Bar Committee letter then responds to the SEC letter’s argument that the states owe deference to the SEC’s interpretation of “good faith” in Section 205.6(c). Recall that the SEC letter made this point to rebut the Washington State Bar’s novel construction of “good faith compliance” with the SEC rules to mean in fact compliance with the state’s ethics rules. But, says the California Bar Committee:

[T]he Committee expects that in specific cases, the question of whether an attorney acted in good faith will involve determinations of questions of fact as well as law. It is unclear to the Committee whether the SEC contemplates that it will make these factual findings in each case of voluntary disclosure by an attorney. In the absence of any SEC determination that the attorney acted in good faith, no conflict exists with a state determination.³²⁰

318. *Id.*

319. The California State Bar letter also cites several cases relevant to this point, one of which deserves special mention. *Santa Fe Industries v. Green*, 430 U.S. 462 (1977), is cited for the proposition that the SEC has no authority to preempt state law in traditional areas. *See Santa Fe Indus.*, 430 U.S. at 462. The letter quotes *Santa Fe Industries*: “[a]bsent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden.” *See id.* at 479. In *Santa Fe Industries*, the Court held that Section 10(b) of the Securities Act and Rule 10b-5 could not be interpreted to cover claims of breach of fiduciary duty involving only internal corporate mismanagement. *See id.* at 479 (reversing lower court). The Court indeed had reason to worry that a contrary ruling would “federalize [a] substantial portion of the law of corporations” traditionally regulated by states. Section 307, by contrast, specifically directs the SEC to create federal rules in part because state regulation has proved inadequate. Moreover, Section 307 modifies the underlying premise of *Santa Fe*, by specifically including breaches of fiduciary duty (i.e., state law violations) within its ambit.

320. State Bar of California Letter, *supra* note 299, at 7. The California State Bar then went on to assert that “[t]he Administrative Procedure Act requires a reviewing court to hold unlawful and set aside any agency action that is in excess of its authority.” *Id.*

We agree that questions of fact may be involved in determining whether a lawyer acted in good faith, and that the SEC will not make these factual findings in state proceedings. We fail to see, however, how that point is at all responsive to the SEC's argument that its construction of good faith is entitled to deference. The Washington State Bar Interim Opinion was not making a factual determination in offering its construction of good faith. Thus, the last sentence in the quotation above is a complete non sequitur.

The California Bar Committee letter's final substantive point is that the State Bar of California has no power, under California law, to refuse to enforce California statutes on the basis of federal preemption unless an appellate court has so ruled. The California Constitution, Article III, Section 3.5 states: "An administrative agency . . . has no power . . . (c) To . . . refuse to *enforce a statute* on the basis that federal law or federal regulations prohibit the enforcement of such statute unless an appellate court has made a determination that the enforcement of such statute is prohibited by federal law or federal regulation."³²¹ This point has merit, though of course it is separate from the merits of the preemption claim. California has a State Bar Court, created by a 1988 statute and funded exclusively by members of the state bar. The State Bar Court acts as an arm of the California Supreme Court in deciding all disciplinary cases. It enforces not only California's ethics rules but also its Business and Professional Code, which contains Section 6068(e), the confidentiality rule. The State Bar Court has the power to suspend or permanently ban lawyers from practicing law, but the attorney may appeal to the California Supreme Court. Thus, if a California lawyer disclosed confidential client information and the California Bar sought to discipline him, the lawyer would not be able to argue successfully a preemption defense in the State Bar Court unless an appellate court had ruled on the question. Nevertheless, the lawyer would be able to raise the defense on appeal.

California lawyers are therefore at some risk if they seek to take advantage of Section 205.6(c). The question then is whether there are any ways of reducing that risk. For example, it is not clear how the California constitutional provision handles the issue of prosecutorial discretion. If the California Bar chooses not to discipline a lawyer for disclosing, does it violate the constitutional provision? What if the discretion not to discipline is based partly on preemption concerns and partly on other reasons? In addition, it is possible that procedural devices, such as a declaratory judgment action in advance or an injunction action in the event of threatened disciplinary action, could be used to protect a lawyer from discipline and establish the requisite appellate ruling on preemption.³²² Unfortunately, but not surprisingly, the California Bar Committee letter does

321. CAL. CONST. art. III, § 3.5 (emphasis added).

322. See Simon, *supra* note 251 (arguing that Washington State Bar, rather than threatening lawyers in its interim opinion, should bring declaratory judgment action to resolve preemption question).

not address these questions. Its interest is not in protecting its members who choose to disclose in good faith compliance with the SEC rules, but in deterring such disclosure.

d. Let's Get Real

This is where things stand at the moment of this writing: an unresolved and unsatisfactory state. We believe the SEC's position on preemption is strong and likely to prevail in the courts. We cannot help but note, however, that this debate has an air of unreality to it. In reality, few if any lawyers will exercise discretion to disclose material violations outside the corporation, despite Section 205.3(d), regardless of what state ethics rules say and regardless of the likelihood of preemption. We believe it is equally true, however, that in the event some lawyer did decide to disclose, it would be very unlikely that the lawyer would be disciplined for doing so.

So what is really going on? What we are seeing is a vivid example of the bar demonstrating its commitment to its vision of lawyering, in which the duty of confidentiality takes center stage, and any law of the state that seeks to diminish or interfere with that duty is trumped, deemed invalid, marginalized and disparaged. In adopting Section 205.3(d), the SEC put itself in something of a bind, because it cannot enforce the provision directly except in its own proceedings. Rather, enforcement of the provision depends crucially on the "good faith" of the bar disciplinary authorities. As we have seen, the bar is not likely to capitulate without a fight. Unwittingly, perhaps, the actions and arguments of the state bars have provided the strongest demonstration of why Section 307 was necessary in the first place, and why the concerns we have expressed with the SEC's implementation rules are well grounded.

6. *State Rules That Go Further Than Those of the SEC*

A number of states already have ethics rules that require more of lawyers who practice before the SEC than do the SEC's rules, particularly in the areas of withdrawal and disclosure. In our initial comments to the SEC, we argued that those rules should not be preempted.³²³ The SEC responded by revising Section 205.1 to include the following statement: "These standards supplement applicable standards of any jurisdiction where an attorney is admitted or practices and are not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with the application of this part."³²⁴

The Commission has acted prudently in making it clear that states that require or permit more disclosure than that prescribed by the Commission's rules are not preempted by the Commission's more limited requirements. Preemption in this situation is not justified under Section 307 and is inconsistent with the broader regulatory regime set forth in

323. See Koniak, Cramton & Cohen Comments, *supra* note 128, at 6-10, 15-16.

324. 17 C.F.R. § 205.1 (2004).

Sarbanes-Oxley and federal securities legislation. Section 307 requires the Commission to adopt “minimum” standards to govern the conduct of securities lawyers, not “maximum” standards.

IV. “NOISY WITHDRAWAL”: REQUIRED DISCLOSURE OF WITHDRAWAL TO THE SEC

A. *Required Withdrawal and Disaffirmance of Tainted Opinions Under State Law*

This topic has been discussed in Part III.A. above. It is sufficient here to repeat a few fundamental matters.

First, all U.S. jurisdictions, we believe, require a lawyer to withdraw when the client demands that the lawyer knowingly assist conduct that is illegal or violates the rules of professional conduct or other law.³²⁵ The lawyer’s honest opinion that proposed conduct is illegal will almost always lead to conduct that is within the bounds of the law. Channeling client conduct along lawful paths is one of the principal purposes and benefits of legal representation and of the professional secrecy with which it is carried on. In the rare situation in which a client insists upon an illegal course of conduct, the lawyer must withdraw. Not doing so would aid and abet the illegality.

Second, in all jurisdictions the lawyer is free to give public notice of the fact of withdrawal; such notice is not a disclosure of information protected by the duty of confidentiality.³²⁶

Third, the ABA takes the position that, after withdrawal, a lawyer may withdraw opinions or representations that the lawyer made to third persons during the course of the representation when the lawyer reasonably believes that they are being relied upon by third persons and the lawyer comes to know that the opinions or representations contain materially inaccurate information or are being used to further a crime or fraud. An ABA formal opinion states that withdrawal of an opinion or representation, without more, does not reveal confidential information.³²⁷ The formal opinion also states that, under some circumstances, disaffirmance of

325. See MODEL RULES 2003, *supra* note 32, R. 1.2(d), 1.16(a); see also ABA Comm. on Ethics and Prof’l Responsibility, Formal Op. 92-366 (1992).

