REUNION 2015

CLASS I

THREE SERIOUS ISSUES IN LAWYER REGULATION (THEY'RE ALL ABOUT MONEY)

1 CLE Credit

Lectured by

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C. SARBANES-OXLEY, DODD-FRANK, AND THE RULE 1.13 AMENDMENTS

On July 25, 2002, Congress passed what has come to be known as the Sarbanes-Oxley Act (or SOX). The House vote was 423 to 3 and the Senate vote was 99 to 0. The President signed the law on July 30, 2002. Sarbanes-Oxley was the most significant federal legislative response to the corporate scandals in the United States, beginning with the collapse of Enron, followed by the indictment, conviction (later reversed), and eventual demise of Arthur Andersen, and the troubles at Imclone, Tyco, WorldCom, and HealthSouth, among others.

Section 307 of the Act (15 U.S.C. §7245) was submitted as an amendment by Senators Edwards, Enzi, and Corzine on July 10, 2002. It passed unanimously. It provides:

RULES OF PROFESSIONAL RESPONSIBILITY FOR ATTORNEYS

Not later than 180 days after July 30, 2002, the Commission shall 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 a rule—

(1) requiring an attorney 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); and
>
> (2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

In introducing §307, Senator Edwards said:

> One of the most critical responsibilities that [corporate] lawyers have is, when they see something occurring or about to occur that violates the law, breaks the law, they must act as an advocate for the shareholders, for the company itself, for the investors. They are there and they can see what is happening. They know the law and their responsibility is to do something about it if they see the law being broken or about to be broken.
>
> This amendment is about making sure those lawyers . . . ensure that the law is being followed.

The premise here is that lawyers who work for companies are likely to know early on if something is amiss. Since the company is the client, the import of §307 is to compel the lawyer to act to protect the client against the misconduct of its other agents. Critics of §307 (and the SEC rules it spawned) and (to a lesser extent) the contemporaneous amendments to Rule 1.13 contend that they micromanage how lawyers should protect their corporate clients. Even lawyers who have no principled quarrel with the content of the SEC rulesmay object to their source—the federal government—in the belief

that the tradition of state regulation of lawyers should not be breached.

The SEC rules implementing §307 can be found at 17 C.F.R. Part 205. In substance, they impose very specific reporting-up requirements for certain lawyers. ‘‘Reporting up’’ is shorthand for a duty to go up the corporate chain of command to correct certain perceived illegalities by corporate constituents. The SEC rule imposing the reporting-up duty on lawyers ‘‘appearing and practicing before the commission’’ is not limited to lawyers who personally submit documents to or appear before the Commission. Rather, the rule expansively includes ‘‘[t]ransacting any business with the Commission’’; representing ‘‘an issuer . . . in connection with any Commission investigation [or] inquiry’’; providing advice regarding any document if the lawyer ‘‘has notice’’ that it will be filed with the Commission or incorporated in another filed document; and advising on whether information is required to be filed with the Commission. A first-year associate can fall within the definition.

Further, the reporting-up obligation is not limited to securities law violations. It extends to ‘‘any breach of fiduciary or similar duty to the issuer recognized under an applicable Federal or State statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions.’’

The Commission’s rules are detailed with various triggers requiring lawyers to act and react. Here, it suffices to focus on the larger picture. Lawyers who become ‘‘aware of evidence of a material violation’’ of securities law or fiduciary duty or similar law, whether federal or state, must report what they know to the company’s chief legal officer or its chief executive officer. The

term ‘‘evidence of a material violation’’ is defined, awkwardly, to mean ‘‘credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.’’ (Emphasis added.) The Commission was criticized for adopting a definition containing a double negative, which in the view of some made reporting too easy to avoid.

In any event, once a report is made, the reporting lawyer and the chief legal officer or chief executive officer have various duties depending upon what a further inquiry, which is mandatory, reveals. The expectation is that once the top officials, especially independent directors, learn of a serious problem, action will follow because inaction can mean substantial personal liability.

The Commission's rules also permit, but do not require, lawyers appearing and practicing before it to disclose to the Commission a client's confidential information related to the representation under certain conditions, called ‘‘reporting out.’’ See 17 C.F.R. §205.3(d)(2), set out in the note.[1] Those conditions overlap but are not identical to the Model Rule provisions

[1] *An attorney appearing and practicing before the Commission in the representation of an issuer 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 perjury, proscribed in 18 U.S.C. 1621; suborning perjury, proscribed in 18 U.S.C. 1622; or committing any act proscribed in 18 U.S.C. 1001 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 were used.

17 C.F.R. §205.3(d)(2).

and differ significantly from the rules in many states, creating the potential for a clash between the scope of a lawyer's authority under SOX and the scope under state rules. The SEC rule took on much greater importance after the Dodd-Frank legislation discussed below.

