LEGAL AND ETHICAL DUTIES OF LAWYERS AFTER SARBANES-OXLEY

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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. Those scandals also 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.

Congress responded by enacting the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), which became effective on July 30, 2002.[1] Sarbanes-Oxley makes many changes in the securities regulation process to improve corporate governance and reporting. 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. Even casual observers of the political reaction to the stunning disclosures about Enron, WorldCom and Tyco's deceitful financial practices might have predicted some such legislative response. But even careful observers might well have been surprised by section 307 of Sarbanes-Oxley, directing the SEC to promulgate "minimum standards of professional conduct for attorneys appearing and practicing before the SEC in any way in the representation of a issuers," because so little public attention

[1]Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §307, 116 Stat. 745, 784. Several other provisions of the Act apply to lawyers but are not considered in this article. Section 602 codified part of Rule 102(e) of the Commission's Rules of Practice, establishing standards for disciplining professionals from practicing before the SEC; section 806 provided "whistleblower" protection for employees of public companies in fraud-related matters; and section 3(b) provided sanctions for violations of the Act or related rules.

had focused on what the lawyers for fraud-ridden corporations had been doing while shareholders and the investing public were being duped.

But there it was. 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 laws or a breach of fiduciary duty or similar violation by the company or any of its agents to the chief legal officer or the chief executive officer of the company (or the equivalent thereof)." If the chief legal officer or chief executive officer fails to provide an "appropriate response" to the evidence, the rule was to require the lawyer to "report the evidence to the audit committee, another independent committee, or the full board of directors." 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 a rule pursuant to section 307, which became effective on August 5, 2003. 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.

The organized bar was against the enactment of section 307. It lobbied Congress, arguing that the federal government should stay out of lawyer regulation and that state regulatory authorities and the bar itself could be counted on to enact and implement appropriate reforms to address the question of lawyer acquiescence or involvement in corporate fraud. Congress, however, had good reason to be skeptical of such claims. Since 1974, when the ABA changed DR 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 fraud. 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. Most damning, the ABA House of Delegates had rejected just such a reform proposal in August 2001, a few months before the disclosure of Enron's massive frauds. And, after the Enron disclosures, while Congress was considering what type of reform legislation to enact, in February 2002, the ABA House of Delegates effectively refused to reconsider the stance on confidentiality and client fraud it had taken in August of 2001. That February, the ABA voted to accept the package of changes to the Model Rules it had approved in August, which included no exception to confidentiality to allow a lawyer to disclose substantial client fraud.

Instead, the ABA created a Task Force on Corporate Responsibility to consider whether to recommend changes to the law of corporate governance and whether to adopt changes to the ABA's Model Rules, particularly the rule on confidentiality, Model Rule 1.6, and the rule on representing organizations, Model Rule 1.13. While that Task Force was studying those questions, Congress enacted Sarbanes-Oxley and that law went into effect.[2]

But the bar had not just argued to Congress that it could take care of any problem through changes in its model ethics rules; it had insisted that state regulatory authorities could handle misconduct by securities lawyers and that federal regulation was thus unnecessary, not to mention inappropriate given that lawyer-regulation was a matter entrusted to the states (generally state courts) in our federalist system.

What about the states? The states had not passively accepted the ABA's position on no-disclosure under any circumstances of client fraud. To 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. On the other hand, the states had a dismal record of enforcing ethics rules against big firm lawyers. Indeed, despite our years of research in this field and the numerous court cases we have read describing conduct by big firm securities lawyers that demonstrate clear violations, in our opinion, 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 do not know of a single instance 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. To argue for exclusive state jurisdiction over securities' lawyer misdeeds is thus, as a practical matter, to argue that securities lawyers remain beyond the reach of discipline. Congress had thus sensibly rejected the bar's states' rights argument, although the bar was to continue that theme in its comments to the SEC with an assist, as we shall see, from the Conference of Chief Justices.

After Congress passed Sarbanes-Oxley, the scene of action shifted to the SEC. The agency had 180 days under Sarbanes-Oxley in which to promulgate an up-the-ladder reporting requirement. On November 21, 2002, the Commission published proposed rules for comment.[3] 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. But much more troubling to the bar, instead of a mere up-the-ladder requirement, the rules went further, requiring (or more accurately, proposing to require) "noisy withdrawal" in certain situations, that is, withdrawal

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[2] Sarbanes-Oxley went into effect on July 30, 2002. The ABA Task Force did not issue its final report until December 2002. ABA Task Force on Corporate Responsibility Report to the House of Delegates and Governance Policy Resolution ABA (Dec. 2002). 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 Preliminary Report of the American Bar Association Task Force on Corporate Responsibility, 58 Bus. Law. 189 (2002). The "required" recommendation was dropped before the final report was issued.

[3] Securities Act Rel. No. 8150, "Proposed Rule: Standards of Conduct for Attorneys Appearing and Practicing before the Commission in the Representation of an Issuer" (Nov. 10, 2002).

from representation of the issue and notice to the Commission of that withdrawal. 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. The battle was on and the bar was now fully engaged.

Here's where the assist from the Conference of Chief Justices comes 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, had adopted a unanimous recommendation that all state high courts now adopt a confidentiality rule allowing disclosure of client fraud in which the lawyer's services had been used [and in some limited cases disclosure to prevent substantial client fraud???] which was the proposal made by the ABA's Ethics 2000 Commission that the ABA's House of Delegates had rejected just a year before.[4] As we have already explained, by the time the Conference adopted that 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 submitted by the Conference to the SEC. They explicitly referred to the state's traditional role as exclusive regulator of the bar and opposed the SEC's proposed "permissive disclosure" and "noisy withdrawal" rules. This, despite the 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 virtually every state already authorize noisy withdrawal without explicit limitation on the circumstances in which the "noise" may be made.

On January 29, 2003, the SEC adopted a rule, which took effect on August 5, 2003.[5] As section 307 mandates, it requires up-the-ladder reporting in certain circumstances. It also provides that lawyers may in some circumstances disclose client fraud to the SEC without the issuer's consent ((a provision often referred to as permissive "reporting out" in contrast to the required "reporting up" the corporate ladder). 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 first proposal on noisy withdrawal, albeit saying at the same time that it would continue to consider that first proposal too.

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

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[4]Conference of Chief Justices, Res. 35, "In Support of [ABA] Rule 1.6(b)(2) and 1.6(b)(3) of Ethics 2000," Aug. 1, 2002 (signed by Judith S. Kaye, President).

[5]Securities Act Rel. No. 8185, "Final Rule: Implementation of Standards of Professional Conduct for Attorneys" (Jan. 29, 2003), adopting regulations that now comprise 17 C.F.R. Part 205.

In August 2003 the ABA House of Delegates amended Rules 1.6 and 1.13 substantially as recommended in the Task Force on Corporate Responsibility's final report. Rule 1.6 was thus changed to allow disclosure of client fraud in certain situations.[6] And 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-levels officers fail to take action to address a law violation (Rule 1.13(b)); and second, to inform the organization's highest authority of a lawyer's discharge or withdrawal for fulfilling the up-the-ladder reporting duties of the rule (Rule 1.13(d)). 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(e)).

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. But as important, and probably more important, was the ABA's desire to keep the SEC and the rest of the federal government at bay.

B. A Situation to Ponder[7]

In March 2003, the SEC filed a partially settled securities fraud complaint against Spiegel, Inc.("Spiegel") in a Chicago federal district court. During the same month Spiegel, a retailer which operates a mail order business and the Eddie Bauer clothing chain, filed for Chapter 11 bankruptcy protection. 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 as a going concern. Terms of the settlement, in which Spiegel neither admitted nor denied wrongdoing, 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.

Six months later, in September 2003, Mr. Crimmins filed his examiner's report with the district court. The Crimmins report states that the law firm responsible for approving Spiegel's

[6] ABA Task Force on Corporate Responsibilty Report to the House of Delegates and Governance Policy ResolutionABA (Dec. 2002). A preliminary report of the Task Force had startled the corporate bar by recommending that "reporting out" be required rather than permissive. See Preliminary Report of the American Bar Association Task Force on Corporate Responsibility, 58 Bus.Law. 189 (2002).

[7] The first four paragraphs that follow are derived from Jonathan Weil & Cassell Bryan-Low, "Report Bolsters SEC's Proposal for Attorneys," Wall St. J., Sept. 15, 2003, at p. ?. For the most part, the ideas and many sentences are taken directly from the article and would be treated as quotations except that they have been reordered to put the scenario in chronological order.

securities disclosures, Kirkland & Ellis LLP ['Kirkland'] "had plainly advised Spiegel that it was violating the law by not filing" its 2001 annual report with the SEC. Kirkland also warned the company's management and top directors that "this illegal act could have serious consequences, including action by the SEC." When Spiegel refused, Kirkland did little to press the point.

A Kirkland spokesman and partner, Jack Levin, told the Wall Street Journal that the law firm "repeatedly advised the company to file its SEC reports, and repeatedly told the company that failure to file was a serious matter," adding, "The [examiner's] report confirms that we gave our advice loudly and clearly." Spiegel "decided not to follow our advice," and "stopped asking advice on the matter," said Mr. Levin, who wasn't involved in the firm's advice to Spiegel. "There are no rules that say you must resign if the client doesn't take your advice." He added: "The SEC, of course, is debating whether it should adopt such rules, and the debate is ongoing."

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.

"Those stated reasons weren't true, and Kirkland knew it, Mr. Crimmins's report says. '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.' 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 Criminal Violations.'"[8]

"Asked about the reasons stated on Spiegel's late-notice filings, Kirkland's Mr. Levin said, 'All the underlying facts – that the company had defaulted on its debt and other financial problems – were disclosed.'"

"Mr. Crimmins's report details numerous accounting violations at Spiegel, which hit the skids after it bagan issuing easy credit to unqualified customers as a way to boost revenues. The report also criticizes KPMG's auditing practices. But Mr. Crimmins's harshest criticism of KPMG comes for what he says was the auditing firm's failure to notify the SEC, as required by federal statute, about apparent illegal acts by the company, namely Spiegel's refusal to disclose KPMG's own going-concern opinion. 'KPMG stood by . . . did not make a report to Spiegel's board, did not resign and did not report the matter to the SEC,' the report says.

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[8]This and the following six paragraphs are direct quotes from Jonathan Weil & Cassell Bryan-Low, "Report Bolsters SEC's Proposal for Attorneys," Wall St. J., Sept. 15, 2003, at p. ?.

"KPMG on Friday said its auditors acted appropriately, adding, 'Spiegel and its audit committee were being advised about its disclosure obligations by competent and respected legal counsel.'"

"According to the report, Spiegel's executive committee rejected the views of Kirkland, KPMG and Spiegel's management during a May [31,] 2002 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 & Case LLP interpreted Kirkland's advice for Spiegel's audit committee, which in turn made recommendations to Spiegel's executive 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,' he said."

The Wall Street Journal article, entitled "Report Bolsters SEC's Proposal for Attorneys," states that "Mr. Crimmins's findings likely will add pressure on the SEC to adopt its proposed "noisy withdrawal" rules for corporate lawyers."

Mr. Crimmins, acting as the district court's examiner of the affairs of a company that was cooperating with the SEC in its enforcement proceeding, based his report 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.

If the facts recited in the Crimmins's report are taken as true, did the applicable state ethics rules permit or require the following actions? If the SEC rule implementing section 307 of Sarbanes-Oxley had been in effect at the time Kirkland acted, would it require or permit the following actions?

1. Require Kirkland, knowing that the company was considering whether to file a false statement with the SEC, to take this matter to Spiegel's highest authority (the appropriate committee of the board or the full board)?