326. See MODEL RULES 2003, *supra* note 32, R. 1.6 cmt. 14; see also *id.* R. 1.16 cmt. 2.

327. See ABA Formal Op. No. 92-366 (1992). The majority in ABA Formal Op. No. 92-366 (1992) concluded that, even though Rule 1.6 prohibited a lawyer from disclosing a client’s prior fraud to anyone, the lawyer must withdraw and must “put [the defrauded party] on notice that something is wrong” by withdrawing the lawyer’s prior opinion, and that this duty applied after discharge or withdrawal. See MODEL RULES 2003, *supra* note 32, R. 1.6 cmt. 15 (including comment from 1983-2003, stating, “Neither this Rule nor Rule 1.8(b) nor Rule 1.16(d) 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”). This sentence creates an exception to Rule 1.6 that is not reflected in the text of the rule.

opinions or representations is required to avoid assisting the client's unlawful conduct. Such disclosure may be made in every jurisdiction when an investigation or proceeding involves an allegation that the lawyer engaged in misconduct during the representation, bringing the self-defense exception to confidentiality into play.

Fourth, all states, either by professional rule or judicial decision, permit disclosure of confidential information for certain purposes: to maintain the integrity and impartiality of adjudicative proceedings; to protect important interests of third persons and the public against illegal invasion; and to protect the lawyer's own interests in self-defense and fee collection. The vast majority of states require disclosure in some cases in the first situation, involving the integrity of the adjudicative process. Where a future financial fraud on third persons or the government is involved, the vast majority of states permit disclosure and a few states require it, but when only an unrectified past fraud is involved a substantial minority of states permit disclosure and a few require it.

Ongoing fraud, in which new crimes or frauds are being committed as investors, consumers or other third persons continue to be deceived by fraudulent past statements, is a situation that should be treated by a uniform national rule, especially when the securities markets are involved. Although state ethics rules have some commonality, the variations make no overall sense and a uniform national pattern is desirable when the application to public companies threatens the integrity of the national market in traded securities. A uniform federal position is desirable and necessary for the protection of investors.

B. *The SEC's Noisy Withdrawal Proposal*

1. *The Original Proposal: Reporting Out by the Issuer's Attorney*

Proposed Section 205.3(d)(1) requires an issuer's attorney, in the rare situation in which the attorney reasonably believes that: (1) an issuer has not made an appropriate response to the attorney's prior report of evidence of a material violation; and (2) "the material violation is ongoing or is about to occur and is likely to result in substantial injury to the financial interest or property of the issuer or of the investors."³²⁸

Commentators have criticized the ABA position that noisy withdrawal does not disclose information protected by the professional duty of confidentiality. New York, apparently concerned that the information inferentially disclosed by a notice of withdrawal of an opinion or representation may reveal protected information, includes a provision in its confidentiality rule permitting disclosure of the information implicit in withdrawing a tainted opinion or misrepresentation. See N.Y. CODE OF PROF'L. RESPONSIBILITY DR 4-101 § 1200.19(c)(5) (2003).

328. When the material violation is not ongoing or about to occur, Section 205.3(d)(2) permits, but does not require, the attorney to withdraw, notify the Commission and disaffirm any tainted opinions or representations. This provision is substantially the same as ABA Model Rules 1.6(b)(3), 1.13(c) and 1.16(b), as amended in August 2003.

[T]o withdraw forthwith from representing the issuer, indicating that the withdrawal is based on professional considerations; . . . promptly disaffirm to the Commission any opinion, document, affirmation, representation, characterization, or the like in a document filed with the Commission, or incorporated into such a document, that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading.³²⁹

As indicated earlier,³³⁰ the ethics rules adopted by most American states reach much the same result when viewed together. In the situation contemplated by the SEC's noisy withdrawal rule, Rule 1.16(a) requires the lawyer to withdraw and comments to Rules 1.2 and 4.1 state that public notice of that withdrawal may be required in some situations. In addition, the combined effect of ABA Model Rules 1.2(d), 1.16(a) and 4.1(b), when Rule 1.6(b)(3) permits disclosure to prevent or rectify a client crime or fraud in which the lawyer's services have been used, is to require the lawyer to correct the false misrepresentations on which third persons are continuing to rely (Rule 4.1(b)). Failure to do so would assist the prospective or ongoing client crime or fraud (1.2(d)).³³¹

Moreover, the fact that most U.S. jurisdictions conform to such a standard indicates that this requirement is a "minimum standard[] of professional conduct for attorneys" of the kind the SEC is required to promulgate "for attorneys appearing and practicing before the Commission in any way." In a situation involving "a [c]lient's ongoing criminal or fraudulent act," an attorney is required to reveal confidential information in forty-four jurisdictions, permitted to do so in three jurisdictions, must resign in one state and is prohibited from revealing confidential information relating to the representation in only three jurisdictions.³³²

The wording of the noisy withdrawal provision suggests that an outside attorney is required to withdraw from all representation of the issuer. Section 205.3(d)(1)(A) provides that "[a]n attorney retained by the issuer [an outside lawyer] shall withdraw from representing the issuer," whereas "[a]n attorney employed by the issuer [an inside lawyer] shall cease forthwith any participation or assistance in any matter concerning the violation."³³³ This may have harsh consequences on the issuer-client when a lawyer in a firm that handles the issuer's securities work is engaged in a transaction or litigation that is unrelated to the matter that has been reported. Consideration should be given to whether withdrawal

329. An attorney employed by the issuer (an "inside lawyer") is not required to resign from employment, but must stop working on the matter involved.

330. See *supra* Part II.A.2.

331. See *supra* Parts II.A.2 and IV.A.

332. See ALAS Memorandum, *supra* note 222.

333. See 17 C.F.R. § 205.3(d)(1)(A) (2004).

should be limited to matters that have a substantial relationship to the material violation.

2. *The Alternative Proposal: Reporting Out by the Issuer*

On January 29, 2003, when the Commission adopted its "reporting up" rule and permissive "reporting out," which are considered in Parts II and III of this Article, it also proposed an alternative to required noisy withdrawal which would require the issuer, rather than the reporting attorney, to notify the Commission of the reporting attorney's withdrawal and also report "the circumstances related thereto."³³⁴

Does a permission or requirement that the circumstances of withdrawal be reported infringe the attorney-client privilege? The attorney-client privilege applies only to communications between lawyers and clients. It does not privilege the underlying facts. Thus, the privilege allows a client (or its lawyer) to refuse to answer a question in this form: What did your lawyer tell you? Or, what did you tell your lawyer? The privilege does not, however, allow a client to refuse to answer questions about a matter simply because the matter was discussed between lawyer and client. That is what courts mean when they say that the privilege "does not protect disclosure of the underlying facts by those who communicated with the attorney."³³⁵

A request that the circumstances of withdrawal be revealed is similar to a discovery request for certain underlying facts. The SEC is not asking issuers to hand over its lawyer's written reports or summarize the oral advice the lawyer gave. The SEC is not asking issuers to describe the back-and-forth between lawyer and client on the matter that was the subject of the report. What the Commission wants from issuers is two things: one, a statement that the lawyer has resigned, whenever a resignation is required by Part 205; and two, a statement that the lawyer's resignation was in connection with the following matter, including a brief description of the matter, with no requirement that the issuer repeat or disclose any of what the lawyer actually said about the matter.

Does this disclosure threaten the attorney-client privilege because it amounts to requiring the issuer to make this implicit statement: "My lawyer said that there is evidence that a material violation of law occurred (is occurring or will occur) in connection with this matter"? We think not. Courts do not treat the privilege so lightly as to find waiver based on "implicit" references to lawyer-client communications.³³⁶ The *Restatement (Third) of the Law Governing Lawyers*, Section 79, Comment e, states:

334. See Implementation of Standards of Professional Conduct for Attorneys, Securities Exchange Act Release No. 33-8186, 68 Fed. Reg. 6824, 6824 n.40 (proposed Jan. 29, 2003) (discussing proposed Section 205.3(e)).

