

Regulating the Legal Profession: Sense or Nonsense?

BY C. EVAN STEWART

As Alice in Wonderland descended down the rabbit hole, she uttered the famous phrase “curiouser and curiouser.” That is sort of how I feel as I survey the intersecting and conflicting regulation of the legal profession—by the profession itself, by a powerful arm of the federal government, and by the courts. At the center of this issue are the obligations lawyers owe to their clients versus what obligations (if any) lawyers owe to third parties.

The ‘Good Old’ Days

In the 1970s, the famous lawyer (and jurist) Simon Rifkind debunked the notion that there was an inherent conflict between a lawyer’s duty to her client and her duty to society. Simply put, Judge Rifkind opined that the lawyer “owes [her client] loyalty, undivided and undiluted, zeal and devotion”; to society, the lawyer owes no duty (except to zealously represent her client, within the canons of ethics). As to whether a lawyer may or should disclose client confidences as a means by which to promote some broader societal good, according to Judge Rifkind, “our revulsion is instantaneous, if not instinctive.... The merest suggestion that the lawyer become a stool pigeon against his client fills us with abhorrence....”¹

Judge Rifkind’s religion has received a serious testing, starting in the 1980s, caused by widespread financial excesses, principally embodied in the savings and loan crisis. When Judge Stanley Sporkin posed the often-cited rhetorical question: “Where were these professionals [i.e., lawyers]...?” that captured a spirit that encouraged angry regulators and the nimble plaintiffs’ bar to target lawyers as fall-guys (and gals).

The Courts Weigh In

*Barker v. Henderson*² was one of the first cases to examine attorneys’ duties (and liabilities) in detail. In *Barker*, a Michigan religious foundation issued unregistered bonds to unsophisticated investors, who ended up taking a bath. Searching for deep pockets, the plaintiffs’ lawyers sued, among others, the foundation’s lawyers. Two law firms had been hired specifically to review the bonds’ selling materials and to advise the foundation on securities law issues; those two firms wrote settlement checks. Left in the litigation

was the foundation’s regular legal counsel, who did not have expertise in securities matters but who also neither blew the whistle on their client nor did anything to stop the sale of the bonds (even after receiving the selling materials).

On behalf of the panel of the U.S. Court of Appeals for the Seventh Circuit, Judge Frank Easterbrook rejected claims that the law firm had aided and abetted fraud. Judge Easterbrook found it factually significant that the firm had not been consulted on any securities issues; there was no evidence, moreover, that the firm had seen any of the selling materials until after they were being utilized. With respect to the law firm’s silence in the face of their client’s actions, Judge Easterbrook wrote that lawyers were not “required to tattle on their clients in the absence of a duty to disclose.” And because there was no such duty under prevailing professional responsibility rules, he ruled that:

[A]n award of damages under the securities laws is not the way to blaze the trail toward improved ethical standards in the legal...profession[]. Liability depends upon an existing duty to disclose. *The securities laws must lag behind changes in ethical and fiduciary standards.* [emphasis added]

So what, in fact, was the ethical state of play with respect to a lawyer’s duty to disclose client “wrong-doing” to third parties at the time of Judge Easterbrook’s 1986 decision in *Barker*?³ In New York, for example, the standards were thus:

- to prevent the client from committing an actual crime (e.g., murder), a lawyer had discretion to breach the client’s confidences.
- to prevent the client from committing a fraud (e.g., financial wrongdoing), a lawyer could not breach the client’s confidences.
- to rectify a crime or fraud, even where a lawyer’s services were used, a lawyer could not breach the client’s confidences.

In the aftermath of Judge Easterbrook’s pronouncement that liability under the securities laws had to “lag behind” changes in lawyers’ professional obligations came a number of important (and perhaps confusing) decisions. In *Schatz v. Rosenberg*,⁴ for example, a law firm represented a fraudster. At the closing of a deal, the law firm handed to the other side a document its client had prepared, in which the client represented that nothing material had changed with respect to his financial condition. That representation was false, and the law firm knew it was false.