2. Require Kirkland to resign from any representation of Spiegel related to its securities filings if Spiegel failed to meet its obligations under the federal securities laws?

3. Require Kirkland to correct the prior material false statements its client had made to the SEC and which Kirkland had prepared?

4. Permit or require Kirkland to disclose confidential information to the SEC or defrauded persons to rectify the prior fraud or prevent the continuing fraud? And

5. If the SEC's "noisy withdrawal" proposal had been in effect at the time Kirkland acted, would Kirkland have been required to withdraw from its representation of Spiegel, disaffirm the filings which it had helped to prepare, and notify the Commission of its withdrawal "for professional considerations"?

This paper will consider these questions along with additional observations on the application, interpretation and ambiguities of the SEC rules implementing section 307 of Sarbanes-Oxley.

II. 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.[9]

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).[10]

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.[11]

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 who own it and does not owe duties of care, diligence or confidentiality to those constituents unless joint representation of the organization and a constituent is agreed upon and does not involve an impermissible conflict of interest.[12]

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 a

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[9]This summary is largely drawn from comments b, d and f of § 96 of American Law Institute, Restatement (Third) of the Law Governing Lawyers (2000) [hereinafter "Restatement of the Law Governing Lawyers"],

[10]The rule that the entity is the client, not those who manage it, is recognized in many judicial decisions, in Model Rule 1.13(a), and in EC 5-18 of the ABA Model Code of Professional Responsibility (1969). The Restatement of the Law Governing Lawyers §96, cmt. *c*, states: "The so-called "entity" theory of organizational representation . . . is now universally recognized in American law, for purposes of determining the identity of the direct beneficiary of legal representation of corporations and other forms of organizations."

[11]Restatement of the Law Governing Lawyers §96, cmt. *d*, states: "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. . . . 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]."

[12]Restatement of the Law Governing Lawyers §96, cmt. *b*.

constituent of the organization from violating a legal obligation to the organization or causing harm to the organization by taking acts on behalf of the organization that will cause injury to it, such as by exposing the organization to criminal or civil liability.[13] 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 the organization communications gained from constituents who are not themselves clients. [14]And the organization, acting through duly authorized constituents, may assert or waive the duty of confidentiality or the attorney-client privilege to such information.[15]

Most of these propositions are stated or are implicit in ABA Rule 1.13 as adopted in 1983 and subsequently by virtually all states.[16] 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(c): When a lawyer for an organization becomes aware that a constituent of the organization is engaged in wrongful conduct that is likely to harm the organization or embarked 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" (emphasis added).

Two circumstances explain the widespread failure of lawyers to understand that Rule 1.13 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 rule itself prior to its amendment in August 2003. Rule 1.13(b) 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

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[13]Restatement of the Law Governing Lawyers §96, cmt. *e*, states that the organization's lawyer "must not knowingly or negligently assist any constituent to breach a legal duty to the organization . . . to act diligently and to exercise case to prevent reasonably foreseeable harm to a client [and] to take action with respect to certain breaches of legal duty to the organization by a constituent." See also Roger C. Cramton, Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues, 58 Bus.Law. 143, 145-58 (2002); and 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).

[14]Disclosure within the 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 . . . ." Restatement of the Law Governing Lawyers §96, cmt. *c*.

[15]See Restatement of the Law Governing Lawyers §73, cmt *j*, discussing the authority of those in control of an organization, not individual constituents, to waive the 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 (1985)

[16]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 ABA Rule 1.13.

the organization" coming last. As a consequence, many lawyers have viewed the provision only as 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 when an organization's lawyer does nothing to prevent organizational wrongdoing resulting in harm to third persons and ultimately to the organization. Judicial decisions and ethics opinions interpreting and applying Rule 1.13 are virtually nonexistent.[17] Disciplinary proceedings against lawyers who failed to report a law violation within the organization, we believe, have not been brought. The newspaper reports of a number of the corporate failures and financial restatements during the last three years indicate that board members were often left uninformed of serious legal matters affecting the corporation, despite the Rule 1.13(b) requirement that company lawyers act in the best interest of the organization.

As indicated earlier, in August 2003 the ABA amended Rule 1.13 to remedy these flaws. Rule 1.13 now: (1) requires a lawyer to inform 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)); (2) requires the lawyer to inform the highest authority of a lawyer's discharge or withdrawal for fulfilling the up-the-ladder reporting duties of the rule (1.13(e)); (3) adds a new provision permitting disclosure of confidential information outside the organization when the highest authority of the organization has failed to address a law violation that was reasonably certain to result in substantial injury to the organization (1.13(c)); and (4) as an exception to this permissive disclosure, provides that a lawyer retained to investigate or defend an alleged violation of law cannot disclose information relating to the representation (1.13(d)).[18]

Despite these desirable changes in ABA 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. Whether or when state high courts will adopt the amended version of the rule remains uncertain. Even if they do adopt the new 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, and that would make enforcement difficult.

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[17]The ABA Annotated Model Rules 5th ed. cites no cases for 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 (2001).

[18]The report duty of an organization's lawyer under ABA Rule 1.13(b) as well as the client fraud disclosures now permitted under Rule 1.6(b)(2) and (3), as amended in August 2003, require that the lawyer's information be related to the representation. State rules that use the same language contain the same restriction. However, the "evidence of a material violation" that a lawyer must report and may disclose under the SEC's rule implementing § 307 of Sarbanes-Oxley need not be related to the lawyer's representation of an issuer. The report may be triggered by information learned from any source, not just the issuer, and by information totally unrelated to the scope of the lawyer's representation of the issuer.

These include: (1) the actual knowledge standard (which we discuss below); (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" rather than to third parties; (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 circumstances."

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 obligation to the organization[19] or 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).[20] 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 a constituent from violating federal securities laws.[21]

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[19]See, e.g., In re American Continental Corp., 794 F.Supp. 1424, 1453 (D.Ariz.1992) (allegations that law firm failed to take corrective action to prevent serious regulatory violations by those then in control of the organization stated a claim for relief; lawyer must go to the board, urge cessation and withdraw when continued representation will assist the ongoing illegality); Financial Gen. Bankshares, Inc. v. Metzger, 523 F.Supp. 744 (D.D.C.1981) (lawyer violated fiduciary duty to organization by assisting a hostile takeover), vacated for lack of jurisdiction, 680 F.2d 768 (D.C.Cir.1982). See also

[20]See, e.g., FDIC v. O'Melveny & Myers, 969 F.2d 744 (9th Cir.1992) (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), reaffirmed on remand, 61 F.3d 17 (9th Cir.1995); FDIC v. Clark, 978 F.2d 1541 (10th Cir.1992) (substantial evidence supported jury verdict that corporation's lawyers breached duty to make a reasonable independent investigation into third-party allegations of fraud on part of corporate officers).

[21]In the Matter of Carter and Johnson, 47 SEC 471 (1981) (stating a 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."); and In re Gutfreund, Exchange Act Release No. 31,553 (1992) (lawyer who had legal compliance duties as chief legal counsel of an investment banking firm, and who knows or has reason to know the misconduct by a company trader has not been addressed, must take appropriate steps to ensure that the misconduct is adequately addressed, including disclosure to the entity's board of directors, resignation from the . . . [representation], or disclosure to regulatory authorities).

B. Required Reporting under Section 307 of Sarbanes-Oxley[22]

The final rules implementing section 307 of Sarbanes-Oxley are set forth in new Part 205 of the Commission's rules.[23] 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 chief legal counsel or to both the chief legal counsel and the chief executive officer. If the chief legal counsel or chief executive officer fails to provide an "appropriate response" to the evidence, the attorney must report the evidence to the audit committee, another independent committee, or the full board of directors.

The SEC rules supplement state ethics rules and are not intended to limit states from imposing additional obligations consistent with their purposes.[24] The SEC is required to promulgate "minimum" rules of professional conduct, not "maximum" ones. Where state rules conflict with the SEC rules, however, the federal rules will govern. Preemption of state standards is most likely to arise with respect to disclosure of confidential information outside the organization ("reporting out"), discussed in Part III-C, below.

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 §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."[25] In accordance with this directive, the SEC promulgated §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;

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[22]One of the authors of this article, Roger Cramton, is indebted to the participants in a program at the annual general meeting of the Attorneys' Liability Assurance Society in Quebec City on June 12, 2003 for expanding his understanding of Part 205. In addition to the oral discussion by all participants, the position papers prepared by ALAS and Simon M. Lorne were especially helpful.

[23]17 CFR § 205.

[24]Section 203.1, dealing with the purpose and scope of the Commission's new rules setting forth "minimum standards of professional conduct for attorneys," states:

> These standards supplement applicable standards of any jurisdiction where an attorney is admitted to practice and are not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with the applicable 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.

[25]15 U.S.C. §7245 (emphasis added).

- 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
- 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.

The definition also contains two important exclusions in §205.2(a)(2). 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." Second, the rules exclude some, but not all, foreign lawyers, specifically those who qualify as "non-appearing foreign attorneys" under a later definitional section, §205.2(j).

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. We consider these in turn.

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 §205.2(a)(1)(iii), which includes as a lawyer "appearing and practicing" before the SEC, one who "[p]rovid[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." Practicing lawyers have expressed concern about the possibility that this provision sweeps within the SEC rules' grasp lawyers in two general situations.[26] First, transactional lawyers who are specialists in some area other than securities law – such as tax, labor, or environmental – 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 information relevant to the question whether the litigation affect's the issuer's financial position. The SEC responded to the bar's concerns by requiring that lawyers have "notice" that their documents will be made part of an SEC filing.[27]

In fact, however, §205.2(a)(1)(iii) is ambiguous as to whether these non-securities lawyers are covered by the SEC rules. The 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

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[26]See, e.g., ABA Comments on Initial Proposed Rules, at 12.

[27]See SEC comments to Section 205.2(a).

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." If "in respect of" means "about," then lawyers who are not securities lawyers would not be giving the required advice. On the other hand, if "in respect of" means "relevant to" (as in, if the information is materially misleading, its inclusion in the filed document may constitute a violation of securities laws), then these lawyers would be covered.

Regardless of how a court would interpret the language of §205.2(a)(1)(iii), we believe that the SEC rules should cover non-securities lawyers in the situations described and either the language of the rule should be changed or the SEC should clarify the 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, may be assisting, or at least facilitating, a securities law violation. The investing public could 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 may be 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, and all material violations of securities law or breach of fiduciary duty the lawyer becomes aware of, not just evidence within the lawyer's area of expertise. It is true that, unlike MR 1.13(b), which limits the obligations imposed on a corporation's lawyers to "matter[s] related to the representation," the duty to report under §205.2(b) contains no similar limitation. The most sensible reading of the duty to report under §205.2(b), however, is that 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 §205.5. Subordinate lawyers, defined broadly as lawyers who appear and practice before the SEC "under the supervision or direction of another attorney," 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 her duties under the rules. Lawyers who are not securities lawyers would 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. Second, as a practical matter, the sanctions the SEC can impose on non-securities lawyers are limited. 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 (and more importantly, his firm's) practice.

