BNA, INC.

SECURITIES REGULATION & LAW

REPORT

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Attorneys

Holding Lawyers Accountable in the Post-Enron Feeding Frenzy

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In *Porgy and Bess*, Ira Gershwin gave Porgy these classic lyrics: ''Summertime, and the livin' is easy. . . .''[1] This summer, however, the living has been anything but easy. And unfortunately this has been particularly true for corporate lawyers.

Because of Enron and the disheartening appearances of additional corporate train wrecks, two *very* significant steps have recently been taken to change lawyers' ethical obligations and to enlarge lawyer liability—both as to regulators and the plaintiffs bar. Whether these ''reforms'' are truly worthy of that moniker remains very much to be seen.

Sarbanes-Oxley. In the direct aftermath of the Enron collapse there was a diverse cacophony of Congressional hearings, political fury and proposed legislation. Initially, there appeared to be little consensus in Congress as to how best to deal with the mess (other than clean house in the accounting profession). During that period, a group of law professors, led by Professor Richard Painter of the University of Illinois College of Law, urged that the SEC use Rule 102(e)—which regulates professionals who practice before the Commission—to punish lawyers (both in-house and outside) who did not report securities laws violations to the affected corporations' board of directors (if management failed to address them). The SEC's general counsel replied to that entreaty in the negative, noting that the applicable rules on attorney obligations in such circumstances have traditionally been governed by state bar rules.[2]

When the bevy of additional corporate scandals broke (e.g., WorldCom, Adelphia, Tyco, etc.), however, a consensus for legislative action quickly coalesced into legislation which became known as the Sarbanes-Oxley Act of 2002.[3] And, as the final pieces were falling into place, Senator John Edwards (from North Carolina) introduced a rider which essentially encapsulated the Painter (et al.) proposal. Without a lot of fanfare, the legislation went through Congress, and it was signed into law by the President on July 30th.

Section 307 of Sarbanes-Oxley requires that the SEC (on or before January 23, 2003) issue rules pursuant to

[1] *Summertime*, George Gershwin, et al. (Gershwin Publishing Corp. 1935).

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[2] ''SEC Unlikely to Mandate that Lawyers Report Violations by Clients,'' 34 *BNA Sec. Reg. & L. Rep.* 555 (April 8, 2002). The SEC's general counsel also noted that Professor Painter, in a prior law review article, had argued that ''any changes to the rules governing lawyers should be the result of Congressional changes to the securities laws.'' Notwithstanding the SEC general counsel's demurer to the request of Professor Painter, et al. (and the rationale expressed therein), in fact the SEC has hardly been a shrinking violet in going after (and seeking to go after) perceived lawyer misconduct. *See* C. Stewart, ''Legal Ethics for Securities Lawyers: A Paradigmatic Oxymoron Gets Harder,'' 33 *BNA Sec. Reg. & L. Rep.* 654 (August 30, 2001).

[3] H.R. 3763, 107 Cong. § 307 (2002).

Rule 102(e). Said rules are to flesh out the bill's substantive requirements that lawyers: (1) report evidence of a material violation of the securities laws *or* a breach of a fiduciary duty *or* a similar violation by or within a company to the company's general counsel or CEO; and (2) if said attorney does not get an ''appropriate response'' at stage 1, he or she must then go to the audit committee of the board of directors, or a similarly constituted group of independent directors.[4]