After the deal cratered (because of the client’s true financial condition), the other side sued the law firm



Even after ‘Stoneridge,’ bar still perplexed over lawyer liability for client wrongdoing.

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under multiple theories of fraud. The U.S. Court of Appeals for the Fourth Circuit, however, ruled that the law firm had no liability. How could this be?!

First off, Judge Robert Chapman, writing for a unanimous court, addressed the claim that the firm was a primary violator of §10b-5 fraud (i) by failing to disclose its client’s misrepresentations, and (ii) by making affirmative misrepresentations of its own about the client’s financial condition. With respect to the former, Judge Chapman determined there was no duty to disclose under the federal securities laws or applicable state law; he further ruled that there was no public policy in favor of disclosure (in fact, public policy would be in favor of non-disclosure, so as to enhance lawyers’ fact-finding abilities⁵).

As to affirmative misrepresentations, Judge Chapman determined that the firm had made no independent representations of its own, but had only passed on their client’s; put another way, the other side’s reliance was on the client’s misrepresentations, not on anything said or written by the law firm (which had “merely ‘papered the deal,’” and whose role was only that of a “scrivener”).

With respect to the claim of aiding and abetting fraud, Judge Chapman gave it short shrift. The law firm did not have the requisite scienter to abet the fraud because the firm owed no duty to the other party to the deal (which was represented by its own counsel). And the law firm did not provide “substantial assistance” to its client’s fraud for the same reasons it was not a primary violator in the fraud.⁶

In 1994, the U.S. Supreme Court stepped into this fray in *Central Bank of Denver v. First Interstate Bank of Denver*.⁷ There, the Court held that since the text of §10(b) does not cover those who aid and abet a §10(b) violation, private plaintiffs seeking money damages could not bring an aiding and abetting claim against a secondary actor. At the same time, the *Central Bank* Court left open that (i) criminal liability for aiding and abetting was still viable, (ii) an SEC enforcement action based upon aiding and abetting was still viable, and (iii) traditional secondary actors in the capital markets (e.g., lawyers) could be pursued by private plaintiffs as primary violators “assuming all of the requirements for primary liability under Rule 10b-5 are met.”

Just as lawyers began to think the water was safe into which to wade, the third door left ajar by the Supreme Court was pounced upon by the plaintiffs' bar, and there began a wave of new cases, premised upon lawyers (and other secondary actors) being held to the same standard of accountability for fraud as their clients. This attack reached its height/nadir in *Klein v. Boyd*.⁸

In *Klein*, the plaintiff (supported by the Securities and Exchange Commission) argued, and a panel of the U.S. Court of Appeals for the Third Circuit agreed, that a law firm could be held liable as a primary violator of securities fraud, even where the lawyer did not sign the document(s) at issue and where the investor was never aware of the lawyer's role in the creation of the document(s). In the Third Circuit's view, the law firm was a primary violator because it "elect[ed] to speak" by its authoring or co-authoring of document(s) with alleged material misrepresentations and/or material omissions; according to the Third Circuit, while the firm did not have an obligation to blow the whistle on its client, it did have a duty to correct its own "statements."

On an en banc review, the SEC made its position even clearer: a law firm should be held accountable for fraud where it helps to "create" a misrepresentation. Prior to a ruling by the entire court of appeals, the case was settled; but the original precedent lived on, with the SEC (and the plaintiffs' bar) continuing to espouse such theories of liability, especially in the aftermath of Enron and similar corporate train wrecks.

In the aforementioned corporate train wrecks aftermath, various courts reached different results as to lawyers' duties to "speak" to third parties.⁹ These different results (and disparate outcomes on the issue of secondary actor liability) ultimately became so profound that the Supreme Court in 2007 agreed to revisit the same ground it had gone over in *Central Bank*. In *Stoneridge Investment Partners LLC v. Scientific-Atlanta Inc.*,¹⁰ the Court (i) re-affirmed its prior ruling in *Central Bank* (noting that Congress had explicitly declined to establish aiding and abetting liability for civil suits when it had passed various securities legislation since 1994), and (ii) rejected the concept of "scheme liability"—a theory consistent with the *Klein v. Boyd* court's rationale—because it failed to require a basic element of a cause of action for fraud (i.e., that the aggrieved plaintiff(s) relied upon some act or omission by an alleged primary violator defendant(s)).¹¹

The *Stoneridge* decision would appear to constitute the last word on the subject of a lawyer's secondary liability for client fraud under the federal securities laws.¹² At first blush, that would therefore seem to put us back to Judge Easterbrook's earlier paradigm. But is that really the case?