335. See, e.g., *Upjohn v. United States*, 449 U.S. 383, 395 (1981).

336. In general, client identity, the fact of consultation and fee payment are not protected by the attorney-client privilege or the professional duty of confidentiality. See RESTATEMENT, *supra* note 52, § 69 cmt. e. The disclosure by a lawyer of

Knowledge by the nonprivileged person that the client consulted a lawyer does not result in waiver, nor does disclosure of nonprivileged portions of a communication *or its general subject matter*. Public disclosure of facts that were discussed in confidence with a lawyer does not waive the privilege if the disclosure does not also reveal that they were communicated to the lawyer.³³⁷

The more general concern that a noisy withdrawal rule will undermine the attorney-client relationship because “our clients will not confide in us anymore” is a makeweight—rhetoric without substance. Why? The people who might be engaged in wrongdoing (e.g., corporate managers who are violating fiduciary duties to the issuer or engaging in law violations that will harm the issuer as well as investors) have no privilege now and no legitimate claim of confidentiality. The privilege and the duty to keep confidences belong to the entity, not the managers or the directors. Either can be waived by future managers or trustees in bankruptcy.³³⁸ Lawyers can disclose confidences in every state to defend themselves when necessary, even before the filing of actual charges or a complaint.³³⁹ Lawyers can disclose confidences to collect a fee, when necessary. The crime-fraud exception to the privilege leaves unprivileged all communications of the client or its agents made in furtherance of illegality. And in most states, lawyers are already permitted, and in some cases required, to disclose client fraud. With all these exceptions to confidentiality and the privilege extant, the idea that noisy withdrawal or the alternative’s “circumstances” provision would suddenly result in clients not talking to their lawyers is untenable.

Corporate clients (through their agents) confide in corporate lawyers (to the extent they do, which is now imperfect and always will be) because corporations need legal advice to carry on their businesses. Period. There is no evidence whatsoever that corporate clients have avoided lawyers in those few states that now *require* disclosure of a client illegality (e.g., New Jersey) or those jurisdictions that *permit* such disclosure (e.g., Penn-

the fact of representation or the general nature of the representation does not constitute a waiver of the privileged communications themselves. *See supra* Part II.A.3 (discussing general rule that lawyer’s disclosure of confidential information, adverse to client and without client’s consent, pursuant to ethics rule permitting or requiring disclosure, does not constitute waiver of privileged communication).

337. RESTATEMENT, *supra* note 52, § 79 cmt. e (emphasis added).

338. *See Commodities Futures Trading Comm’n v. Weintraub*, 471 U.S. 343, 349 (1985) (noting that when control of corporation passes to new management, so too does authority to raise or waive attorney-client privilege). The privilege belongs to the entity, not to individual officers and may be waived by the board of directors or a person authorized by the board to act for it. *See id.* The successor in interest of the entity, including the trustee of a bankrupt entity, may waive the privilege over the objections of its former or current officers. *See id.* at 354.

339. *See* RESTATEMENT, *supra* note 52, § 64 cmt. a (providing exception to general duty of confidentiality that “gives a lawyer limited permission to employ confidential client information to defend against a threatened accusation that the lawyer . . . acted wrongfully in the course of representing a client”).

sylvania), as distinct from the few that *prohibit* disclosure (e.g., District of Columbia). There is no evidence that lawyers in such states are told less than lawyers in other states. Corporate clients that function across state lines, as so many do, have a fairly wide choice of states from which they may secure outside lawyers. No evidence exists that lawyers in disclosure states have suffered at all or that the quality of representation or compliance with law in those states has been reduced.

Moreover, securities laws now require issuers to disclose a contingent liability when that liability is likely to be significant enough to be of concern to investors. Any such disclosure involves as much of an implicit statement about what a lawyer told the issuer as the "circumstances" provision of the alternative proposal of a report by the issuer to the SEC would require. In sum, eliminating the "circumstances" provision would render the alternative less protective than the original proposal. It should not be eliminated. If it is, the original proposal requiring the reporting lawyer to notify the Commission should be adopted. Whatever version of the rule is adopted should include the requirement that the lawyer disaffirm any opinions or representations that the lawyer reasonably believes are or may be materially false or misleading. This additional step is required to ensure that these "minimum" standards are not lower than the fraud provisions of the securities laws or the ethics rules of most states.

C. *Does Noisy Withdrawal Undermine Confidentiality and Adversely Affect the Lawyer-Client Relationship?*

The major argument against broadening exceptions to confidentiality is that clients will be deterred from confiding information to their lawyers. The lack of candor on the part of clients, it is said, will make it difficult for a lawyer to give informed advice. The "sound advice" and "sound administration of justice" thought to result from this highly confidential relationship will not be achieved.³⁴⁰ Moreover, the ability of the lawyer to disclose client information may diminish client trust and adversely affect the quality of the relationship and the single-mindedness with which the lawyer pursues the client's interests. If and when the lawyer informs the client that disclosure is desirable or contemplated, a serious conflict of interest arises between the lawyer and the client. The relationship ends in bitterness and a sense of betrayal.

There are several responses to these arguments. First, significant exceptions to both the professional duty and to the attorney-client privilege are long-standing and have not had the consequences that are feared. The self-defense and crime-fraud exceptions involve situations that arise

340. See *Upjohn*, 449 U.S. at 389 (stating utilitarian justifications for corporate attorney-client privilege). Communications made to corporation's lawyer by lower-level corporate employees who were not in "control group" were protected by attorney-client privilege when made to counsel at direction of corporate superiors to secure legal advice from counsel.

quite frequently and have limited lawyer secrecy from the very beginning. There is no evidence that those broad exceptions have had undesirable effects on the candor with which clients communicate to lawyers. There is no reason to believe that a slight broadening of the exceptions in situations that arise less frequently will have any discernible effect.

A great deal of romanticism often surrounds discussion of "trust" and "candor" in the lawyer-client relationship. Studies indicate that mistrust and suspicion are frequently encountered in the relationship; lawyers frequently state that clients are unwilling to reveal embarrassing or sensitive facts, which need to be dynamited out of them; and factors that restrict candor operate in various practice contexts in powerful ways.³⁴¹ In the criminal defense field, for example, both lawyer and client have powerful incentives not to candidly discuss facts relating directly to guilt.

Second, the available empirical evidence, albeit limited, suggests that most lawyers and clients expect that confidentiality will be breached when extremely important interests of third persons or courts would be impaired.³⁴² Nor is there any indication that clients are more candid with their lawyers in jurisdictions that have fewer exceptions to confidentiality than they are in jurisdictions with broader exceptions. Any objective observer must concede that there is insufficient solid empirical evidence to support firm conclusions in either direction. Do New Jersey lawyers, who are required to disclose to rectify a client's prior fraud on a third person, have an inferior relationship with their corporate clients than those in the District of Columbia, where such disclosure is prohibited? When severe harm, which could be prevented by disclosure, is threatened, the reality of that more certain interest should be preferred to dubious assumptions about effects on client candor.

Third, the confidentiality interests of public companies regulated by the SEC have less a moral claim for protection than those of private individuals who are suddenly confronted with a legal problem that requires a lawyer.³⁴³ Inexperienced individual clients, unfamiliar with legal matters and fearful of their predicament, have confidentiality interests that derive in part from constitutional provisions involving individual rights, especially

341. See, e.g., Robert A. Burt, *Conflict and Trust Between Attorney and Client*, 69 GEO. L.J. 1015, 1015 (1981) ("Many attorneys and clients mistrust one another notwithstanding their initial hopes and the insistence of the profession's formal norms that a proper relationship requires mutual trust.").

342. See Fred C. Zacharias, *Rethinking Confidentiality*, 74 IOWA L. REV. 351, 377-78 (1989) (discussing attitudes of general public and of lawyers regarding lawyers' obligations to disclose confidential information when questioned by court).

343. See, e.g., MONROE H. FREEDMAN, *UNDERSTANDING LAWYERS' ETHICS* 197 (1990). Freedman's well-known argument for nearly absolute confidentiality relies heavily on the special constitutional protections afforded individual criminal defendants, a principle that never applies to public companies. See *id.* at 103-07 (criticizing leniency of Model Rules in permitting disclosure of confidential client information in situations other than those in which it is necessary to avoid death or serious bodily harm).

the special protections given to criminal defendants. On the other hand, a public corporation has neither a "soul to be damned [nor] body to be kicked."³⁴⁴

The public companies regulated by the SEC have many public obligations, operate in a goldfish bowl of scrutiny and have large experience and sophistication concerning the hiring, supervision and firing of lawyers. They are sophisticated repeat-players who use law regularly in carrying on their business, entering into transactions, dealing with regulatory authorities and participating in litigation. They are the major group of clients who are well informed about the details of the attorney-client privilege and the exceptions to it, the work-product immunity and the professional duty of confidentiality. They are also clients whose managers may have a large economic incentive to use lawyer secrecy to delay compliance with regulations or to conceal ongoing violations of them. This group of clients has many advantages in litigation over those with less resources, experience and staying power.³⁴⁵ The social value of secrecy versus disclosure is less when one is dealing not with individual citizens encountering law for the first time, but with large and informed repeat-players, profit-making organizations that have strong incentives to delay or conceal compliance with regulatory requirements that impose substantial costs.