Activity, meanwhile, was proceeding on a parallel track. Anticipating congressional action in light of the corporate scandals, in March 2002 the ABA created a Task Force on Corporate Responsibility. If the ABA and then state courts modified their own rules of professional conduct in a way the SEC approved, the bar could hope that the agency would take a minimalist approach to the authority Congress conferred in §307. Indeed, the Task Force's recommendations to amend Rules 1.6 and 1.13, which the House of Delegates accepted in August 2003, likely explains the SEC's decision not to adopt a mandatory reporting-out obligation. As stated in chapter 2, the amendments to Rule 1.6 expand the exceptions under which a lawyer is permitted to reveal client confidential information to third persons.

The amendments to Rule 1.13 are also significant. First, they strengthen the reporting-up obligation in Rule 1.13(b). Although reporting up is not obligatory, it is now presumptively required ''[u]nless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so.'' Previously, reporting up was simply one option available to the lawyer. Of greater consequence, Rule 1.13 now contains its own exception to confidentiality. It permits, but does not require, reporting out if, after reporting up, ''the highest authority . . . insists upon or fails to address in a timely and appropriate manner an action, or a refusal to act, that is clearly a violation of law,'' and if, in addition, ''the lawyer reasonably believes that the violation is

reasonably certain to result in substantial injury to the organization.''

Rule 1.13 applies to lawyers for all organizational clients, even if the client is not a public company within the jurisdiction of the SEC.

Cash for Confidences. What if we paid lawyers to tattle on their clients? Okay, I've loaded the question. What if we paid lawyers to reveal client wrongdoing that has harmed or will harm others? Paid them to report out. Hard to imagine? The post–Civil War False Claims (or Qui Tam) Act and the 2010 Dodd-Frank legislation both hold out the promise of rewards that can amount to tens of millions of dollars for information revealing (respectively) fraud against the United States or public company illegality. In short, both of these laws envision that a lawyer can be a whistleblower against her own client.

Take Dodd-Frank, which was passed in the wake of the financial crisis that hit the United States in 2008. The part of the law germane here, as implemented by the SEC, promises generous rewards for disclosure of information that reveals violation of securities laws, breach of fiduciary duty, or ''similar'' violations of Federal or State law. Lawyers can be among those whistleblowers, even by disclosing client confidences, so long as their information is within an exception to confidentiality or privilege. But there's a twist here. Whose exceptions? The SEC's or the lawyer's licensing jurisdiction? 17 C.F.R. §240-21F-4(b) provides as follows (the ''unless'' clauses are where the action is):

> The Commission will not consider information to be derived from your independent knowledge or independent analysis in any of the following

circumstances [and therefore the information is not a basis for a reward]:

(i) If you obtained the information through a communication that was subject to the attorney-client privilege, unless disclosure of that information would otherwise be permitted by an attorney pursuant to §205.3(d)(2) of this chapter, the applicable state attorney conduct rules, or otherwise.

(ii) If you obtained the information in connection with the legal representation of a client on whose behalf you or your employer or firm are providing services, and you seek to use the information to make a whistleblower submission for your own benefit, unless disclosure would otherwise be permitted by an attorney pursuant to §205.3(d)(2) of this chapter, the applicable state attorney conduct rules, or otherwise. . . . [Emphasis added.]

Now a lawyer's own jurisdiction may or may not have the same privilege and confidentiality exceptions as those the SEC recognizes in §205.3(d)(2), which is quoted in the footnote on page 400. If its exceptions are narrower, a federal agency, with congressional authorization, will have offered monetary rewards to encourage lawyers to violate their own state's rules. If the state exceptions are the same as or broader than those the SEC adopted, we will have added large financial incentives to induce lawyers to blow the whistle on their clients.[2]

The public policy and professional regulation questions here are formidable

[2] The SEC rules are broader than Rule 1.6 in one significant way. Paragraph (2)(i), unlike its analogue in Rule 1.6(b)(2), does not require that the lawyer's services have been used in connection with the violation that permissive disclosure is meant to prevent. Unlike Dodd-Frank regulations, the Civil War–era False Claims Act says nothing about whether a lawyer may disclose confidential or privileged information to get a reward.

and will likely demand the attention of judges and lawyers for some time. It's one thing to create a permissive confidentiality exception and leave it to each individual lawyer, in the exercise of his or her conscience and moral judgment, to decide whether to invoke it. It is quite different, however, to hold out the promise of a large reward to tempt a lawyer to make the decision in favor of disclosure. The difference is between disclosing because it's the right thing to do and disclosing to get the money. A lawyer might persuade herself that she would have disclosed anyway, so why not take the money. But surely the reward will influence the lawyer's judgment.

And what effect will the prospect of a whistleblower reward have on a client's trust in the lawyer? In the only federal appellate case to confront these questions directly, a former in-house lawyer sought (unsuccessfully) to become a whistleblower against a client under the False Claims Act. United States v. Quest Diagnostics, Inc., 734 F.3d 154 (2d Cir. 2013). The district court opinion in the same case, which was affirmed, addresses additional issues under professional conduct rules that the circuit decided it did not need to reach. 2011 Westlaw 1330542 (S.D.N.Y. 2011).

No court decisions or ethics rules have yet grappled with these policy questions, but in a few cases lawyers have sought to be whistleblowers for rewards.