Changing Ethical Landscape

As lawyers' liability under the securities laws was undergoing vast swings, the ethics rules governing the profession were not standing still. In early 2003, pursuant to authority granted to it by Congress in the Sarbanes-Oxley legislation, the SEC formally federalized lawyer conduct for the first time in U.S. history. Asserting jurisdiction over lawyers who have a capital markets practice and/or appear before the SEC, the commission, inter alia, enacted the following permissive disclosure requirements: lawyers would be permitted to disclose a client's "material violation" (current, prospective, or past) to the SEC; and failure to do so—where in hindsight a "reasonable lawyer" should have made disclosure—would subject lawyers

to the full panoply of sanctions under the Securities Exchange Act of 1934.

Not content to stop there, the SEC thereafter used its significant leverage to "jawbone" the American Bar Association later that year into abandoning its prior positions on permissive disclosure of client confidence, so as to bring the ABA's Model Rules into line with the SEC's new standards.¹³ The commission was undoubtedly emboldened to take that "jawboning" step because it had also opined (without any sense of humor or irony) that its new oversight of the legal profession did not preempt conflicting or inconsistent state law governing lawyer conduct—so long as the states meet the minimum standards of the SEC's rules and regulations! And in the five years since that pronouncement, many states have amended their ethics rules to bring them into line with the SEC's rules and regulations (and the ABA's Model Rules)—but not all have done so in toto, or even in the main (e.g., New York state).¹⁴

A Changing Paradigm

Whether or not all of the states ultimately come into line with these permissive disclosure rules, the fact of the matter (as they say in Washington, D.C.) is that the paradigm established by Judge Easterbrook has been transformed. The ethics rules have indisputably changed, creating situations in which lawyers will be "ethically" ratting out their clients. At the same time, however, the federal securities laws, per the Supreme Court, now protect lawyers from aiding and abetting fraud liability for failing to rat out their clients. In effect, the Easterbrook paradigm has been turned on its head.

Has this rendered lawyers bullet-proof? Not likely. While the profession may have bought some protection from money damages exposure, more serious liabilities now lurk. As noted above, lawyers screwing up under Sarbanes-Oxley have a lot of weapons pointed at them. One prominent example of this scary scenario is the currently pending civil suit the SEC has brought in Houston against two very senior Enron lawyers (the former general counsel and the former associate general counsel in charge of securities filings). Their failings? They "knew or were reckless in not knowing" that Enron's SEC filings were materially misleading.¹⁵

In another case, the Justice Department and the SEC have brought on parallel proceedings (i.e., criminal and civil suits) against, inter alia, a General Re Corp. assistant general counsel. The crime/fraud? He helped American International Group (AIG) commit accounting fraud by participating in the creation of a structure for two alleged sham/riskless transactions (and by drafting transaction documents); the General Re lawyer's obligation, according to the government's charges, was to prevent AIG from engaging in fraud.¹⁶

And by way of one last example, last year a number of pharmaceutical company executives, including the general counsel, pled guilty to violating federal misbranding law, based upon the company's misconduct, notwithstanding that each individual officer specifically denied knowledge of the facts giving rise to corporate liability.¹⁷

Conclusion

Lawyers' duties and obligations beyond those owed to their clients—to third parties and society in general—have dramatically changed in a brief period of time. At the intersection of the bar's traditional

role of self-regulation, the federal government's strong-armed intrusion into the bar's historic preserve, and the courts' changing notions of civil liability for attorneys, it is safe to say that no one really knows how and where this game of musical chairs will end. It is at least as easy to predict that it will be a very challenging environment for lawyers going forward to discern how to please all of their old and new constituencies—without running afoul of the SEC, Justice Department, and whoever else wants to come after our learned profession. One last prediction: Judge Rifkind would be filled "with abhorrence."