Speculating on the dangers of this new provision prior to the Commission issuing rules may be premature, but let us explore just six possibilities/problems. First off, we are now in unchartered water—we now have a direct and concrete step forward in the federal preemption of state oversight of the practice of law; where that is going to lead, and whether that is for the better, who knows? Second, what constitutes ''evidence'' and the necessary quantum thereof to trigger attorney obligations?[5] Third, how elastic are the notions of ''fiduciary duty'' and ''similar violations''? And how will the SEC interpret them in future enforcement proceedings that the staff brings on (to those who say that the Edwards rider merely tinkers with the obligations set forth in current Model Rule 1.13, it is instructive to note that 1.13 has no mention of such notions as ''fiduciary duty'' or ''similar violation(s)''—it speaks only of ''substantial injury to the organization'').[6] Fourth, what constitutes an ''appropriate response''? Or will it ever matter, with everything being interpreted in perfect hindsight after a corporate train wreck, to the detriment of the lawyer(s) involved (i.e., nothing was, or could ever be, ''appropriate''). Fifth, besides constituting regulatory penalties, this provision will likely constitute a useful tool for the plaintiffs bar to go after securities lawyers for money damages (regardless of *Central Bank of Denver*[7]). Sixth (but not last, for there will surely be any number of unintended consequences that lay ahead), will these new obligations make corporate lawyers more effective in eliciting information out of their clients (and thus ensuring greater corporate compliance with the law), or less so? Human nature and experience with corporate managers, not to mention Supreme Court jurisprudence, all would suggest a less than optimistic answer to this last question.[8]

The ABA Task Force. On March 28, 2002, the American Bar Association appointed a blue-ribbon task force to address the Enron mess and Enron-like fallout. On July 16th, the group submitted its ''preliminary report''; by its terms, the ''preliminary report'' seeks to ''elicit public comments from interested observers'' over the course of the next several months, with an eye to completing its work by calendar year end.

Much of the task force's report relates to corporate governance issues, and the recommendations relating thereto generally appear sound. With respect to its recommendations for lawyers, however, it is a different matter altogether. What the task force proposes is a sea change in the profession's confidentiality obligations to its clients.[9] More specifically, the task force suggests four basic changes to those obligations:

1. disclosure would be *mandated* to prevent a client from engaging in felonies or other ''serious'' crimes (for example, violations of the federal securities laws), where substantial financial injury would likely result and the client used the lawyer's services;
2. disclosure would be *permitted* to prevent a client from engaging in ''lesser'' crimes or fraud, where substantial financial injury would likely result and the client used the lawyer's services;
3. disclosure would be *permitted* to allow a client to rectify a client's past crime or fraud, where substantial financial injury occurred and the client used the lawyer's services; and
4. all of the foregoing disclosure obligations would not be governed by an ''actual knowledge'' standard—the current standard—but rather on what a lawyer knows or ''reasonably should know'' standard.

What issues/problems do these proposals raise? There are at least six (on top of the serious issue of changing the knowledge standard):

- The preliminary report suggests that it is merely adopting the proposals and rationale(s) of the ABA Ethics 2000 Commission (*see* pp. 30-32), whose recommendations (by and large) were rejected by the ABA House of Delegates in August of 2001. That is a bit disingenuous since that prior group did not recommend the mandatory disclosure of client confidences in *any* context.
- The preliminary report suggests that its proposals are consistent with the mainstream of current practices in most states (*see* pp. 32-33). In fact, its proposals are directly at odds with the rules in New York, California,

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[4] Section 703 of the same legislation directs the SEC to study secondary actors (e.g., lawyers and accountants) in the context of aiding and abetting securities fraud. The only logical inference is that some members of Congress are contemplating legislation to overturn the Supreme Court's ruling in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) (aiding and abetting liability for money damages barred). The wisdom of such a course is, at best, open to serious debate. *See* C. Stewart, ''Caveat 'Reformers': Lessons *Not* to Be Learned From Enron's Collapse,'' 34 *BNA Sec. Reg. & L. Rep.* 310 (February 25, 2002).

[5] *See* ''Sarbanes-Oxley Mainly Good; Statute of Limitations Not So, SIA Says,'' 34 *BNA Sec. Reg. & L. Rep.* 1417-18 (August 26, 2002) (comments of S. Kaswell).