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

With respect to lawyers who do specialize in securities law, the main coverage question addressed and resolved by the SEC rules is whether lawyers who do not sign documents filed with the SEC are covered. One scenario involves 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)(iv) expressly includes lawyers who "[a]dvis[e] 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." The securities laws are as concerned with failures to make required disclosures as they are with affirmative misstatements in required disclosures. Thus, there is no good reason to exclude lawyers who advise against disclosure 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 §205.2(a)(iii), quoted in the previous section. We applaud the SEC's decision to include these lawyers. Any other rule would facilitate circumvention of Part 205 by encouraging some 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 nonsigning 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 third-party liability for aiding and abetting a securities violation – the assistance that lawyers most commonly provide to risk-taking clients – is no longer available because of the *Central Bank* decision.[28]

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 when a reasonable lawyer would not, to advise that legally required documents need not be filed, or to counsel that information that

[28]Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994) (eliminating accessory liability in private suits under §10(b) of the Securities Exchange Act).

should be disclosed need not be.[29] In *SEC v. National Student Marketing*,[30] the court said that, in some circumstances, such conduct is more than malpractice; it amounts to aiding and abetting securities fraud. Finally, and most recently, *In re Enron Corp. Securities, Derivative & ERISA Litigation* held that lawyers can be primary violators of the securities laws even if they do not sign the relevant documents.[31]

Civil liability, however, provides an insufficient deterrent. First, under *Central Bank*, private parties can no longer bring civil suits for aiding and abetting. 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 us 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 malpractice, and 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 Part 205 does.

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 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, whoever signed it.[32] The argument that advising as described in § 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 the concern that the rules could be read to cover people employed by corporations who are trained and licensed lawyers, but who do not practice law within the company. In response, the SEC drafted §205.2(a)(2)(i), which excludes from coverage lawyers who engage in the activities described in §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."

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[29]In the *O'Melveny* case, supra n. ?, 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.

[30]457 F. Supp. 682 (D.D.C. 1978).

[31]235 F. Supp.2d 549 (S.D. Texas 2002).

[32][cite from legislative history]

It is not clear that the exemption in §205.2(a)(2)(i) was necessary at all. In the first place, the duty to report under §205.3(b) is limited to an attorney "appearing and practicing before the Commission *in the representation of an issuer*." "In the representation of an issuer" is defined in §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." 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 huge problem. The bigger problem with §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."[33] That phrase was not necessary to exempt licensed lawyers who perform only business functions for the corporations that employ them. What the phrase does is exempt lawyers who do provide legal services to the issuer, but not in the context of an "attorney-client relationship" with the issuer. Who might such lawyers be? They could include lawyers for a related corporate entity (such as a subsidiary or SPE) or for an agent of the issuer (such as the CFO). For an example of such lawyers, we need look no further than the Enron case itself, in which Kirkland & Ellis is alleged to have provided substantial legal advice to Enron while representing only Fastow and the SPEs. We do not see any 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 had no "attorney-client relationship" with the issuer.

The rules address this problem in part in the definition of "issuer" in §205.2(h). 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, regardless of whether the attorney is employed or retained by the issuer." This could take care of problems like Kirkland's representation of the Enron SPE's, 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 shouldn't it be 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"[34] §205.2(a)(2)(i). In our view, however, the cleaner solution is to drop the "attorney-client relationship" limitation, and substitute the "on behalf or, or at the behest, or for the benefit of the issuer" phrase in §205.2(a)(2)(i).

d. The Partial Inclusion of Foreign Lawyers

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[33]A similar point could be made about the phrase "as an attorney for an issuer" in §205.2(g).

[34]The SEC, in its comments to §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."

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.[35] Despite the universal outcry from foreign lawyers, the SEC did not completely back down in its final rules,[36] though it did retreat somewhat, in two separate rules. 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." Section 205.2(a)(2)(ii) excludes all "non-appearing foreign attorneys," a term defined in §205.2(j). Section 205.6(d) seems sensible and straightforward (if not sufficient to address the legitimate concerns of foreign lawyers, as well as US lawyers practicing in foreign countries),[37] so we will focus our brief comments on §205.2(j).

To qualify as a "non-appearing foreign attorney" under §205.2(j), a lawyer must meet three criteria. First, the lawyer must be "admitted to practice in a jurisdiction outside the United States." Second, the lawyer must neither "hold himself or herself out as practicing," nor "give legal advice regarding, United States federal or state securities or other laws," unless done "in consultation with" a US lawyer. Third, the lawyer's "appearing and practicing" activity within the meaning of the SEC rules is done in either one of two contexts. 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." 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."

Section 205.2(j) essentially gives foreign lawyers the ability to opt out of the SEC rules by hooking up with a US lawyer. The key question is how "in consultation with" will be interpreted. There would not be much problem if the requirement means that the US lawyer is responsible for the representation and for the conduct of the foreign lawyer. That would be an extension of the rules for supervisory and subordinate lawyers outlined in §§ 205.4, 205.5, except that the foreign "subordinate" would not even have reporting responsibilities to the US "superior." If the US lawyer were vicariously liable for the foreign lawyer's conduct, however, the US lawyer would have an incentive to ensure compliance by the foreign lawyer. But "in consultation with" more likely is intended as a looser connection between the foreign and US lawyer. In that case, the exemption would be more troubling. The looser the connection, the more foreign lawyers will 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.

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[35]According to its comments to §205.2(j), the SEC received more than 40 comment letters addressing the international aspects of the initial proposed rule.

[36]See §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....").

[37]Some question may arise about the meaning of "applicable." When is foreign law "applicable" to a US-licensed lawyer practicing in a foreign jurisdiction?

In this regard, it is important to note that even foreign-licensed lawyers who practice US securities law in the United States (and who apparently may even be US-licensed lawyers as well) 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 US lawyer, then the foreign lawyer can be exempt only if he practices or gives advice with respect to foreign law, practices law outside the US, 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 US-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 the relationship the foreign lawyer has with the US issuer and the more often the foreign lawyer as part of his regular practice provides information on foreign law for the purpose of inclusion in a US securities filing, the greater the justification for regulating such 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. The SEC rules appear directed at individual attorneys.[38] In our view, 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.

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[38]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." The comments accompanying §205.2(c) make 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 §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."). This could support the conclusion that "attorney" does not include "firm," though the comment to this provision suggests otherwise ("The Commission is of the view that the protection of this provision should extend to any entity that might be compelled to take action under this part. . . .").

The rationale for including law firms within the SEC rules is straightforward.[39] Corporate clients who hire outside counsel usually understand that they are represented by the law firm, not any one individual lawyer within the firm. And in matters of any size or complexity multiple lawyers 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 up 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 what was done. The law of agency addresses these realities through rules of vicarious liability and imputed knowledge, which we discuss in more detail in the next section. Moreover, the SEC itself has sought to discipline law firms in the past in exercising its authority under Rule 2(e).[40]

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

The heart of §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)." The rule implementing this requirement, §205.3(b), 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 [CLO] (of the equivalent thereof) or the both the issuer's chief legal officer and its chief executive officer (or the equivalents thereof) forthwith."[41] The SEC rules define "evidence of a material violation" in §205.2(e) as "credible

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[39]For a persuasive argument in favor of disciplining law firms, see Ted Schneyer, Professional Discipline for Law Firms?, 77 Cornell L.Rev. 1 (1991); cf. Wilkins article in Geo. J. Legal Ethics. For a critique, of Schneyer's proposal, see Julie Rose O'Sullivan, Professional Discipline for Law Firms? A Response to Professor Scheneyer's Proposal, 16 Geo. J. Legal Ethics 1 (2002). New York and New Jersey now allow for discipline of law firms. See DR 1-104, 5-105(E) [NY]; NJ R. Prof. Conduct 5.1(a).

[40]See In re Keating, Muething & Klekamp, Release No. 34-15982, 1979 WL 186370 (July 2, 1979) (finding that a "law firm has a duty to make sure that disclosure documents filed with the Commission include all material facts about a client of which it has knowledge as a result of its legal representation of that client," and imposing sanctions on law firm for "fail[ing] to carry out its professional responsibilities").

[41]17 C.F.R. §205.3(b)(1). The SEC rules provide two alternative first steps to reporting to the chief legal officer: reporting to a qualified legal compliance committee and 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 chief legal officer. Id. §205.3(c) (stating trigger for duty to report as 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, id. §205.2(k). The alternative of bypassing the chief legal officer 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 legal officer and chief executive officer." Id. §205.3(b)(4). Reasonable belief is defined as actual belief plus

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."[42]

In assessing how faithfully and well the SEC rules implement the Congressional mandate, it is important to keep in mind the goals of §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 demonstrates, 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 §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 "reasonable 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 §205.2(e) must ask herself whether it would be *unreasonable not to conclude* 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

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circumstances suggesting that the belief is "not unreasonable." Id. §205.2(m).

[42] 17 C.F.R. §205.2(e). Other relevant definitions are "material violation" in §205.2(i) and "breach of fiduciary duty" in §205.2(d).

understand, interpret or apply.[43] 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."

Moreover, the SEC's standard fails another critical test of sound rulemaking. It would be a nightmare to enforce. 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."[44] 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 §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, and to find any possible way to avoid doing so.

The SEC could easily have adopted a rule 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 triggering standard we proposed in our comments to the SEC, and which we still support. 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.[45] It would also be consistent with Congress's intent by providing an objective

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[43]See Floyd Norris, No Positives in This Double Negative, N.Y.Times, Jan.24, 2003, at p. ?, stating that the change from a "straightforward" and "reasonably simple definition" to one that is "confusing" and makes the required reporting up the ladder "a lot harder to enforce."

[44]CITE to SEC Comments. The SEC used a similar double negative to define "reasonable" in §205.2(l) and "reasonably believes" in §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," making that definition even more confusing and solicitous of lawyer discretion.

[45]See, e.g., Restatement (Third) Law Governing Lawyers §52 cmt. b (interpreting a 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 measures or select the same options as would other competent lawyers in the many different situations in which competent lawyers reasonably exercise professional judgment in different ways"). Moreover, our proposed reasonableness standard, by using the word

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"). We fear that 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 materiality 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.[46] If the language 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.[47]

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.'"[48] 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

"would" rather than "could," ensures the recognition of sufficient lawyer discretion without undermining the rule.

[46]Simon N. Lorne, An Issue-Annotated Version of the SOx 307 Rules, in ALAS Loss Prevention Programs, p. A-117, 125 (June 12, 2003).

[47]In our first set of comments to the SEC, we recommended a "probable cause" standard for handling this concern.

[48]Comment of Attorneys' Liability Assurance Society, Inc., on the SEC Proposed Rule (Mar. 28, 2003), at p. ???.

the meaning 'possible,' which is counter-intuitive for most attorneys, confusing and contrary to the commonly accepted meaning."[49]

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 enforcement cannot be based, 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 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),[50] which Congress sought to replace in §307, 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.[51] 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.[52] The law of malpractice goes even further and recognizes a duty to

[49]Id.

[50]Under Model Rule 1.13(b), a lawyer for a corporation has no duty to act unless he "knows" that a violation is occurring or about to occur. "Knows" is defined in Model Rule 1.0(f) as "actual knowledge," which "may be inferred from circumstances." It is important to note that 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.

[51]See 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 transactions with a particular vendor that were numerous and unusual, and received a letter from OPM's former chief financial officer, just resigned, that many of the transactions with that vendor were fraudulent.

[52]Whether the "actual knowledge" standard of the Model Rules adopts the "willful blindness" standard is unclear. The argument that they do derives from the "inferred from circumstances" language in the definition of "knows," Model Rule 1.0(f). The comment to one of the Model Rules does make reference to the willful blindness

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;[53] failed to inquire when a number of suspicious circumstances would have stimulated action by a prudent and competent lawyer;[54] failed to report illegal activities by the client's managers to its board of directors;[55] turned a blind eye to facts that were plain to see;[56] or failed to take steps to prevent a continuing violation of law.[57] 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

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standard, see Model Rule 4.2 cmt. [8]. But since no similar comment accompanies Model Rule 1.13, or even Model Rule 1.2(d) (the aiding and abetting rule), that only raises the question of whether the willful blindness standard is limited to rule for which the comment was included. The Restatement position is similarly ambiguous, though the Restatement does suggest there is no duty to investigate. See Restatement (Third) of the Law Governing Lawyers §94, cmt *g*:

> When a lawyer's state of knowledge is relevant, in the absence of circumstances indicating otherwise, a lawyer may assume that a client will use the lawyer's counsel for proper purposes. Mere suspicion on the part of the lawyer that the client might intend to commit a crime or fraud is not knowledge. Under the actual knowledge standard [including knowledge inferred from the circumstances]. . . , a lawyer is not required to make a particular kind of investigation in order to ascertain more certainly what the facts are, although it will often be prudent for the lawyer to do so. . . . On the other hand, the prohibitions . . . do apply at whatever point the lawyer does know that the client's intended conduct is [unlawful].