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1. S. Rifkind, "The Lawyer's Role and Responsibility in Modern Society," 30 *The Record* 534 (1975).

2. 797 F.2d 490 (7th Cir. 1986).

3. It should go without saying, but because there has been so much confusion on this subject, I suppose it cannot go without saying a lawyer should never be an active participant in a client's crime or fraud (and no notions of confidentiality or the attorney-client privilege attach to such circumstances); and even where the attorney is an unwitting participant in a client's crime or fraud, the crime/fraud exception to the attorney-client privilege is applicable.

4. 943 F.2d 485 (4th Cir. 1991).

5. See *U.S. v. Upjohn*, 449 U.S. 383 (1981).

6. In the savings and loan crisis cited above, a number of very prominent law firms were caught up. O'Melveny & Myers, for example, tried to avoid civil liability by arguing it owed a duty to investors, but not to its client. See *FDIC v. O'Melveny & Myers*, 969 F.2d 744, 749 (9th Cir. 1992), rev'd, 114 S. Ct. 2048 (1994), on remand, 61 F.3d 17 (9th Cir. 1995).

7. 511 U.S. 164 (1994).

8. 1998 WL 55245, Fed. Sec. L. Reg. (CCH) ¶90,136 (3d Cir. 1998).

9. See, e.g., *Howard v. Everet Systems Inc.*, Fed. Sec. L. Reg. (CCH) ¶91, 217 (9th Cir. 2000); *Ziamba v. Cascade International Inc.*, 2001 U.S. App. LEXIS 15529 (11th Cir. 2001); *In re Enron Corp. Derivative & ERISA Litig.*, 235 F.Supp.2d 549 (S.D. Tex. 2002); *In re Lernout & Hauspie Sec. Litig.*, 236 F.Supp.2d 161 (D. Mass. 2003); *Simpson v. AOL Time Warner Inc.*, 452 F.2d 1040 (9th Cir. 2006).

10. 2008 WL 123801, 128 S. Ct. 761, 522 U.S. (Jan. 15, 2008).

11. See *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1998).

12. Apparently, under some state "blue sky" laws, aider and abettor liability for lawyers goes on. See A. Lin, "Oregon 'Blue Sky' Suit Proceeds Against Seward & Kissel in N.Y.," *New York Law Journal* (April 2, 2008).

13. See J. Glater, "Bar Association in a Shift on Disclosure," *N.Y. Times* A12 (Aug. 12, 2003); see also C.E. Stewart, "Liability for Securities Lawyers in the Post-Enron Era," 35 *Rev. Sec. & Comm. Reg.* (Sept. 11, 2002) (review of prior ABA votes against such standards; previously, the ABA Model Rules allowed permissive disclosure only to prevent "reasonably certain death or substantial bodily harm"). One area where the ABA pushed back against the SEC was as to the "reasonable lawyer" hindsight standard, adhering instead to the time-honored requirement of an attorney's actual knowledge.

14. There are five basic clusters as to how states have approached the disclosure of client confidences. For a review of how the states have, and have not, come into compliance with these rules and regulations, see C.E. Stewart, "The Pit, the Pendulum, and the Legal Profession: Where Do We Stand After Five Years of Sarbanes-Oxley?" *BNA Securities Regulations & Law Report* (Feb. 18, 2008).

15. For a greater explication of that case, as well as other recent SEC cases against lawyers, see Stewart supra note 14.

16. In February of this year, a jury in Hartford, Conn., found all the defendants, including the General Re in-house lawyer, guilty in the case brought on by the Justice Department. What will happen to the General Re lawyer in the SEC case remains to be seen. Clearly, the lawyers in *Schatz v. Rosenberg* should be unsettled by the government's actions here.

17. See J. Cooper and W. Vodra, "New Questions About Guilty Pleas in Purdue OxyContin Case," 5 *BNA Pharmaceutical Law & Industry Report* (Sept. 7, 2007).