Fourth, one useful aspect of disciplinary requirements is to allow a lawyer to deflect responsibility for thwarting a client's will from the lawyer to the rule. The ability to say, "I have no choice" stiffens the spine of a lawyer by blaming the command of law. It also threatens the lawyer with liability or discipline if the lawyer disobeys. Equally important, it warns the client that help cannot be obtained from other lawyers, who would be subject to the same constraint. Even if lawyers would prefer not to have to exercise judgment about the legality of the actions of a client's agent, a strong reporting rule is likely to be better than a discretionary rule because it eliminates the lawyer's worry that the client will take the problem and attendant legal matters to a more malleable lawyer.

Fifth, as indicated at the end of Part IV.B.2. above, a lawyer's public disclosure of his or her withdrawal and the general nature of the matter involved, does not violate or waive the client's attorney-client privilege.³⁴⁶

Finally, there is no evidence that exceptions to confidentiality have led or will lead to frequent whistle-blowing on the part of lawyers. Indeed, it is clear that the incidence of whistle-blowing by lawyers is astonishingly

344. John C. Coffee, Jr., "No Soul to Damn: No Body to Kick": *An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 386 (1981) (quoting Edward, First Baron Thurlow (1731-1806)).

345. See, e.g., Marc Galanter, *Why the Haves Come Out Ahead: Speculations on the Limits of Legal Change*, 9 LAW & SOC'Y REV. 95, 97-104 (1974) (discussing advantages of "repeat players," such as corporations, over those with less litigation experience or familiarity with court system).

346. For a further discussion of the withdrawing lawyer's obligations and duties of confidentiality owed to its former clients, see *supra* notes 338-45 and accompanying text.

low given the fact that most or all states require disclosure when a crime or fraud has been perpetrated on a tribunal. Thirty-seven states permit disclosure to prevent a client criminal fraud and four with many lawyers require disclosure in that situation. Disciplinary proceedings for failing to disclose information when required to do so are virtually non-existent and the same is true for failure to withdraw when withdrawal is required. On the other hand, law firms that learn that a client has used their services to defraud others and who have taken no action to prevent or stop the fraud have frequently settled malpractice and third-party liability claims for large amounts. Further, available evidence indicates that lawyers who have discretion to disclose almost always decide not to do so, even when that course of action risks civil liability. The objection to rules permitting or requiring disclosure is not that they will lead to professional discipline, but the effect of the existence of such rules on the likelihood and success of the malpractice and third-party liability claims. Such claims are the real risk and, prior to the SEC's implementation of Sarbanes-Oxley, the principal deterrent force.

V. THE *SPIEGEL* CASE

A. "Reporting Up" in the Spiegel Case

1. *The Relevant Facts*

The report of Stephen J. Crimmins, the examiner appointed by the district court in the SEC's enforcement proceeding against Spiegel,³⁴⁷ attributes Spiegel's financial decline in 1999-2001 to an attempt to improve poor sales performance in its retail subsidiaries by providing easy credit to customers who often could not get credit elsewhere.³⁴⁸ This strategy resulted in deterioration of Spiegel's financial condition when the 1990s boom ended and increased credit card losses triggered Spiegel's securitization obligations on its receivables.³⁴⁹ In 2001, Spiegel's financial condition worsened and it breached all four loan covenants in its bank loan agreements.³⁵⁰ On February 7, 2002, after efforts at renegotiating financing failed, Spiegel's auditor, KMPG, advised the company that a "going concern" opinion would have to be included in its 2001 Form 10-K to the SEC, due at the end of March 2002.³⁵¹ A going concern opinion is a public warning of the auditor's substantial doubt about a company's ability to remain in business. A few weeks later Spiegel announced in a press re-

347. See Crimmins Report, *supra* note 41.

348. See *id.* at 2 (discussing tactics employed by Spiegel to boost short-term profit margins).

349. See *id.* at 2-3 (noting that when economy "soured," many high-risk Spiegel customers stopped paying their credit card bills).

350. See *id.* at 3 (stating that impending bankruptcy and worsening financial condition resulted in Spiegel's breach of its loan agreements).

351. See *id.* (providing opinion of Spiegel's auditor, KMPG, as to Spiegel's declining financial health).

lease that it would record a \$398 million 2001 loss, but other facts in the release "seriously understated Spiegel's desperate circumstances."³⁵²

When more bad news concerning sale of Spiegel's credit card business and possible refinancing came from Spiegel's investment bankers in March, a crisis meeting of Spiegel's executive committee, which was empowered to act for the full board, was held on May 31, 2002, in Hamburg, Germany.³⁵³ The board participants were Michael Otto, the sole voting stockholder, who owned ninety percent of Spiegel stock and two of his business associates, Cruesemann and Zapfel.³⁵⁴ The meeting was preceded by earlier meetings discussing all of the financial problems faced by Spiegel, as well as its disclosure obligations under federal securities laws.³⁵⁵ The Form 10-K for 2001, which included KPMG's going concern warning, had been prepared by Spiegel's securities lawyers (Kirkland) and was virtually ready for filing.³⁵⁶

At the meeting on May 31, the committee, rejecting the advice of all of the Chicago-based managers of Spiegel, Kirkland and its auditor (KPMG), decided to file a notification of delayed filing.³⁵⁷ On April 1, 2002, Spiegel filed the Form 12b-25 notice of delayed filing that also had been previously drafted by Kirkland.³⁵⁸ The Form 12b-25 filing stated that the 2001 annual report could not be filed because Spiegel was not currently in compliance with its 2001 loan covenants and had reached a strategic decision to sell its credit card subsidiary that, "as disclosed in the Company's press release of February 21, 2002, [will result] in a significant loss."³⁵⁹ The same statements were included in subsequent quarterly filings for 2002.

Examiner Crimmins concludes in his report that this notification of delayed filing was false and misleading because it failed to reveal the real reason for not filing the required annual report: KMPG's opinion that the annual filing had to include the going concern warning and Spiegel's fears that the warning would cause suppliers to refuse to sell goods to Spiegel on credit, depress its stock price and adversely affect sales and em-

352. *Id.* at 44 ("Spiegel's February 2002 release said that Spiegel's 2001 net loss was \$398 million, but its actual 2001 net loss was \$587 million.").

353. *See id.* at 45-50 (enumerating topics discussed among Spiegel executives during May 31 crisis meeting).

354. *See id.* at 45-46 (noting individuals in attendance at meeting).

355. *See id.* at 44-45 (characterizing discussions as involving "life threatening" issues then facing Spiegel).

356. *See id.* at 50 (stating that at time of meeting in Hamburg, Germany, Form 10-K already was prepared and ready to file).

357. *See id.* (noting that decision to delay filing was made after consultation with Spiegel Chairman Michael Otto).

358. *See id.* (discussing Spiegel's rationale in filing "notification of late filing" rather than standard Form 10-K).

359. *Id.* at 50-51 (quoting Spiegel's response to questions asked on Form 12b-25 filing).

ployee morale and turnover.³⁶⁰ Kirkland, on the other hand, which drafted the Form 12b-25 language and continued to use the same language in Spiegel's later Forms 12b-25 for its missing quarterly Form 10-Q reports during the remainder of 2002, contends that a Form 12b-25 is just notice to the SEC of a missed return and not itself a disclosure document.³⁶¹ The examiner disagreed, stating that Rule 12b-25 requires both disclosure of the inability to make a filing "and the reasons therefore in *reasonable* detail."³⁶² The examiner concluded that the real and unstated reason for the delayed filing and for several subsequent quarterly reports in 2002, in which the same language was used, was KPMG's going concern warning and the business consequences it would have for Spiegel.³⁶³ Therefore, the failure to provide this material information to investors was fraudulent and misleading.³⁶⁴

The net effect was that investors did not learn of KPMG's going concern warning and other materially adverse information until March 2003, almost a year later. That occurred only when the SEC brought an enforcement proceeding against Spiegel for fraudulently withholding public disclosure of the company's 2001 annual report and subsequent quarterly reports, each of which failed to disclose KPMG's going concern opinion. Kirkland had advised Spiegel, both before and during the May 31, 2002 board meeting, that Spiegel was required to file a 2001 annual Form 10-K including KPMG's going concern warning.³⁶⁵ On May 15, 2002, Kirkland gave Sorensen, Spiegel's general counsel, its opinion that failure to file its Form 10-K could result in an SEC enforcement action against Spiegel, its officers and directors and its controlling shareholder.³⁶⁶ Kirkland also noted that the SEC could take the position that, in addition to failing to file, Spiegel had engaged in fraudulent or deceptive conduct, and that the sanctions could include civil penalties, officer and director bars and criminal prosecution.³⁶⁷

360. *See id.* at 51-52 (concluding that Spiegel's "real reason" for not filing was its desire to avoid negative publicity that would be created from KPMG's "going concern" opinion).