[53]See, e.g., FDIC v. Clark, 978 F.2d 1541 (10th Cir.1992) (lawyers for a bank, after receiving plausible allegations that the bank's president had defrauded the bank, accepted the president's explanation without making further inquiry or informing the bank's board of the allegations; the jury's verdict against the law firm in a suit by the bank's received was affirmed).

[54]See, e.g., FDIC v. O'Melveny & Myers, 969 F.2d 744 (9th Cir.1994)(law firm, knowing of the recent resignation of its client's prior auditors and outside law firm, made no further inquiry before giving legal opinions and doing other work assisting the client in giving legal opinions and doing other work that assisted the client in selling securities that turned out to be fraudulent).

[55]See, e.g., American Continental Corp., 794 F.Supp. 1424 (D.Ariz.1992) (failure to report the illegal activity of the client's managers to its board of directors "could not be excused because thought to be 'futile.'").

[56]United States v. Benjamin, 328 F.2d 854 (2d Cir.1964) (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 the scienter requirement of a mail fraud conviction for securities fraud); 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 the 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").

[57]SEC v. National Student Marketing Corp., 457 F.Supp. 682 (D.D.C. 1978) (lawyers who closed a merger transaction knowing that the 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 the Matter of Carter and Johnson, 47 SEC 471 (1981) (a lawyer's continued representation knowing of a client's ongoing securities fraud "violates professional standards unless he takes prompt steps to end the client's noncompliance"); and In re Gutfreund, Exchange Act Release No. 31544 (1992) (the chief legal officer of a public company must take affirmative steps to ensure that misconduct by a company trader is adequately addressed).

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.[58]

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." By lowering the trigger from "violation" to "evidence," §307 and the SEC rules in effect shift much of the burden of a duty of inquiry to the chief legal officer to whom initial reports are made.[59] But 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 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.[60] One reason is that lawyers are

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[58]See, e.g., Kline v. First Western Gov't Secs., Inc., 24 F.3d 480 (3d Cir.), cert. denied, 513 U.S. 1032 (1994)(facts relied on in legal opinion must be investigated when firm had notice they might not be accurate); Breard v. Sachnoff & Weaver, Ltd., 941 F.2d 142, 144 (2d Cir.1991) (firm's knowledge that client's principal had been convicted of mail fraud required it to conduct an independent investigation); and Ackerman v. Schwartz, 947 F.2d 841 (7th Cir.1991) (knowledge of suspicious circumstances makes a further inquiry necessary).

[59]The duty of inquiry for the chief legal officer as a result of a "report" of evidence of a material violation is made explicit in §205.3(b)(2).

[60]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 cmt. d, e. 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 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 necessary 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 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

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.[61] We do not think the rules should be interpreted to 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 the rules 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 they do risk falling into a trap for the unwary.

Of course, prudent lawyers will investigate suspicious, credible information in any event. 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 chief legal officer 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 change of the relationship with the issuer can set a similar tone within her firm to insure that she may be fully informed and serve a function analogous to that of the client's chief legal officer in determining what inquiry is necessary or prudent and how it should be carried out.

In our view, however, the thrust of §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.[62] The SEC rules should implement that vision.

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in his position would infer such fact from other facts already known to him.

[61]The SEC in its comments refers to §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 §205.1 ("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."); §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."). 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.

[62]Simon Lorne, a former SEC general counsel, draws a very different conclusion. He argues: "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." Simon N. Lorne, An Issue-Annotated Version of the SOx 307 Rules, in ALAS Loss Prevention Programs, p. A-117, 126 (June 12, 2003).

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" 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.[63] 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."[64] 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.[65]

When the agent has a duty to disclose information to the principal, the imputation of knowledge from the agent to the principal 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 principal in the

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[63]Restatement (Second) Agency §272.

[64]Uniform Partnership Act §12. 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 supra note ___. The Revised Uniform Partnership Act, now adopted by a majority of US 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), 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. [CHECK]

[65]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.

transaction.[66] 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.[67] 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.[68] The SEC has previously endorsed the composite knowledge idea in exercising its disciplinary authority against law firms under Rule 2(e).[69]

In our view, not only should the SEC rules apply to law firms, but the application to law firms should include the idea 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. Moreover, we would not expect a composite knowledge rule to add significantly to legal costs. Firms often have good economic 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 itself would unnecessarily escalate fees, as well as an increased 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.

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[66]Restatement (Second) Agency §275 cmt. b.

[67]Id. §277 cmt. b.

[68]See, e.g. US v. T.I.M.E.-D.C. Inc., 381 F. Supp. 730, 738 (W.D. Va. 1974): "knowledge 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." But cf. Woodmont v. Daniels, 274 F.2d 132, 137 (10th Cir. 1959) ("While in some cases a corporation may be held constructively responsible for knowledge of its agents, whether acting in unison or not, . . . we are unwilling to apply the rule to fix iability where, as here, intent is an essential ingredient of tort liability as for deceit.")

[69]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."

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 sanction, 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.[70]

There is, of course, one area in which we do 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 we worry that lawyers will disclose information that they should not, and presume that they do. In the case of client wrongdoing, the concern is that lawyer will fail to disclose information that they should. 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 is through the rule concerning the responsibilities of supervisory attorneys. Under §205.4(b), a "supervisory attorney shall make reasonable efforts to ensure that a subordinate attorney . . . that he or she directs conforms to this part." The rule as drafted 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 §205.4(b). Section 205.4(b) could, however, 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 would recommend clarifying that the chief legal officer of the corporation, who defined as a supervisory attorney under §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. Just as law firms should not have an incentive to balkanize work among its various lawyers, neither should the issuer have an

[70] See Restatement (Third) Law Governing Lawyers §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.").

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 rules. If that standard is so weak that lawyers inclined to do so can easily circumvent it, if it is so ambiguous, convoluted, and weak that the SEC cannot effectively enforce it, the rules will have accomplished nothing. 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 standard, which 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 chief legal officer. The "report" is not a formal, detailed document, but can be a simple phone call, e-mail, or even casual water cooler comment.[71] More important, the lawyer is not required to take any further steps without an additional, more demanding trigger, being satisfied. We consider those further steps and their accompanying trigger in the next section.

3. Obligations of the Reporting Lawyer after the Initial Report

Aside from the initial duty to report evidence of a material violation to the chief legal officer or chief executive officer, the other key component of §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 chief legal officer or chief executive officer does not "appropriately respond" to the reporting lawyer. The SEC implemented this directive in §205.3(b)(3), which states that the reporting lawyer "shall report evidence of a material violation" to the board or relevant board committee, unless the lawyer "reasonably believes that the chief legal officer or chief executive officer . . . has provided an appropriate response within a reasonable time."[72] The lawyer who

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[71]"Report" is defined in §205.2(n) as simply "mak[ing] known to directly, either in person, by telephone, by e-amil, electronically, or in writing." In its initial proposed set of rules, the SEC had required written reports, but even those could have been very informal.

[72]17 C.F.R. §205.3(b)(3). "Reasonably believes" is defined in §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, §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

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."[73] 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."[74]

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 evidence of a material violation as a result of which the attorney reasonably believes"[75] any one of three things. First, there is no problem; that is, "no material violation . . . has occurred, is ongoing, or is about to occur."[76] Second, the issuer is fixing whatever problem exists by adopting "appropriate remedial measures."[77] 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.[78] Either this

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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."

[73] 17 C.F.R. §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 §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.

[74] 17 C.F.R. §205.3(b)(8).

[75] 17 C.F.R. §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 §205.3(b)(3), the rules create an unfortunate redundancy so that if read literally they lead 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."

[76] 17 C.F.R. §205.2(b)(1).

[77] 17 C.F.R. §205.2(b)(2).

[78] 17 C.F.R. §205.2(b)(3). Note that the chief legal officer is obligated to "cause such inquiry into the evidence of a material violation as he or she reasonably believes is appropriate." §205.3(b)(2). Whether such an inquiry by the CLO qualifies as a "review" by an "attorney" under §205.2(b)(3), or whether §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 yes, though the structure of §205.3(b)(2) suggests that an "inquiry" by the CLO is separate from an "appropriate response." Under §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, §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 §205.2(b)(1) includes a determination of "no material violation" as one "appropriate response."

"investigatory lawyer"[79] must conduct a "reasonable investigation and evaluation of the reported evidence," make "remedial recommendations," and have those recommendations "substantially implemented" by the issuer.[80] 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."[81]

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 we do not deny that 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 the investigatory lawyer, and in particular the investigatory lawyer's assertion of a "colorable defense." The reason is that the definition 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 §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 §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 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 a material violation is uncertain, or at least is contested. But as we shall see, the differences far outweigh the similarities.

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[79]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 completing in this subsection.

[80]17 C.F.R. §205.2(b)(3)(i).

[81]17 C.F.R. §205.2(b)(3)(ii).

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 us, expressed the concern that the SEC rules should not chill legitimate advocacy on behalf of issuers. The chilling effect could be particularly strong in cases in which the SEC appeared as a party, particularly in those cases in which the SEC acted as both 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.[82] In our system, advocates 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 11[83] and state ethics rules,[84] and expressly incorporated into §205.2(b)(3)(ii),[85] are quite low. These standards suggest that virtually any argument or assertion is permissible if it has the slightest chance of prevailing.[86] 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 § 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

[82]We argued for precisely such a rule in our comments to the SEC. Our proposed rule stated: "Nothing in these rules prevents a lawyer who is acting as an 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."

[83]Federal Rules of Civil Procedure, Rule 11.

[84]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 . . . ."

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

[86]One experienced litigator has described his own test for "frivolous": "if nobody in the office giggles, it passes muster." See David Margolick, N.Y.Times, Jan. 20, 1989, at B4, quoting Harvey Silverglate, a well-known Boston lawyer.

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.[87]

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 by the CLO or CEO (rather than by the initially reporting lawyer) to the board. But the SEC did not take this route, with two exceptions: (1) allowing the CLO to refer the matter to a previously created QLCC;[88] and (2) ending the duty to report of a lawyer hired to investigate the evidence after the initial report.[89] 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.[90] 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 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, however, 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. 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 standard of "substantial evidence" 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

[87]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.

[88]§§ 205.3(b)(2), 205.3(c)(2).

[89]§205.3(b)(6)(i)(B) (lawyer retained or directed by the CLO to investigate reported evidence of a material violation has no duty of his own to report if the 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.

[90]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." §205.3(b)(4). Moreover, why would the SEC deem the CLO more trustworthy in reporting an investigating lawyer's report under §205.3(b)(6)(i)(B) than in reporting an initial report?

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 to locate the stricter standard.[91]

Our point is simply that 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. In particular, 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 fall far short of the statutory mandate.

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

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[91]There are at least three candidates for where the stricter standard could be located: the definition of "evidence of a material violation," §205.2(e) (which already includes a "reasonably likely" standard), the definition of "appropriate response," §205.2(b), or the triggering rule itself, §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.