[6] It is true, as many legal academics have noted, that Section 307 does not impact the attorney-client privilege insofar as the attorney is not going beyond his or her client to reveal the ''evidence'' of one of the three types of violations. At the same time, however, a central purpose of the privilege within a corporation—to encourage corporate officers and employees to confide in corporate counsel—could take a big hit. *See infra* note 8 and accompanying text.

[7] *See supra* note 4.

[8] As the Supreme Court held in *Upjohn Co. v. U.S.*, 449 U.S. 383 (1981), full and candid communications between lawyers and their business colleagues/clients are vital to ensure effective compliance with the law. Ratcheting up (to an even greater degree) sanctions against in-house lawyers may well be counterproductive to that end because: (i) it misunderstands the roles of corporate lawyers (particularly in-house lawyers), (ii) it misunderstands the dynamics of the lawyer-client relationship; and (iii) it misunderstands the ability of corporate lawyers (particularly in-house lawyers) to effect change within a corporation. *See* C. Stewart, ''Liability for Securities Lawyers in the Post-Enron Era,'' *The Review of Securities & Commodities Regulation* (forthcoming).

[9] They have also made recommendations to amend/alter Model Rule 1.13. These are not materially different from what is in Sarbanes-Oxley; regardless, they would have likely been (or will be) preempted by that legislation (and the SEC rules promulgated thereunder).

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and many other major commercial hubs in this country. Indeed, the rules in the states that make up the tri-state New York metropolitan region, for example, are wholly inconsistent with one another.[10]

■ The preliminary report bases its recommendations upon Enron and a number of other highly publicized corporate failings of late (e.g., WorldCom, Adelphia, etc.). But there is no evidence in the public record that any ''reforms'' vis-à-vis lawyers' confidentiality obligations to clients would have averted those disasters.[11]

■ Changing lawyers' disclosure obligations—in particular when you move from a total bar to a permissive disclosure standard—is a probable hook for civil liability when the lawyer makes the wrong decision.

[10] *See supra* note 4, Stewart at p. 314.

[11] The ABA is not the only group to believe that lawyers may somehow be at the heart of these corporate failures. The New York County Lawyers' Association recently appointed a similar task force, with an aim ''to get higher standards of integrity for corporate leaders and the accounting profession as well as attorneys.''

Note to Readers

The editors of BNA's *Securities Regulation & Law Report* invite the submission for publication of articles of interest to practitioners.

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■ The first ''reform'' would have the curious effect of placing lawyers' disclosure obligations on a higher plane to protect property interests (a mandatory disclosure obligation); of lesser concern would be the interests of protecting people from death or serious injury (a permissive disclosure obligation).

■ The task force does not delineate where the line would be drawn between ''serious'' crimes (mandatory disclosure) versus ''lesser'' crimes; given that many/most frauds are now being characterized as crimes, this definitional issue could become problematic (at a minimum).

Conclusion. The task force's recommendations are just that; and they have time to be addressed. Alternatively, the ABA's House of Delegates may simply choose to reject them, as it has repeatedly done in the past when presented with far less reaching ''reforms'' to lawyers' confidentiality obligations. In any event, this process deserves careful attention.

With respect to Sarbanes-Oxley, it is, of course, the law of the land. We will therefore need to watch closely what the SEC does at the turn of the new year. That SEC Commissioner Harvey Pitt and a number of his colleagues have vast professional experience on the other side of the fence may be reason to hope that the SEC's rules will be well thought out and measured.[12]

[12] This hope may be more than wishful thinking. The Commission's prior effort in this area—*In re Carter & Johnson*, 47 S.E.C. 471, *Fed. Sec. L. Rep.* (CCH) ¶ 82,847 (February 28, 1981)—resulted in the most nuanced and sensible approach to attorney responsibilities in this area that any court or regulatory agency has articulated. In the main, I believe this was due to the fact that it was authored by Stephen J. Friedman—a Commissioner who previously had been a highly distinguished lawyer in private practice.