361. *See id.* at 51 n.14 (stating Kirkland's position that purpose of 12b-25 form is to provide notice only).

362. *Id.* (quoting applicable provision of governing SEC Rule 12b-25) (emphasis added).

363. *See id.* at 51.

364. *See id.* at 5 (noting that Spiegel matter involved "failure to make disclosure of material information about Spiegel's financial condition" and that Spiegel was charged with fraud for "failing to disclose its auditors' going concern position").

365. *See id.* at 80-81 ("By mid-May 2002, Kirkland . . . had plainly advised Spiegel that it was violating the law by not filing its Form 10-K, and that this illegal act could have serious consequences, including action by the SEC.").

366. *See id.*

367. *See id.* at 64 (describing extent of Kirkland's legal advice concerning SEC action for Spiegel's failure to file its Form 10-K).

2. *Did Kirkland Perform Its "Up the Corporate Ladder" Report Obligations?*

Most of the events considered above, concluding with Spiegel's final decision at the executive committee meeting on May 31, 2002 to file a notice of delayed filing of its 2001 annual report, occurred before public concern about corporate integrity had led to the enactment of Sarbanes-Oxley and the SEC regulation implementing Section 307. Nevertheless, as indicated in the earlier discussion, state and federal law concerning the obligation of a securities lawyer in advising a public company concerning its disclosure obligations recognized then and now the following proposition: A lawyer, in representing an organization, must, when agents of the organization or the organization itself are considering conduct that would constitute a violation of law, act in the best interest of the organization, which may require a lawyer in some circumstances to report the prospective law violation to the organization's highest authority.³⁶⁸

Kirkland's conduct prior to the end of May 2002 conformed to this requirement.³⁶⁹ Kirkland advised Spiegel managers of Spiegel's disclosure obligations under federal securities law and persuaded them that the 2001 annual report should include KPMG's going concern warning. Kirkland provided the same advice to the Spiegel executive committee, acting for the full board, at and before the May 31, 2002 meeting in Hamburg, where the decision was made to file a notice of delayed filing. The board participants in the final decision, including the sole voting stockholder, Michael Otto, were advised of the risks involved in filing a notice of delayed filing that did not fully and fairly state the reasons for doing so.

B. *Lawyer Conduct in the Spiegel Case: Withdrawal and Disclosure*

1. *Facts Reported by the Examiner in the Spiegel Case*

When Robert Sorensen joined Spiegel as its general counsel in June 2001, Kirkland was retained as Spiegel's principal outside counsel "to provide additional depth in corporate and securities matters."³⁷⁰ Kirkland replaced Rooks & Pitts, which continued to represent Spiegel in securitization and other matters. "[B]y mid-May 2002, Kirkland . . . had plainly

368. See MODEL RULES 2003, *supra* note 32, R. 1.13(b) (stating that organization's lawyer may be required to refer matter to "higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority than can act on behalf of the organization"). Comment 4 to Model Rule 1.13 provides: "The organization's highest authority to whom a matter may be referred ordinarily will be the board of directors or similar governing body. However, applicable law may prescribe that under certain conditions the highest authority reposes elsewhere, for example, in the independent directors of a corporation." *Id.* R. 1.13 cmt. 4. See also Comment 8, which states, "Whether such warning should be given by the lawyer for the organization to any constituent individual may turn on the facts of each case." *Id.* R. 1.13 cmt. 8.

369. The implications of Kirkland's role in drafting and approving the misleading language in Spiegel's March 29, 2002 notice of delayed filing and in subsequent quarterly filings are considered in Part III.C. of this Article.

370. Crimmins Report, *supra* note 41, at 80.

advised Spiegel that it was violating the law by not filing its [2001] Form 10-K, and that this illegal act could have serious consequences³⁷¹ Sorensen concurred with this advice, and it was communicated to Zapfel, Spiegel's president and a member of the board committee empowered to act for the full board. By the end of May 2002, Kirkland's advice had been reported to Otto and Cruesemann, the other two members of the board committee. As discussed earlier, Kirkland reported its opinion of a material violation to Spiegel's CLO, Sorensen, and to the appropriate board committee.³⁷² If SEC Part 205 had been in effect at the time, Kirkland would have been in full compliance with it through the end of May 2002, when the final decision not to file the 2001 Form 10-K was made by the board committee.

White & Case became involved in Spiegel's affairs as counsel for Spiegel's sole voting shareholder, Michael Otto, and his corporate interests. "Through its Hamburg partner, Urs Aschenbrenner, White & Case 'interpreted' for the Otto interests the advice received from Spiegel's U.S. legal advisers, and it clearly played a substantial role in helping Otto and the Spiegel board committee evaluate that advice . . . during much of 2002."³⁷³ At the critical May 31, 2002 meeting, Aschenbrenner was present and "was heard to challenge Kirkland & Ellis' advice on the need to file Spiegel's Form 10-K and the consequences of non-filing."³⁷⁴ Subsequently, "neither Aschenbrenner nor his New York partners did anything to express their agreement with Kirkland & Ellis' advice."³⁷⁵ Through the balance of 2002, none of the lawyers did anything "to press Spiegel to make its required filings . . . or otherwise to update, supplement or correct disclosures made in Spiegel's Forms 12b-25 and/or its press releases."³⁷⁶

After May 2002, Spiegel's German directors considered replacing Kirkland and Sorensen, viewing them as pessimists who were exaggerating the seriousness of the situation.³⁷⁷ The effort failed when U.S. management pointed out the cost of bringing in a new firm to draft documentation for Spiegel's refinancing and other pending matters.

Meanwhile, White & Case, "ostensibly still only counsel for Spiegel's sole voting shareholder," assumed a prominent role in Spiegel's search for refinancing.³⁷⁸ White & Case never reported any concerns about Spie-

371. *Id.*

372. *See id.* at 80-81 (noting Kirkland's admonition to Spiegel's general counsel and board meeting members). For a further discussion of Kirkland's actions in this regard, see *supra* notes 358-59 and accompanying text.

373. Crimmins Report, *supra* note 41, at 81.

374. *Id.* at 82.

375. *Id.*

376. *Id.*

377. *See id.* (noting that term "black painters" was used by German directors to describe Spiegel's U.S. management team).

378. *Id.* at 83 (discussing role of White & Case in Spiegel's refinancing efforts).

gel's disclosure obligations "up the ladder" to the company's audit and board committees.³⁷⁹

Kirkland, until the SEC fraud proceeding against Spiegel was filed in March 2003, continued to prepare and file Spiegel's Forms 12b-25, providing public notice of Spiegel's failure to file its required quarterly reports for the balance of 2002. These filings repeated that Spiegel was not filing its reports because it was "not currently in compliance with 2001 loan covenants and is currently working with its bank group to amend and replace its existing credit facilities," and, thus, "not in a position to issue financial statements . . . pending resolution of this issue."³⁸⁰ "Of course, as Kirkland & Ellis knew, the real reason why Spiegel was not filing its periodic reports was that it did not want to disclose KPMG's going concern qualification and other material bad facts and circumstances threatening Spiegel's survival."³⁸¹

The examiner makes a pointed reference to the SEC's proposed noisy withdrawal rule:

None of Spiegel's legal advisers withdrew—"noisily" or otherwise—from representing Spiegel. If the SEC's proposed withdrawal rule had then been in effect, the SEC would have been alerted to take action sooner, and investors would have received information they could have acted on to make informed investment decisions about Spiegel. In this case, the absence of a "noisy withdrawal" requirement allowed Spiegel to keep investors and the SEC in the dark.³⁸²

2. *Kirkland's Failure to Withdraw, Disaffirm Filings and Notify the SEC*

Spiegel's principal place of business is in Illinois, and Kirkland is a Chicago law firm. We assume that the client-lawyer relationship was formed in Illinois and the representation largely took place in Illinois. If so, Kirkland's conduct in representing Spiegel must be examined under Illinois law and professional rules.