Advocates operate in an environment designed to guard against abuses of that 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 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. 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 that our adversary system depends upon. 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, 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. The result of 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 when acting as an advocate, i.e., once conduct is challenged in a forum in which another party is arguing that the conduct is unlawful, the lawyer may 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 be too tempted to exploit these ambiguities.

The "colorable defense" prong of the third option in §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.[92] The SEC's intention may have been to avoid tying the hands of the issuer in subsequent litigation. The issuer might, for strategic reasons, forego 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

[92]Cf. §205.3(b)(6)(ii), providing an exemption to the duty to report for lawyers retained or directed "to assert . . . a colorable defense." We discuss this exemption in the next section.

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 §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.[93] 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." 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.[94] The opinions would inevitably have a 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.[95]

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

[94]Further support for the possibility of "colorable defense opinions" given in advance of any proceeding or investigation comes from the fact that §205.2(b)(3)(ii) contemplates that the lawyer retained or directed to "review" the 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."

[95]We note that a similar, and equally disturbing, problem of potential lawyer-shopping is created by §205.2(b)(3)(i), which deems the issuer to have made an appropriate response when an investigating 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 investigating lawyer. Compare also the unqualified "remedial recommendations" under §205.2(b)(3)(i) with the second "appropriate response" option in §205.2(b)(2), which refers to "appropriate remedial measures." An interpreter of §205.2(b)(3)(i) might reasonably ask why that option is there if it merely replicates the remedial standards of §205.2(b)(2). Given the apparent absence of constraints on the "remedial recommendations" made by lawyers hired to "review" evidence of a material violation under §205.2(b)(3)(i), issuers could be tempted to hire investigating lawyers known for making light or even no "remedial recommendations."

"May" is not the only small word that creates problems in §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 defenses "may" be available if litigation is filed be sufficient? It seems crazy to contemplate these possibilities, but a literal reading of §205.2(b)(3)(ii) unfortunately supports them. There is no explicit requirement that the "colorable defense" be a *complete* and substantive defense to *all* possible material violations in all possible proceedings based on the evidence.

Other parts of §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." Does this phrase mean, for example, that if the issuer has a colorable defense to terminating a whistleblowing employee in a wrongful discharge suit, the underlying material violation that gave rise to the whistleblower's actions need not be reported up? This problem could be avoided if "any" is interpreted to mean "all possible" rather than "any one." But 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, §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."[96] 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 CLO[97] – could serve the purpose. Equally

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[96]"Attorney" is defined, broadly, in §205.2(c).

[97]See supra note ___.

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.[98]

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.[99] 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 been informed, or otherwise already knew, about the evidence – exactly what 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 §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.[100] Thus, even if informed consent were required, informed consent might not mean that the board, before retaining or directing the reviewing attorney under §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.[101] Whether or not that is acceptable under §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 §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

[98]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, though apparently many practitioners do not see this as a problem. See MR 1.7.

[99]Cite to SEC comments.

[100]Cf. Model Rule 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. cmt. [6], [7].

[101]Lorne ALAS article.

appear in §205.3(b)(6) and §205.3(b)(7) and involve two types of lawyers: advocates and investigating lawyers.[102] 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,"[103] so long as the chief legal officer "provides reasonable and timely reports on the progress and outcome of such proceeding to the issuer's board of directors" or relevant board committee. Similarly, under §205.3(b)(7)(ii), a lawyer retained or directed by a qualified legal 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. These sections exempt advocate lawyers from reporting duties with respect to new evidence of ongoing or potential illegalities that she might discover as part of her 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 §205.2(b)(3)(ii), the "colorable defense" option under the "appropriate response" definition, §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 §205.3(b)(6)(ii). In addition, all the board need get to exempt the advocate from the duty to report is "reports on

[102]These lawyers roughly correspond to the lawyers mentioned in the "third option" under the definition of "appropriate response," §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 §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 §205.2(b)(3)(ii) requires for an "appropriate response" based on the potential assertion of a colorable defense.

[103]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.

the progress and outcome of such proceeding."[104] These progress reports need not contain information about any newly discovered evidence.[105]

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 §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.[106] 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. 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 ordinary Americans, who are held to account for crossing legal lines that also are gray at the edges. And 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

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[104]This phrase concerning progress reports to the board does not include "investigations," which are distinguished from "proceedings" but which the SEC apparently intended to suffice as supporting the exemption for advocates. This omission 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." We do not revisit that debate here.

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

[106]See Model Rules 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 constituents associated with the organization against a claim arising out of an alleged violation of law." Model Rule 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

"reports the results of the investigation to the issuer's board of directors" or relevant board committee.[107] And §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. At first blush, 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. At least that is what the SEC thinks they say.

On further inspection, however, the exemption rules for investigating lawyers provide inadequate assurance that the reporting up demanded by §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 §205.3(b)(6)(i), the CLO, not the board, "retains or directs" the investigating lawyer. And under both §205.3(b)(6)(i) and §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 §205.3(b)(6)(i) or §205.3(b)(7)(i) that the investigation be reasonable.[108] Indeed, §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 §205.3(b)(6)(i) nor §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 §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 §205.3(b)(7)(i), though presumably most such lawyers would in fact make a report.

And 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 reporting lawyer is deemed not to have received an "appropriate response" under §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 §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

[107]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.

[108]Cf. 17 C.F.R. §205.2(b)(3)(i), referring in the third option under the "appropriate response" definition, to a "reasonable investigation and evaluation of the reported evidence."

seems slight.[109] And as with advocates, the SEC could have drafted a narrow exemption for investigating 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. The SEC's adoption, instead, of overly broad exemptions for advocates and investigating lawyers threatens to seriously weaken the reporting up mandate of §307.

C. 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,[110] 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.[111] This strategy resulted in deterioration of Spiegel's financial condition when the 1990's boom ended and increased credit card losses triggered Spiegel's securitization obligations on its receivables. In 2001, Spiegel's financial condition worsened and it breached all four loan covenants in its bank loan agreements.[112] When efforts at renegotiating financing failed, its auditor, KMPG, on February 7, 2002, advised 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. 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 release that it would record a $398 million 2001 loss, but other facts in the release "seriously understated Spiegel's desperate circumstances."[113]

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, empowered to act for the full board, was held on March 31, 2002, in

[109] 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 seems overblown.

[110] Independent Examiner's Report Concerning Spiegel, Inc. of Stephen J. Crimmins, SEC v. Speigel, Inc., No. 03 C 1685 (D.C.N.D.Ill.) (available at SEC website) [hereinafter "Crimmins Report"]. The facts stated below are drawn from the Examiner's report.

[111] Id., at 2-3.

[112] Id.

[113] Id., at 44-49.

Hamburg, Germany.[114] The board participants were Michael Otto, the sole voting stockholder, who owned 90 percent of Spiegel stock, and two of his business associates, Cruesemann and Zapfel. The meeting was preceded by earlier meetings and discussions discussing all of the financial problems faced by Spiegel as well as its disclosure obligations under federal securities laws. The Form 10-K for 2001, which included KPMG's going concern warning, had been prepared by Kirkland and was virtually ready for filing.

At the May 31 meeting, the committee, rejecting the advice of all of the Chicago-based managers of Spiegel, its securities lawyers (Kirkland) and its auditor (KPMG), decided to file a notification of delayed filing. On April 1, 2002, Spiegel filed the Form 12b-25 notice of delayed filing that had also been previously drafted by Kirkland. 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 which, "as disclosed in the Company's press release of February 21, 2002, [will result] in a significant loss . . . ."[115] 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 employee morale and turnover.[116] 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. The examiner disagrees, stating that Rule 12b-25 requires both disclosure of the inability to make a filing "and the reasons therefore in *reasonable* detail" (emphasis added).[117] 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. Therefore, the failure to provide this material information to investors was fraudulent and misleading.[118]

The net effect was that investors did not learn of KPMG's going concern warning and other material adverse information until March 2003, almost a year later, when the SEC brought

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[114]Id., at 4, 50-52.

[115]Id., at 4-5, 50-52.

[116]Id., at 5-7, 53-61.

[117]Id., at 51, n. 14.

[118]Id., at 5-6.

an enforcement proceeding against Spiegel for failing to provide required reports for fraudulently withholding public disclosure of the company's 2001 annual report as well as subsequent quarterly reports, all 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; 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.[119] 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.[120]

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 the Sarbanes-Oxley Act and the SEC regulation implementing section 307 of that Act. 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 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.[121]

Kirkland's conduct prior to the end of May 2002 conformed to this requirement.[122] 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, at which 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.

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[119] Id. at 80-81.

[120] Id., at 64.

[121] Model Rule 1.13(b) and Comment [4] and [8].

[122] The implications of Kirkland's role in drafting and approving the misleading language in Speigel's March 29, 2002 notice of delayed filing and in subsequent quarterly filings will be considered in Part III, C of this article.

II. DISCLOSURE OF CONFIDENTIAL INFORMATION OUTSIDE THE CORPORATION ("REPORTING OUT")

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.[123] Second, when continued representation of a client would constitute illegal assistance, the lawyer is required to withdraw from the representation.[124] Third, a lawyer is permitted to disclose confidential information to prevent a client's prospective crime or fraud.[125] 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.[126] The last of these propositions echoes 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 fraud 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."[127]

The policies and purposes that justify the attorney-client privilege and its exceptions argue strongly for a permissive exception to the duty of confidentiality corresponding to the client-fraud exception of the attorney-client privilege. If a lawyer is required to testify to a client communication, otherwise privileged, when the client uses the lawyer's services to perpetrate a

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[123]Model Rule 1.2(d).

[124]Model Rule 1.16(a).

[125]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."

[126]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 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." Model Code 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.

[127]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).

fraud on a client 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 lawyers may be used by clients 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; and 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 frequent occurrence, the client's confidentiality will inevitably disappear.[128]

The American Bar Association (ABA) abandoned one of the four principles stated above in 1974 and another in 1983. In 1974, the fourth proposition was turned on its head.[129] 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. 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."[130]

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, 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 1970's to

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[128]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; finally, if the lawyer is charged by defrauded persons, the lawyer will use the self-defense exception to confidentiality.

[129]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 282-288 (3d ed.1999) [hereinafter "Hazard, Koniak & Cramton"].

[130]ABA Model Rule 3.3(a) (from 1983-August 2003).

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 securities laws.[131] 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.[132] But when SEC enforcement came into play with the *National Student Marketing* case,[133] 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 law-making 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); and 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.[134]

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 the frauds have continuing consequences that are unrectified. In 2002, only eighteen states permitted (two of them required) an explicit

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[131]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 the ABA's actions in 1974 and 1983 to opposition of powerful litigator groups (e.g., the American College of Trial Lawyers) and concern among some business lawyers about the SEC's enforcement of the profession's rules in the *National Student Marketing* case.

[132]See the remarks by Senator Michael Enzi during the Senate's consideration of § 307:

> 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 unenforced.

148 Cong. Rec. at S6555 (date?).

[133]457 F.Supp. 682 (D.D.C. 1978).

[134]Attorneys' Liability Assurance Society [ALAS], "Ethics Rule on Client Confidences," reprinted in Thomas D. Morgan and 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 51 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.

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.[135] 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) Because 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 Rule 1.2(d), Rule 1.16(a) requires the lawyer to withdraw unless the client corrects the prior false statement; (2) because the lawyer's continued representation would assist the client's continuing crime or fraud, Rule 4.1(b) requires the lawyer to correct the client's prior false statement of material fact when disclosure is permitted under Rule 1.6; and (3) 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. Hence the permission under Rule 1.6(b) becomes a mandate under Rule 4.1(b).[136]

In summary:

- Every state prohibits a lawyer from assisting a client's crime or fraud.[137]
- Every state requires a lawyer to withdraw from any related representation when continued representation would assist a client's crime or fraud.[138]
- Forty-one states permit (and four of them require) a lawyer to disclose confidential information to prevent a client's criminal fraud.[139]

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[135]ALAS Memorandum, column D, disclosure to rectify the consequences of 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.