According to the ALAS chart summarizing the position of all states and the District of Columbia on disclosure of client confidences, the applicable Illinois ethics rules are as follows: the Illinois rules *permit* a lawyer to disclose a client's intention to commit a criminal fraud likely to result to injury to the financial interest or property of another party; *prohibit* a lawyer from disclosing a client's intention to commit a non-criminal fraud likely to result in injury to the financial interest or property of another

379. *See id.* (concluding that if White & Case had reported its views concerning Kirkland & Ellis "up the ladder," Spiegel may well have avoided SEC fraud charge).

380. *Id.* (quoting Spiegel's response in completing Forms 12b-25 during course of 2002).

381. *Id.*

382. *Id.* at 84.

party; and *require* a lawyer to reveal confidential information relating to a client's ongoing criminal and fraudulent act.³⁸³

The result in the latter situation, which was involved in Kirkland's representation of Spiegel, comes about because of the relationship of Rule 4.1(b) to Rules 1.2(d), 1.16(a) and 1.6. Here is the ALAS explanation for the required disclosure:

Although the lawyer [in this situation of an ongoing client crime or fraud] is prohibited by the final clause of [Rule 4.1(b)] from explicitly disclosing that the client is concealing or misrepresenting material facts, the lawyer in this situation is *required* by Rules 1.2(d) and 1.16(a)(1) to resign forthwith as counsel if the client cannot be persuaded to correct the record. Further, under Official Comment [14] to Rule 1.6 . . . , the lawyer after resigning may also noisily "withdraw or disaffirm" any fraudulent statement of the client with which the lawyer might be deemed to be associated by reason of the lawyer's prior presence in the transaction as the client's counsel. In other words, . . . Rule 4.1(b) does not permit "whistle-blowing" in the normal sense, but (when interpreted in harmony with Rules 1.2(d) and 1.16(a)(1)), it clearly *requires* a certain amount of flag-waving that will alert even the most naive citizen to the fact that the lawyer's client has probably concealed or misrepresented material facts. . . . Additionally, where the client's behavior constitutes continuing misconduct, the permissive disclosure provision of [the Illinois version of Rule 1.6(b)] comes into play. . . . If disclosure of a client's intent to commit a crime or fraud is permitted under Rule 1.6, then such disclosure becomes mandatory under [the "shall not knowingly fail to disclose" language of] Rule 4.1(b) if the situation also meets the requirements of that Rule.³⁸⁴

The law in its various forms (tort law, criminal law and the law governing lawyers) "prohibits a lawyer from knowingly counseling or assisting a client to commit a crime or fraud."³⁸⁵ Although Kirkland, as it should have, gave its honest opinion about the actual consequences that ap-

383. See ALAS Memorandum, *supra* note 222, at 132-38 (reprinting ALAS chart indicating provisions adopted by Illinois).

384. *Id.* at 139 n.3. In Spiegel's case, the "record" referred to in the ALAS explanation included material false statements previously made to the SEC by Kirkland in drafting and approving Spiegel's required filings as a public company. See Crimmins Report, *supra* note 41, at 4-6 (summarizing extent of Spiegel's fraudulent disclosures). Here, Kirkland failed in fulfilling its obligation under Rule 4.1 when it did not disclose Spiegel's prior fraudulent statements to the SEC and its investors. See ALAS Memorandum, *supra* note 222, at 139 (noting that attorney violates Rule 4.1 when it fails to disclose material fact to third person when disclosure is necessary to avoid assisting criminal or fraudulent act by client, such as by continuing representation when attorney knows that prior false statement was made in course of representation).

385. MODEL RULES 2003, *supra* note 32, R. 1.2 cmt. 9.

peared to be likely to result from Spiegel's conduct, its responsibility became "especially delicate" after Spiegel had committed itself to a fraudulent course of conduct.³⁸⁶ At that point, according to the current Comment 10 to ABA Model Rule 1.2:

[A] lawyer is required to avoid assisting the client, for example, by drafting or delivering documents that the lawyer knows are fraudulent A lawyer may not continue assisting a client in conduct that the lawyer originally supposed was legally proper but then discovers is criminal or fraudulent. The lawyer must, therefore, withdraw from the representation of the client in the matter. See Rule 1.16(a).³⁸⁷

But Comment 10 does not stop at this point. It states further that, "[i]n some cases, withdrawal alone might be insufficient. It may be necessary for the lawyer to give notice of the fact of withdrawal and to disaffirm any opinion, document, affirmation or the like. See Rule 4.1"³⁸⁸ Turning to Rule 4.1, Comment 3 provides, "In extreme cases, substantive law may require a lawyer to disclose information relating to the representation to avoid being deemed to have assisted the client's crime or fraud."³⁸⁹

We think the statements in Comment 10 to Rule 1.2(d) correctly summarize Kirkland's obligations in the situation it faced after May 31, 2002.³⁹⁰ Kirkland knew and had repeatedly advised that Spiegel would be violating the securities laws by failing to file an annual report that, if filed, would have to contain bad news for Spiegel's investors, suppliers and employees. Any further act, such as filing quarterly notices covering the bal-

386. *See id.* at cmt. 10 ("When a client's course of action has already begun and is continuing, the lawyer's responsibility is especially delicate.").

387. *Id.*

388. *Id.*

389. *Id.* R. 4.1 cmt. 3.

390. The text presents its argument in terms of the general ethics law prevailing in the United States today. Although Illinois has not adopted the language from the ABA comments quoted in the text, the result would be the same under the applicable Illinois rules. Rule 1.6(c)(2) of those rules permits a lawyer to "use or reveal . . . the intention of a client to commit a crime . . ." ILL. RULES OF PROF'L CONDUCT R. 1.6(c)(2) (2003). Rule 4.1(b) provides that "[i]n the course of representing a client a lawyer shall not . . . fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6." *Id.* R. 4.1(b). Because disclosure is not prohibited by Illinois Rule 1.6, a lawyer, who, in the course of the representation, knows that the client has communicated a material fact to a third person that the lawyer now knows is false, will assist the client's wrongdoing unless the material fact is corrected. Hence, disclosure is required. *See, e.g.*, Ill. State Bar Assoc., Formal Op. 93-6 (1994), *reprinted in* UNIVERSITY PUBLICATIONS OF AMERICA, NATIONAL REPORTER ON LEGAL ETHICS AND PROFESSIONAL RESPONSIBILITY II: RULES: 4-5 (transfer vol. 1997) (explaining that lawyer who knows that client has committed tax violations must avoid making false representations about such matters and must ensure in future representation that information is not used by client to perpetrate fraud on third persons).

ance of 2002 that stated reasons other than the real ones, would be misleading and fraudulent and, therefore, would and did assist Spiegel's ongoing fraud.

A Kirkland partner and spokesman, Jack Levin, has been quoted in the *Wall Street Journal* as stating, "Spiegel 'decided not to follow our advice'" and that "[t]here are no rules that say you must resign if the client doesn't take your advice."³⁹¹ That is a true statement, of course, if the advice involves a choice that is permitted by law. But if the choice is between a lawful course of conduct and an unlawful one and the client uses the lawyer's services to choose the unlawful one, the lawyer must resign because the lawyer cannot continue to represent a client on the matter when the client refuses to act "within the bounds of the law."

In addition to withdrawal, Kirkland's continued participation in the drafting and filing of false notices of delayed filing put it in a position in which it was subject to civil or criminal charges by the SEC for aiding and abetting a securities fraud. Although third-party civil liability for assisting a client's securities fraud has been eliminated by the *Central Bank* decision, Kirkland's role in drafting and approving the filings may subject it to civil liability under federal securities law as a participant in the fraud or for negligent misrepresentation under Illinois law.³⁹²

Finally, Part 205 became effective on August 5, 2003. Section 205.3(d)(2)(iii) permits disclosure of confidential information "[t]o rectify the consequences of a material violation by the issuer that caused . . . substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used."³⁹³ The language has a literal application to Kirkland, which was appearing and practicing before the Commission in preparing and filing Spiegel's securities filings. There is nothing in the language that makes it applicable only to representation or client acts that occurred after the effective date of the regulation. Of course, reporting in the Spiegel situation would serve no purpose now that the SEC proceeding and the bankruptcy examination has revealed the relevant information. However, other law firms, facing a situation in which they now know of an ongoing client fraud that has not become publicly known, can use the leverage provided by the SEC's rectification provision to force a client or former client to face the consequences of the client's past fraud, whether or not state ethics rules permit disclosure under the same circumstances.