[136]Id., nn. 3 and 4. These notes discuss this issue and include material on the seven states which have retained at least part of the Model Code approach to confidentiality, including Illinois.

[137]Model Rule 1.2(d); Model Code DR 7-102(A)(7) and (8).

[138]Model Rule 1.16(a); Model Code DR 5-102(B)(2).

[139]ALAS Memorandum, supra n. ?, at 161-166.

- 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.[140]
- Forty-four states permit (and three require) a lawyer to disclose confidential information relating to a client's ongoing criminal or fraudulent act.[141]

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 in that information.[142] These statements reflect the fact that 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 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."[143] 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.[144] 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:[145]

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[140]Id.

[141]Id.

[142] [cite examples: news stories which speak of lawyer disclosure as "waiving" the privilege]

[143]Purcell v. District Attorney, 676 N.E.2d 436, 438 (Mass. 1997), discussed infra.

[144]See, e.g., Christopher B. Mueller & Laird C. Kirkpatrict, 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.

[145]ALI, Restatement (Third) of the Law Governing Lawyers § 78, Cmt. c, 596-97 (2000).

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 fraud (§ 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]."[146]

In *Macumber v. State*, for example, a lawyer reported to public officials that his client had committed a crime for which another person had been convicted. The disclosure was viewed as permissible under Arizona's ethics rules (i.e., not in violation of the lawyer's duty of confidentiality). Nevertheless, the lawyer's testimony concerning the client's communication was not admissible in a subsequent hearing challenging the allegedly wrongful communication.[147]

In *Purcell v. District Attorney*[148] 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. The client, a maintenance man with an apartment in the building, had consulted the lawyer about matters relating to loss of both job and apartment. 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 whether the client informed the lawyer of the intention to commit arson "for the purpose of receiving legal advice" concerning the unlawful conduct. On remand in *Purcell*, the defense lawyer was not required to testify against his client. The court held that the client's communication of the proposed arson, unlike those relating to the client's job and housing, were not made for purposes of legal advice.

As Susan Martyn has stated in commenting on the *Purcell* case:

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[146]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)."

[147]State v. Macumber, 544 P.2d 1084 (Ariz. 1976) (holding that lawyer's permissible disclosure to authorities of client's information that he was responsible for a crime for which another person had been convicted did not waive the client's attorney-client privilege; reversing conviction and remanding for a new trial); and State v. Macumber, 582 P.2d 162 (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 Loyalo 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 a robbery for which the defendant had been convicted).

[148]676 N.E.2d 436, 438 (Mass. 1997).

> Because [the court] approved of a lawyer's discretion to disclose a client intention to commit a serious future crime, it gave lawyers an added incentive to do so when efforts to dissuade the client prove unsuccessful. Lawyers who disclose this confidential information need not worry that it can be used directly against the client in a subsequent proceeding, as long as the client sought legal advice about lawful matters. A lawyer can act to save lives [or property], and at the same time avoid being the instrument of the client's conviction.[149]

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. The SEC language merely makes clear what is implicit under the language of ABA Rule 1.6(b)(6): that an official investigation that precedes a formal proceeding comes within the lawyer's right "to respond to allegations in *any proceeding* concerning the lawyer's representation of the client." (Emphasis added.)

Section 205.3(d)(2)(ii) permits disclosure to protect the integrity of SEC proceedings. Its parallel under the Model Rules is 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

[149] Susan Martyn, The Restatement (3d) of the Law Governing Lawyers and the Courts, The Professional Lawyer 115, 124 (Symposium Issue 1998).

proceeding [and] knows that a person intends to engag[e] in or has engaged in criminal or fraudulent conduct related to the proceeding." This is a situation in which the vast majority of states (forty-four, according to the ALAS Memorandum), require the lawyer to disclose confidential information to the tribunal.[150] In this instance state ethics rules go substantially beyond the SEC's provision vesting lawyers with a 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 there are differences, the SEC provision in general allows for more disclosure than the ABA rules. 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. On the other hand, 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. In addition, the SEC rule allows disclosure whether the harm from the material violation affects the issuer or third party investors. On the other hand, Rule 1.13(c) disclosure is limited to preventing injury to the organization, whereas Rule 1.6(b)(2) disclosure is limited to preventing injury to "another," a term which would not include the issuer client. A difference between the SEC and ABA rules whose import is less certain is that the SEC rule requires that substantial financial harm be "likely," while both ABA rules require substantial injury to be "reasonably certain." 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.[151]

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 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 service have been used in furtherance of the fraud. As indicated earlier in this Part, in 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 disclosure. 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. So it should perhaps have been no surprise that the first important

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[150]ALAS Memorandum, column G.

[151]ALAS Memorandum, column C.

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.[152] 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 permissive disclosure rules involves several considerations. The first question is whether Congress in §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 state; 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 states preempt state law with which the federal statute "actually conflicts."[153] Because §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 if either it is "impossible for a private party 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."[154] The SEC rules for the most part 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 (ie reporting up) that some state rules merely permit; and permit something (ie reporting out) that some state rules prohibit or restrict. And unlike §307, the SEC rules do 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. In general, courts are likely to give great deference to the SEC's interpretations of these iinterpretations.[155]

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[152]For another recent discussion by an ethics scholar that reaches the same general conclusion, see Roy Simon, The Washington State Bar Takes on the SEC (draft of Sept. 11, 2003). [check to see if published yet]

[153]See generally Caleb Nelson, Preemption, 86 Va. L. Rev. 225, 225-231 (2000) (citing cases setting forth preemption doctrine).

[154]See, e.g., Sprietsma v. Mercury Marine, 537 U.S. 51, 64 (2002).

[155]See, e.g., 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 the regulation); Chevron v Natural Resources Defense Counsel, 467 US 837 (1984) (if the statute is silent with respect to a specific issue court must sustain the agency's interpretation if it is based on a permissible construction of the act); Geier v. American Honda,

1. Validity of the SEC Permissive Disclosure Rule

We must first consider whether Congress in §307 authorized the SEC to promulgate a permissive disclosure rule, and to give that rule preemptive effect. The language of §307 grants broad authority to the SEC. 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. Permissive disclosure rules fit comfortably within that legislative mandate. First, §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 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 §307 were not the only ones Congress intended the SEC to adopt. Moreover, there is no language in §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 §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 §307, stated the that the reporting up required by the amendment

> is 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.[156]

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

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529 US 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").

[156] 148 Cong. Rec. S6555 (Jul. 10, 2002) (statement of Sen. Enzi).

> 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.
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> 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.[157]

In our view, these statements do not support the proposition that §307 prohibits the SEC from adopting rules requiring disclosure, 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.[158] 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 §205.3(d)(2), which requires that the lawyer "reasonably believe" the disclosure is "necessary." 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," though we could support language in §205.3(d)(2) making that point explicit. 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"

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[157] 148 Cong. Rec. S6557 (Jul. 10, 2002).

[158] Interestingly, in another part of his statement, Senator Enzi expressed the view that lawyer, "[b]y reporting violations to the board of directors, . . . can avoid being found guilty of aiding and abetting their client." 148 Cong. Rec. S6555 (Jul. 10, 2002). 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.

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 to mandatory reporting to the SEC. Neither the permissive disclosure rule adopted in §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."

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. 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 §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 §307, although the statute makes not 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.[159]

The primary substantive goal of §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 a lawyer who "knows" of a violation "in a matter related to the representation" that is "likely to result in substantial injury to the organization" to "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, §307 not only

[159]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. Among other things, courts relied on the fact that the Thornburgh Memorandum was not authorized by any federal statute. See, e.g., US 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); In re Howes, 940 P.2d 159, 169 (N.M. 1997); US 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); US v. Lopez, 765 F. Supp. 1433, 1445-50 (N.D. Cal. 1991), vacated, 989 F.3d 1032 (9th Cir.), amended and superseded, 4 F.3d 1455 (9th Cir. 1993).

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 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 §307 was to displace the standard of 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.[160] They also argued directly that state standards were inadequate, as well as underenforced.[161]

Moreover, prior to the Senate vote on section 307, the Senate considered the question of preemption because it was raised by opponents of the amendment. The arguments were rejected.[162] 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.[163] The same arguments are likely to be presented to courts when they

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[160]148 Cong. Rec. S6554 (Jul. 10, 2002) (statement of Sen. Edwards); id. S6555 (statement of Sen. Enzi); id. S6557 (statement of Sen. Sarbanes).

[161]See 148 Cong. Rec. S6555 (Jul. 10, 2002) (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. . . .
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> . . . . 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.

[162][citation]

[163][citation]

are asked to review an SEC enforcement proceeding under section 307. The arguments are not meritorious.

The arguments against preemptive authority made in comments to the SEC emphasize the traditional role of the states in the regulation of the bar.[164] 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 and courts have generally rejected claims that state law in conflict 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 under the Commerce Clause to regulate lawyers (and thus, the Commission's power) is more limited than its power to regulate other groups traditionally regulated by the states that are involved in the issuance and trading of securities, it can only be due to some other language in the Constitution that provides that singular status for lawyers. The Sixth Amendment is often invoked 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.[165] 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 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 some novel, alien and dangerous concept are false. The IRS regulates tax lawyers in some respects,[166] federal banking agencies have considered the responsibilities of lawyers in bank examinations and filings,[167] the Patent and Trademark Office regulates patent and trademark lawyers,[168] federal bankruptcy judges regulate bankruptcy lawyers (with rules, by the way, that conflict with the conflict of interest rules in

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[164]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.").

[165][citation]

[166][citation]

[167][citation]

[168][citation]

virtually every state),[169] to provide five prominent examples. The federal government rightly exercises the right to regulate lawyers in those areas because all 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.

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 to regulate anyone. Notwithstanding complaints about the bar's independence from the government, it is the states through rules, procedures and proceedings promulgated or supervised by the highest court in each state that are empowered to regulate the bar (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[170]. 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 firms' 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 detail, in many cases through the internal memoranda and testimony of lawyers within a firm, what can only be described as compelling evidence of misconduct connected to securities work at a substantial

[169] [citation]

[170] [cite Pitts comment about state non-action when SEC referred cases to state disciplinary authorities and Enzi's comment, quoted earlier]

number of successful and venerable law firms. The bulk of lawyers in those firms and elsewhere are decent, dedicated and highly competent people. 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. But there is 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.[171] 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 disciplinary 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.[172]

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 §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 §205.3(d)(2) have such preemptive effect? We

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[171][cite ABA reports detailing the effects of poor funding on disciplinary enforcement; Clark report; McKay report; recent study in Calif of reasons why there are very few disciplinary proceedings involving large firm lawyers (most involve solo practitioners or small firm lawyers).]

[172][cite Sup Ct case discussed in HKC]

think the SEC did promulgate rules with preemptive effect, and that §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, §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." Similarly, one of the last rules, §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." 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 "conflict" or "inconsistent" mean that it is not possible for the lawyer to comply with both the SEC and state standard, then §205.3(d)(2) does not conflict with state law, because a lawyer can comply with both the SEC and state standard by not disclosing. On the other hand, if "conflict" and "inconsistent" mean 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.[173] So as long as the SEC intended, in using the words "conflict" and "inconsistent" to incorporate the preemption caselaw understanding of these terms, §205.3(d)(2) should have preemptive effect.

The strongest argument in favor of the "obstacle" interpretation of §205.1 and §205.6(c) is to look at the purpose of §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 §205.3(d)(2) is an exception. For example, if a lawyer makes a disclosure under §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. Thus, 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 §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 §307.[174]

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[173]See, e.g., Nelson, supra note ___.

[174]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

5. The SEC and the State Bars Square Off

a. Round One: The Washington State Bar Interim Opinion

Despite these strong arguments that §205.3(d)(2) preempts state ethics rules prohibiting or restricting disclosure, two state bars expressed contrary opinions this past summer. 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." The reason for the unusual "interim" designation of the opinion, as explained in a footnote, was "the lack of caselaw 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."

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.[175] 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 . . . confidences or secrets to the extent the lawyer reasonably believes necessary to prevent the client from committing a crime." Of course, as the opinion pointed out, the disclosure permitted by §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 as well as 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 [§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." 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, §205.1 and §205.6(c). The opinion states that there is no need to consider §205.1 because there is no conflict between §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 §205.1, thus opining on a question of law (no such concept appearing anywhere in the ethics

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rules preempting state ethics provisions, with both courts showing deference to the SEC's views on whether such obstacles exist. On the other hand, the cases are distinguishable on several 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.

[175] A LEXIS search in the Washington ethics opinion database revealed no other interim opinions.

rules), is nowhere explained in the opinion.[176] 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."[177]

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." The opinion thus fires a clear warning shot to lawyer's appearing and practicing before the SEC: 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, §205.6(c) protects lawyers from discipline if they "comply in good faith" with §205.3(d)(2). Think again, the Washington State Bar opinion asserts. The opinion then goes on to opine on yet another question of law, this time the meaning of "good faith" and "complies" under §205.3(d)(2).[178] But whereas the opinion's interpretation of "conflict" at least had some basis in (uncited and not controlling) caselaw, these interpretations have no basis in anything other than the opinion authors' vivid imaginations. With respect to "good faith," the opinion states that "as a general matter and with the current lack of case law on the pre-emption issue, a Washington attorney could not fairly claim to be complying in 'good faith' with the SEC Regulations, as that term is used in Section 205.6(c) of the Regulations, if (s)he took an action that was contrary to this Formal Opinion." That, of course, 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 say that the SEC intended in this rule to preserve the ability of state rules to punish conduct the SEC rules permit is absurd because it would nullify the very purpose of the permissive rule.

Even more bizarrely, the opinion concludes that the use of the term "complies" in §205.6(c) "means that the good faith defense applies only to those provisions which are mandatory in nature and not to discretionary disclosures." This interpretation of "complies" makes no sense and appears nowhere else in law to the best of our knowledge. In normal usage,

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[176]For an explanation of this phenomenon, see Susan P. Koniak, The Law Between the Bar and the State (discussing how the bar's vision of its law and its relationship to state law competes with the state's vision).

[177]In his article on the subject, Professor Simon perhaps more generously refers to this statement as "cryptic."

[178]Somewhat surprisingly, the opinion does not focus instead on the meaning of "inconsistent" in §205.6(c), which would have obviated the need for the opinion's creative interpretations.

people "comply" with nonmandatory 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. A lawyer who seeks the safe harbor of §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 §205.6(c) is "complies in good faith with the provisions of this part." This language suggests no limitation to mandatory provisions.

b. Round Two: The SEC Response

In response to the Washington State Bar Interim Opinion, but before the opinion was published, the SEC through its general counsel wrote a letter to try to persuade the Washington State Bar not to go forward with its opinion. Obviously, the letter was not successful. The brief letter essentially made three points. First, the SEC letter argued that §205.3(d)(2) pre-empts 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.[179] Second, the letter argued that the meaning of good faith compliance under §205.6(c) is a question of federal law in which the SEC's views are to be given deference and would preempt inconsistent state interpretations.[180] Finally, in a thinly veiled threat (of what is not exactly clear[181]), 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.

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

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[179]The letter cited two opinions. The first, Sperry v. State Bar of Florida, 373 U.S. 379 (1963) was cited 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." More relevant to the Washington State Bar's argument, the letter cited Fidelity Fed. Sav. & 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. Although the SEC letter does not specifically refer to "obstacle preemption," that is the doctrine *Fidelity Federal* relies on in finding a conflict.

[180]In support of these propositions, the SEC cited Barnhart v. Walton, 535 U.S. 212 (2002); US v. Locke, 529 U.S. 108, 110 (2000); City of New York v. FCC, 486 U.S. 57, 64 (1989).

[181]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 §205.6 are sanctions against lawyers appearing and practicing before the SEC.

response letter to the SEC taking issue with the SEC's views on preemption. Unlike Washington, California is one of the few jurisdictions with an ethics rule that prohibits all disclosure in cases of corporate fraud.[182] The California Bar Committee letter opened with a warning that 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. The alleged harm to the client would come from the risk of waiver of the attorney-client privilege through "selective disclosure" to SEC.[183] 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. In fact, said the California Bar Committee: "An attorney faced with choosing between potential 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." The whole basis for this position, then, 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 §205.3(d)(2) or §205.6(c).[184] 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. The letter does knock down a few straw man arguments, such as the fact that the

[182] See California Business and Professions Code §6068(e) (stating that an attorney has a duty to "maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client"); Cal. Rules of Conduct, Rule 3-600(B) ("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)."). Even old Model Rule 1.13(b) does not contain as strong an anti-disclosure statement as California's Rule 3-600(B).

[183] We have already addressed the reason why we find this assertion unconvincing. See supra ____. The letter in particular referred to the SEC's own concern with "selective waiver." But the "selective waiver" problem that the SEC is concerned with involves a 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.

[184] That the SEC has only the authority to adopt regulations to carry out the will of Congress as expressed by the statute, as the letter notes, is of course true. It is also true, as the letter state, that courts have on occasion struck down SEC rulemaking for lack of authority. Interestingly, the case the letter cites for that proposition is Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990). In that case, however, 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 the court found that the rule did not further the main purpose of the securities laws, namely *disclosure*. 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, for the proposition that the SEC lacks "the power to preempt validly adopted regulations of a sovereign state," is La. Pub. Serv. Comm'n v. FCC, 476 U.S. 355, 374 (1986). The statute in that case specifically carved out a role for state regulation with respect to intrastate matters, unlike §307, which is designed to redress dissatisfaction with state regulation.

"references 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." But of course these are not the only possible phrases in §307 that could be relevant. As we argued above, the very specific reference in §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 §307 cited by 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." True enough, but again not responsive to the affirmative case we have made.

The letter also draws distinctions between §307 and two other statutory provisions. First, the letter distinguishes §301 of the Private Securities Litigation Reform Act, which "specifically requires a registered accounting firm to report to the SEC in specific circumstances." But §205.3(d)(2) does not require a lawyer to report to the SEC, or even permit the lawyer to report to the SEC as a general matter. 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." But in what sense §307 is "limited" is not clear, unless 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."[185]

Next, the California Bar Committee letter seeks to distinguish Sperry v. State of Florida,[186] which the SEC letter had 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." In *Sperry*, the Supreme Court vacated, on

[185] A better argument for the California Bar Committee is that §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 of the benefits of §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. See discussion of the "safe harbor" provision, supra ___.

[186] 373 U.S. 379 (1963).

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. 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." This distinction is nothing short of astonishing. Does the California Bar Committee mean to suggest that the SEC may be 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 has ever remotely suggested such a standard. Second, "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." Something seems to have gotten lost in the parallelism here. Does not §307 expressly grant, indeed require, the SEC to prescribe regulations concerning attorneys who appear and practice before the SEC? If so, how exactly is §307 distinguishable from the patent statute? Third, "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." But as we have already discussed, given Rule 102(e), as well as other federal statutes already authorizing the regulation of lawyers practicing before federal agencies, the change effected by §307 was not so radical. Moreover, as we have said, the whole point of §307 was to redress inadequate state regulation.[187] Finally, the California Bar Committee letter neatly overlooks the fact that the longstanding 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 §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,

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[187]The letter also cites several cases at this point, one of which deserves special mention because it purports to stand for the proposition that the SEC has no authority to preempt state law in traditional areas. The case is Santa Fe Industries v. Green, 430 U.S. 462 (1977). The letter quotes the following passage from the case: "Absent 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." Id. at 479. In *Santa Fe Industries*, the Court held that §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. 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, §307 modifies the underlying premise of *Santa Fe*, by specifically including breaches of fiduciary duty (ie state law violations) within its ambit.

> the 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.

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 statues on the basis of federal preemption unless an appellate court has so ruled. The California Constitution, Article III, §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." 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 1988 statute and funded exclusively by members of 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 Business and Professional Code, which contains §6068(e), the confidentiality rule. The State Bar Court has the power to suspend or permanently ban lawyers from practicing law, though the attorney may appeal to 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 successfully argue a preemption defense in the State Bar Court unless an appellate court had ruled on the question, but would be able to raise the question on appeal.

That does put California lawyers at some risk if they seek to take advantage of §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 seek discipline of a lawyer for disclosing, does the Bar 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.[188] Unfortunately, but not surprisingly, the California Bar Committee letter does 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 §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, or disparaged. In adopting §205.3(d), the SEC put itself in something of a bind, because it cannot enforce the provision directly. 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 §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 the SEC's rules, particular in the areas of withdrawal and disclosure. In our initial comments to the SEC, we argued that those rules should not be preempted. The SEC responded by revising §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."

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 Sarbanes-Oxley

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[188]In his article, Professor Simon argues that the Washington State Bar, rather than threatening lawyers in its interim opinion, should bring a declaratory judgment action to resolve the preemption question.

and federal securities legislation. Section 307 requires the Commission to adopt "minimum" standards to govern the conduct of securities lawyers, not "maximum" standards.

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

1. Facts Reported by Spiegel's Bankruptcy Examiner

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."[189] Kirkland replaced Rooks & Pitts, which continued to represent Spiegel in securitization and other matters. "[B]y mid-May 2002, Kirkland had plainly advised Spiegel that it was violating the law by not filing its [2001] Form 10-K, and that this illegal act could have serious consequences."[190] Sorensen concurred in 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,[191] Kirkland reported its opinion of a material violation to Spiegel's chief legal officer, Sorensen, and to the appropriate board committee.[192] 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."[193] 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."[194] Subsequently, "neither Aschenbrenner nor his New York partners did anything to express their agreement with Kirkland & Ellis' advice."[195] Through the balance of 2002, none of the lawyers

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[189]Crimmins Report, supra n. ???, at 80.

[190]Id.

[191]See the text at n. ???, supra.

[192]Id., at 4, 80-81.

[193]Id., at 81.

[194]Id., at 82.

[195]Id.

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."[196]

After May 2002, Spiegel's German directors considering replacing Kirkland and Sorensen, viewing them as pessimists who were exaggerating the seriousness of the situation.[197] 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 on Spiegel's search for refinancing. White & Case never reported any concerns about Spiegel's disclosure obligations "up the ladder" to the company's audit and board committees.[198]

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 group to amend and replace its existing credit facilities," and thus "not in a position to issue financial statements . . . . pending resolution of this issue." "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."[199]

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

> None of Spiegel's legal advisers withdrew – "noisly" or otherwise – from representing Spiegl. 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.[200]

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

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[196]Id.

[197]Id.

[198]Id., at 81-82.

[199]Id., at 83.

[200]Id., at 84.

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

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 [which involves material false statements previously made to the SEC by Kirkland in drafting and approving Spiegel's required filings as a public company]. 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), 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 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 [i.e., when failure to disclose a material fact to a third person is necessary to avoid assisting a criminal or fraudulent act by a client," such as by continuing a representation knowing that a prior false statement was made in the course of representing the client].[201]

[201] ALAS Memorandum, supra n. ???, at n. 3 (n. 4 also contains a reference to Illinois law).