391. See Weil & Bryan-Low, *supra* note 36.

392. See *Greykas v. Proud*, 826 F.2d 1560, 1565 (7th Cir. 1987) (holding that lawyer's false representations in opinion letter constituted negligent misrepresentation under Illinois law); *In re Enron Corp. Sec.*, 235 F. Supp. 2d 549, 704-05 (S.D. Tex. 2002) (dismissing law firm's summary judgment motion on grounds that plaintiff had sufficiently pled firm's participation in client's fraudulent conduct to such extent that firm could be subject to primary liability if allegations proved true).

393. 17 C.F.R. § 205.3(d)(2)(iii) (2004).

3. *Was White & Case Required to Withdraw, Disaffirm Documents or Disclose to the SEC?*

White & Case, according to the *Wall Street Journal* article, takes the position that it represented only the Otto interests, not Spiegel, implying that it had no duties to Spiegel.³⁹⁴ That premise is questionable.³⁹⁵ First, White & Case played an important role in Spiegel's decision not to file the required 2001 Form 10-K. The minutes of a critical May 31, 2002 meeting of the audit committee, prior to the executive committee decision later in the day when the decision not to file a 2001 Form 10-K was made, state that the audit committee engaged in "intensive discussion, careful deliberation and consultation with [Spiegel's] outside law firm (White & Case)" concerning the Form 10-K filing issue.³⁹⁶ Prior to the meeting, Aschenbrenner, White & Case's Hamburg partner, e-mailed his New York partners for "urgent" advice as to "whether we file the 10-K later today with the 'going concern' opinion."³⁹⁷ The examiner's report indicates that it is not clear whether such advice was received.³⁹⁸ During the audit committee meeting, the Kirkland partner responsible for Spiegel's securities filings was consulted by telephone. He later stated that he gave "unequivocal" and "heated" advice that Spiegel's failure to file was "illegal" and might result in liability of Spiegel and its individual officers.³⁹⁹ Nevertheless, the audit committee was persuaded by Aschenbrenner's contrary advice that "it was unacceptable to file the Form 10-K as long as it contained a going concern opinion."⁴⁰⁰ The audit committee recommended that Spiegel delay filing its Form 10-K "until financing is in place with [Spiegel's] lenders and an unqualified opinion is received from KPMG."⁴⁰¹ Later that same day, the board committee accepted that recommendation.

Second, from that date on, White & Case took the leading role in representing Spiegel in its efforts to obtain refinancing.⁴⁰² The nature and extent of White & Case's participation in Spiegel's decision not to file its 2001 Form 10-K suggest that a lawyer-client relationship with Spiegel may have been established. If so, White & Case owed Spiegel all the duties a lawyer owes to an organizational client.

394. See Weil & Bryan-Low, *supra* note 36, at C1 (reporting that White & Case regarded Otto Versand as its sole client).

395. See Crimmins Report, *supra* note 41, at 70-72 (discussing participation of White & Case counsel in meetings with Spiegel's audit committee in which decision was reached to delay filing of SEC Form 10-K).

396. *Id.* at 71-72 (quoting minutes taken at Spiegel audit committee meeting in Hamburg on May 31, 2002).

397. *Id.* at 70.

398. See *id.* (making no mention of response from Aschenbrenner's partners).

399. See *id.* at 71 (providing lawyer's advice that it would be "illegal and would be breaking the law for Spiegel not to file [the Form 10-K]").

400. *Id.*

401. *Id.* at 72 (quoting minutes from audit committee meeting).

402. See *id.* at 78-79 (indicating that White & Case assumed lead role in negotiating new financing arrangement for Spiegel).

An alternative argument is worth considering. Even if Michael Otto and his German financial interests were the sole client of White & Case, Otto, as sole voting shareholder of Spiegel and as a director and member of the board committee that acted for the full board, had fiduciary duties to protect Spiegel from harm flowing from illegal conduct.⁴⁰³ Present or developing corporation law may include a duty of care on directors and those in control to prevent the company from suffering serious legal harm.⁴⁰⁴ If so, the lawyers representing Spiegel's sole controlling shareholder had a derivative duty to Spiegel to prevent it from such harm.

In making these statements, we are asking questions and proposing possibilities, not reporting clearly established fact or law. But there are signs that corporate law is moving in this direction. If so, the analysis of the conduct of White & Case would be similar to that provided with respect to Kirkland.

The White & Case situation also poses an interesting question under Sarbanes-Oxley. Was White & Case, even if its sole client was Otto and his German financial interests, "appearing and practicing before the Commission" when it refused to endorse Kirkland's advice that failure to file the Form 10-K constituted a violation of the law? This question is especially significant when considering that White & Case knew that Otto's control of Spiegel made his view and vote decisive in the decision by the German directors to override the view of Spiegel's U.S. management and its principal outside counsel, Kirkland.

Section 205.2(h), defining "issuer," makes it clear that a lawyer for a wholly owned subsidiary of an issuer "appears and practices" before the Commission where the services are provided for the benefit of or on behalf of the issuer.⁴⁰⁵ Here, we have a situation in which the sole control-

403. As sole controlling shareholder and director who could control Spiegel decisions, Otto had fiduciary duties to Spiegel. The Restatement of the Law Governing Lawyers states: "[I]f the lawyer represents as a client either the entity or the constituent owing fiduciary duties, the lawyer may not counsel or assist a breach of any fiduciary obligation owed by the constituent to the organization." RESTATEMENT, *supra* note 52, § 96 cmt. g. Aschenbrenner, by urging Otto not to file Spiegel's annual report, may have breached this obligation.

404. Two recent decisions have emphasized the duties of directors to protect the company from harm. See Geraldine Fabrikant, *Private Concern, Public Consequences*, N.Y. TIMES, June 15, 2003, at E1 (reporting decision of U.S. district court in which officers and directors of Trace International Holdings Corp. were held liable for breach of their fiduciary duty when they "rubber-stamped" actions of chief executive Marshall Cogan, who looted company of millions of dollars while directors stood by and did nothing); Patrick McGeehan, *Case Could Redefine Board Members' Liability*, N.Y. TIMES, June 14, 2003, at C1 (discussing Delaware decision permitting shareholders' suit to proceed against current and former members of board of Walt Disney Company alleging that board's failure to participate meaningfully in compensation arrangements made by Disney's CEO, Michael Eisner, with President, Michael Ovitz, led to compensation of about \$138 million for Ovitz's fourteen-months service with company).

405. For a further discussion of how the term "issuer" is defined for purposes of enforcing SEC regulations, see *supra* notes 107-08 and accompanying text.

ling stockholder, represented by a law firm, is taking positions and exercising authority concerning the required filings of the controlled company. If the situation arose today, with Part 205 in effect, a law firm in White & Case's situation might reasonably be viewed as being covered by the Rule and subject to its report obligation.

C. *The Spiegel Case Indicates Why the SEC Should Require Noisy Withdrawal*

The vigorous objections of many bar associations, law firms and lawyers to the Commission's proposed rule requiring noisy withdrawal are usually predicated on the assertion that the permissive disclosure required by most states' ethics rules and by Section 205.3(d) is sufficient to protect issuers and investors from prospective or ongoing violations of law by public companies. The American experience with corporate fraud in recent decades, reinforced by the events of recent years, supports a contrary conclusion.

Lawyers for public companies have not exercised the authority given under state ethics rules to disclose prospective or ongoing illegality by the corporate managers who hire and can fire them. Many lawyers confronted with client fraud situations have not reported the material violations of law up the corporate ladder. Moreover, many have not withdrawn even when ethics rules required them to do so; if they did withdraw, they did so silently, often without notifying the highest authority of the company of the reasons for withdrawal. And many corporate lawyers, such as the Kirkland partner quoted in the *Wall Street Journal* article to the effect that no rule even required Kirkland to withdraw,⁴⁰⁶ appear to be oblivious to the arguments made by the ABA, ALAS and by this Article that the combined effect of Rules 1.2(d), 1.16(a) and 4.1(b), when permissive disclosure is provided by the state's equivalent of Rule 1.6, requires a lawyer to withdraw, to disaffirm false documents or representations and, in many jurisdictions, to disclose information to persons who are being or will be harmed by an ongoing client crime or fraud.

Experience also tells us that professional discipline is never invoked to punish and deter these violations of existing state rules in complex client fraud situations involving difficult issues of what the lawyer knew when the lawyer acted or failed to act. Many client fraud situations, witness Enron, involve complex and multiple transactions and raise difficult legal and factual issues. There also is the difficulty, in a disciplinary context, of pinning responsibility on particular lawyers within the law firm. The principal deterrent force has been the fear of law firms that silent withdrawal will be insufficient to protect the law firm from civil liability to those harmed by the client's fraud: liability to the corporate client in a malpractice action when bankruptcy has occurred or new management is put in

406. See Weil & Bryan-Low, *supra* note 36, at C1 (stating Kirkland's position that withdrawal was not mandated, even though Kirkland knew of Spiegel's fraudulent practices).

place, or to third persons in actions for negligent misrepresentation or for state or federal securities law violations.

However, the most effective civil remedy—third-party liability for aiding and abetting a federal securities fraud—was eliminated by *Central Bank*⁴⁰⁷ and Congress's refusal to undo that decision when it passed the Private Securities Litigation Reform Act.⁴⁰⁸ These changes left private plaintiffs with only the more difficult cause of action against the law firm as a principal participant in the fraud rather than a secondary actor.⁴⁰⁹ The normal role of a lawyer, of course, is to be a secondary actor: to provide advice and assistance within the bounds of the law. The absence of such third-party civil liability requires the SEC to be vigilant in exercising its authority to proceed against law firms that have assisted an issuer in violating the securities laws.

If the facts recited by Examiner Crimmins in the *Spiegel* case turn out to be true, along with his legal conclusions that Spiegel's notices of delayed filing were false and misleading in violation of federal securities laws, and known to be such by the Kirkland firm, the case provides an object lesson of the failure of existing law and the need for adoption by the Commission of its proposed noisy withdrawal provision in one of the forms proposed.

Spiegel, thus viewed, is a situation in which a major law firm (perhaps two such law firms), knowing that an ongoing criminal fraud was taking

407. 511 U.S. 164, 190-91 (1994) (overruling long-standing federal decisional law and holding that secondary actor in securities transaction (e.g., lawyer or accountant) is not liable for damages in private cause of action for aiding and abetting securities violation). The decision did not affect the SEC's authority under statute to bring an enforcement action for aiding and abetting a securities violation. But it requires private plaintiffs to cast the defendant as a primary violator of Section 10(b), i.e., that the defendant engaged in manipulative or deceptive acts or made fraudulent representations rather than merely assisted in the acts. See, e.g., Jill Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants*, 99 COLUM. L. REV. 1293, 1298 (1999) ("Nonetheless, the Court explicitly stated that outside professionals could still be liable under Section 10(b) as long as the requirements for primary liability were met.").

408. Private Securities Litigation Reform Act of 1995 (PSLRA), Pub. L. No. 105-353 (codified at 15 U.S.C. § 77a *et seq.*). Although *Central Bank* did not consider and thus did not change the SEC's ability to bring suits for aiding and abetting, Congress did not consider and change that authority. Under the PSLRA, the SEC's authority to bring suits for aiding and abetting is explicitly recognized, but to establish aiding-and-abetting liability, the PSLRA requires the SEC to show that the defendant acted knowingly and willfully. See 15 U.S.C. § 77t(2)(f) (1995). For over forty years, the courts had held that a showing of recklessness was sufficient to establish aiding and abetting in a suit brought by a private party or the SEC. The PSLRA thus not only refused to reinstate a private cause of action for aiding and abetting, it also made it more difficult for the SEC to succeed in an aiding-and-abetting case.

409. For an additional discussion of the various theories under which a law firm's involvement in a client's ongoing fraud might be considered so substantial that the firm would be primarily liable under Section 10(b), see *In re Enron Corp. Securities, Derivative & ERISA Litigation*, 235 F. Supp. 2d 549 (S.D. Tex. 2002).

place, did little to prevent or rectify the ongoing fraud. Although Kirkland reported to Spiegel's highest authority, it did not press managers or directors to file the long overdue 2001 Form-10K annual report. Instead, the firm continued to file on a quarterly basis a false and misleading notice of delayed filing. This conduct resulted in losses to the issuer and to investors, suppliers, employees and others and could have been prevented by doing what state ethics rules clearly required. First, the firm should have remonstrated with the client, and especially its highest authority, warning the client of the risks incurred by its criminal course of conduct. Second, as a last resort, the firm should have advised the client of the law firm's obligation to withdraw and threatened to disclose to the SEC the reasons for withdrawal. And finally, the firm should have carried out that threat if the board continued to refuse to comply with the law.

As Examiner Crimmins stated, "[T]his was a case where reporting 'up the ladder' was not enough. The advice from the lawyers here was rejected by Spiegel's audit and board committees, and the material information that should have reached investors was kept under wraps."⁴¹⁰ If the SEC's proposed noisy withdrawal rule had been in effect, the fraud perpetrated upon Spiegel investors might well have been avoided.⁴¹¹

VI. CONCLUSION

Three major propositions are advanced in this Article. First, the obligations and permissions conferred on securities lawyers by the SEC's adopted and proposed rules implementing Section 307 of Sarbanes-Oxley are consistent with and reflect the duties of lawyers under the ethics rules of the vast majority of American jurisdictions. The characterization of these rules as novel requirements that would result in a fundamental change in the relationship of a lawyer to a corporate client is hot air: a hullabaloo stirred up primarily to defeat or limit a new vehicle of regulation that might, unlike the disciplinary process of the states, provide a substantial deterrent to lawyer assistance of corporate fraud and criminality.

Second, the reporting up obligation of the Commission's Part 205 already has served a valuable function: reminding corporate lawyers that, under corporate law and state ethics rules, their fundamental obligation is to the corporate entity, not to the officers who temporarily direct its affairs.⁴¹² Informing the ultimate authority—the board of directors—of a

410. Crimmins Report, *supra* note 41, at 81.

411. *See id.* at 84 (noting efficacy of noisy withdrawal requirement in this situation).

412. The first published application of the SEC's reporting up rules occurred in December 2003. A partner in the New York office of a major firm, Akin Gump Strauss Hauer & Feld, wrote a letter to directors of TV Azteca, a large Mexican broadcasting company, informing the board that Akin Gump was withdrawing as general outside counsel because company officials had refused to disclose in a securities filing sufficient information concerning a corporate transaction that could have yielded a profit of \$100 million to the company's chairman and controlling shareholder. *See* Patrick McGeehan, *Lawyers Take Suspicions on TV Azteca to*

prospective or ongoing illegality that will cause substantial harm to the corporation is not a radical new idea but a restatement of the requirements of both corporate law and state ethics rules.⁴¹³

However, a number of major loopholes in the SEC's rules implementing Section 307 threaten to nullify the effectiveness of the reporting up requirement. The loopholes discussed in this Article are likely to result in noncompliance by lawyers and issuers and ineffective enforcement by the SEC. The SEC should move promptly to close those loopholes through amendments that narrow or eliminate them.

Third, the reporting out obligation that remains pending before the SEC (usually referred to as "noisy withdrawal"), although of much less importance than correcting the deficiencies in the reporting up rules, is a good idea. And it, like the reporting up requirement, is consistent with the ethics rules of the vast majority of states. We have given this point special attention because it is contradicted by the statements and understanding of many, perhaps most, lawyers.

The *Spiegel* case provides a vivid example of a situation in which reporting up was not enough to prevent a securities fraud. When the authoritative committee of the issuer refused to follow the law firm's advice that the filing the company proposed to make would violate the federal securities laws, the issuer embarked on a fraudulent course of conduct. When this happened, the law firm not only failed to withdraw but also assisted the issuer in making additional fraudulent filings. The issuer and its investors were harmed. No one knows how frequently situations of this kind have occurred and will occur, but the lessons of the many corporate frauds in recent years, supplemented by the unprecedented number of financial restatements by public companies, strongly suggest that the problem is frequent enough to justify adoption of one of the two pending noisy withdrawal proposals.

Its Board, N.Y. TIMES, Dec. 24, 2003, at C1 (reporting actions taken by Akin Gump pursuant to provisions of Sarbanes-Oxley Act). The lawyer's letter also stated that Akin Gump "reserve[d] the right to inform the S.E.C. of our withdrawal and the reasons therefore." *Id.*

413. *In re Gutfreund*, Exchange Act Release No. 31554 (1992), provides another vivid example of why reporting up is not enough. Feurstein, Salomon's CLO, was informed that a trader had engaged in illegal trading, investigated the matter and reported it to the CEO. When the CEO failed to take action, Feurstein did nothing. The Commission held that Feurstein, knowing about the wrongdoing, "was obliged to take affirmative steps to ensure that the misconduct was adequately addressed," including "resignation from the . . . [representation], or disclosure to regulatory authorities." In the absence of required noisy withdrawal, currently required by only a small minority of jurisdictions, disclosure outside the organization is extraordinarily unlikely.