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 fraud."[202] Although Kirkland, as it should have, gave its honest opinion about the actual consequences that appeared 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.[203]

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)."[204]

But Comment [10] does not stop at this point. There is more:

> In 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. 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. See Rule 4.1.[205]

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. Kirkland knew and had repeatedly advised that Spiegel would be violating the securities laws by failing to file an annual report which, 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 balance of 2002 that stated reasons other than the real ones would be misleading and fraudulent, and therefore assisted 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 "There are no rules that

[202] MR 1.2, Comment [9].

[203] This sentence is a paraphrase of the first sentence of Comment [10] of Rule 1.2 (Ethics 2000 version); Rule 1.2 cmt. [7] (pre-2000 version).

[204] ABA Model Rule 1.2, Comment [10]. [NEED TO CHECK WHETHER ILLINOIS ADOPTED ETHICS 2000 VERSION OF COMMENT, AS OPPOSED TO OLD COMMENT 7]

[205] Id.

say you must resign if the client doesn't take your advice."[206] 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.[207]

Finally, SEC 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 injury or property of the issuer or investors in the furtherance of which the attorney's services were used." 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 preceded 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 situations 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 their past fraud, whether or not state ethics rules permit disclosure under the same circumstances.

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. That premise is questionable.[208] 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

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[206] Jonathan Weil & Cassell Bryan-Low, "Report Bolsters SEC's Proposal for Attorneys," Wall St. J., Sept. 15, 2003, at p. ?.

[207] [cite Harmon's decision in Enron case involving V&E (dismissing summary judgment motion of law firm that was alleged to have participated so extensively in the client's fraudulent conduct that it could be subject to primary liability); and Greycas v. Proud, 826 F.2d 1560 (7th Cir.1987) (lawyer who was negligent in representing in an opinion letter to a third person that there were no prior liens was liable for negligent misrepresentation under Illinois law).

[208] Jonathan Weil & Cassell Bryan-Low, "Report Bolsters SEC's Proposal for Attorneys," Wall St. J., Sept. 15, 2003, at p. ?.

committee, prior to the executive committee decision later in the day when the decision not to file a 2001 Form10-K was made, state that the audit committee engaged in "intensive discussion, careful deliberation and consultation with the Company's [Spiegel's] outside law firm (White & Case)"concerning the Form 10-K filing issue.[209] 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 . . . ;" the examiner's report indicates that it is not clear whether or not such advice was received.[210] 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.[211] 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." 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."[212] 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.[213] 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.

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.[214] Present or developing corporation law may include a duty of care on directors and those in control to

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[209]Crimmins Report, supra n. ???, at 71-72.

[210]Id. at 70.

[211]Id. at 71.

[212]Id. at 71-72.

[213]Id., at ???.

[214]As sole controlling shareholder and director who could control Spiegel decision, Otto had fiduciary duties to Spiegel. The Restatement of the Law Governing Lawyers, § 96, cmt. *g* states: "if 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. Aschenbrenner, by urging Otto not to file Spiegel's annual report, may have breached this obligation.

prevent the company from suffering serious legal harm.[215] 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 Michael Otto and his German financial interests, "appearing and practicing before the Commission" by advising the sole voting stockholder and controlling director of Spiegel concerning the application and advice of Kirkland relating to Spiegel's filings in a situation in which the firm 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 its U.S. management and its principal outside counsel?

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.[216] Here we have a situation in which the sole controlling 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 covered by the Rule and subject to the report obligation.

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[215]Two recent decisions have emphasized the duties of directors to protect the company from harm. See Patrick McGeehan, "Case Could Redefine Board Member's Liability," N.Y.Times, June 14, 2003 (discussing Delaware decision ruling that current and former members of the board of Walt Disney Company may be liable in a shareholders' suit for their failure to participate meaningfully in the compensation arrangements made by Disney's CEO, Michael Eisner, with Michael Ovitz, that led to compensation of about $138 million for Ovitz's fourteen-months service with the company); and Geraldine Fabrikant, "Private Concern, Public Consequences," N.Y.Times, June 15, 2003 (reporting that officers and directors of Trace International Holdings were held liable in a decision by Judge Sweet, S.D.N.Y., for rubber-stamping actions of Marshall Cogan, its chief executive, who looted the company of millions while they stood by and did nothing).

[216]Cite to earlier discussion of this section.

IV. "NOISY WITHDRAWAL"

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

This topic has been discussed in Parts III, D, 2 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.[217] 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.[218]

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. The fact that an opinion or representation has been withdrawn, without more, an ABA formal opinion states, does not reveal confidential information.[219] The formal opinion also states that, under some circumstances, disaffirmance of opinions or representations is required to avoid assisting the client's unlawful

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[217]ABA Rules 1.2(d) and 1.16(a). See also ABA Formal Op. No. 92-366 (1992).

[218]Comment [14] to ABA Rule 1.6 and Comment [2] to Rule 1.16.

[219]Comment [15] to Model Rule 1.6 included a comment from 1983-2003 stating that "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." The sentence creates an exception to Rule 1.6 that is not reflected in the text of the Rule. 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. 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. DR 4-101(C)(5).

conduct. And 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 permit disclosure and a few states require it; when 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:"[220]

> to 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

[220]When the material violation is a totally past violation and it 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.

prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading.[221]

As indicated earlier,[222] 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 comments to Rules 1.2 and 4.1 state that public notice of that withdrawal may be required. 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 required by Rule 4.1(b) to correct the false misrepresentations on which third persons are continuing to rely. Failure to do so would assist the prospective or ongoing client crime or fraud.[223]

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.[224]

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 . . . ." 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 should be limited to matters that have a substantial relationship with 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

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

[222][cross-reference to earlier discussion]

[223][x-ref to the two places were this argument is made.]

[224][cite ALAS memorandum]

reporting attorney, to notify the Commission of the reporting attorney's withdrawal and also report "the circumstances related thereto . . . ."[225]

Will 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 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."[226]

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?" Courts do not, however, treat the privilege so lightly as to find waiver based on "implicit" references to lawyer-client communications. The "circumstances" portion of the Commission's proposed alternative should not be changed in the absence of a convincing showing that the current law of attorney-client privilege adopts the proposition that "implicit" statements amount to waiver of the privilege. We know of no such authority and do not believe that any outlier authority that might exist for such a proposition would be followed by other courts. The Restatement (Third) of the Law Governing Lawyers §79, Comment *e,* states that "[k]nowledge 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." (Emphasis added.)

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[225]SEC Release No. 33-8186, "Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys," Jan. 29, 2003.

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

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 (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. Lawyers can disclose confidences in every state to defend themselves when necessary, even before the filing of actual charges or a complaint. 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 business. 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 states that *permit* such disclosure (e.g., Pennsylvania), 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.

Finally, the 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. That 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.

[*3. Which Form of Noisy Withdrawal Is Preferable?* **Do we want to say anything more and, especially, take a position on which approach is preferable?**]

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.[227] 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.

The response to these arguments is several fold. First, some exceptions to both the professional duty and to the attorney-client privilege are longstanding and have not had the consequences that are feared. The self-defense and client-fraud exceptions involve situations that arise 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.[228] In the criminal defense field, for example, both lawyer and client have powerful incentives not to discuss with candor 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.[229] 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

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[227]The Supreme Court stated these utilitarian justifications for the corporate attorney-client privilege in Upjohn v. United States, 449 U.S. 483, ??? (1981)(communications made to a corporation's lawyer by lower-level corporate employees not in the "control group" were protected by the attorney-client privilege when made to counsel at the direction of corporate superiors to secure legal advice from counsel).

[228]See, e.g., Robert A. Burt, Conflict and Trust Between Attorney and Client, 69 Geo.L.J. 1015 (1981).

[229]See Fred C. Zacharias, Rethinking Confidentiality, 74 Iowa L.Rev. 351, ??? (1989).

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 is threatened that can be prevented by disclosure, 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 a lesser moral claim for protection than those of private individuals who are suddenly confronted with a legal problem that requires a lawyer.[230] 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 the special protections given to criminal defendants. On the other hand, a public corporation "has neither a body that can be kicked or a soul that can be damned."

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.[231] 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-player, profit-making organizations that have strong incentives to delay or conceal compliance with regulatory requirements that impose substantial costs.[232]

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 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 populous states 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

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[230]See, e.g., Monroe H. Freedman, Understanding Legal Ethics (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.

[231]See, e.g., Marc Galanter, Why the Haves Come Out Ahead, [cite needed].

[232][cite Simon's recent article in Columbia.]

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 and sometimes huge amounts. 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 that are the real risk and, prior to the SEC's implementation of the Sarbanes-Oxley Act, the principal deterrent force.

D. 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) of Part 205 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, given emphasis 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; and, if they did withdraw, 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,[233] appear to be oblivious of the arguments made by the ABA, ALAS and by this article that the combined effect of Rules 1.2(d), 1.16(a), 4.1(b), when permissive disclosure is provided by the state's equivalent of Rule 1.6, requires a lawyer to withdraw, 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. And there is also 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

[233] [x-ref to earlier Levin quote in WSJ article]

bankruptcy has occurred or new management is put in 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 the *Central Bank* decision,[234] leaving only the more difficult cause of action against the law firm as a principal participant in the fraud rather than a secondary actor.[235] The normal role of lawyers, 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 law.

If the facts recited by the 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 place, took no steps 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-K 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, supplies, employees and others which could have been prevented by doing what state ethics rules clearly required: First, remonstrate with the client, and especially the highest authority, warning the client of the risks incurred by its criminal course of conduct. Second, as a last resort, advise the client of the law firm's obligation to withdraw and threaten to disclose to the SEC the reasons for withdrawal. And finally, carry out that threat in the extraordinary situation in which an obdurate board refuses to heed the threat to withdraw and to disclose confidential information to the SEC.

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. . . .[236]

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

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[234][cite and summarize decision]

[235][cite Enron and cases its relied on]

[236]Crimmins Report, supra n. ???, at 81.

SEC would have been alerted to take action sooner, and investors would have received information they could have acted on to make informed decisions about Spiegel. In this case, the absence of a "noisy withdrawal" requirement allowed Spiegel to keep investors and the SEC in the dark.[237]

[237] Id., at 84.

CONCLUSION

The American experience with corporate fraud strongly suggests that lawyers are not fulfilling their obligation to prevent corporate clients from engaging in securities and other frauds. 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; and, if they did withdraw, did so silently, often without notifying the highest authority of the company of the reasons for withdrawal. 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. And many corporate lawyers appear to be oblivious of the arguments made by the ABA, ALAS and by this paper 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 and to correct the false opinions or representations.

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, in addition to scienter problems, involve complicated and multiple transactions that raise difficult factual and legal issues. And there is also the further difficulty, in a disciplinary context, of pinning responsibility on particular lawyers within the law firm. Professional discipline in these situations is a non-starter. 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 the corporation's successor in interest or to those harmed by the organizational fraud.

The most effective civil remedy, third-party liability for aiding and abetting a federal securities fraud, was eliminated in 1994 by the *Central Bank* decision, leaving only the more difficult cause of action against the law firm as a principal participant in the fraud rather than a secondary actor. The normal role of lawyers, 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 law.

Three major propositions are advanced in this paper. 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 those 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 hullaballoo 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 Rule 205 has already 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. Informing the ultimate authority – the board of directors – of a 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. The major problem here is not that the SEC has acted but that the adopted rules contain major loopholes that are inconsistent with the congressional intent and may result in noncompliance by some issuers and ineffective enforcement by the SEC.

Third, the reporting out obligation that remains pending before the SEC (usually referred to as "noisy withdrawal") is also 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.

If the facts recited by the 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.