THE LAWS OF SECURITIES LAWYERING AFTER SARBANES-OXLEY

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> In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar.[1]

INTRODUCTION

In the summer of 2002, Congress passed the Sarbanes-Oxley Act[2] in response to a barrage of corporate governance crises and flagging investor confidence in the securities markets.[3] In section 307, the Act expands the powers of the Securities and Exchange Commission (SEC) by authorizing it to regulate lawyers.[4] In turn, the SEC promulgated regulations (Part 205) that implemented the requirements of section 307.[5] Naturally, corporate lawyers and various bar organizations protested this regulation, arguing that it is

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1. United States v. Benjamin, 328 F.2d 854, 863 (2d Cir. 1964). Judge Friendly wrote this statement in 1964, a time when the volume of publicly traded, domestic equity securities was three-tenths of a percent of what it is today. Market Statistics, *at* http://www.nyse.com/marketinfo/1022221393023.html (last visited Oct. 26, 2003) (on file with the *Duke Law Journal*) (listing share volume on February 17, 1964 as 4,782,320 shares outstanding and on September 30, 2003 as 1,590,417,109 shares outstanding). Common sense indicates that these tools must have grown even more potent and dangerous in such an environment; a glance at the history of Enron or Adelphia proves it. *See, e.g.*, Kurt Eichenwald & Diana B. Henriques, *Enron's Many Strands: The Company Unravels*, N.Y. TIMES, Feb. 10, 2002, at C1 (describing the collapse of Enron and the role of accountants and lawyers in the events leading up to the collapse); Andrew Ross Sorkin, *Fallen Founder of Adelphia Tries to Explain*, N.Y. TIMES, Apr. 7, 2003, at C1 (describing the collapse of Adelphia and its founders' claims of reliance on the advice of lawyers and accountants).

2. Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.A. (West Supp. 2003)).

3. S. REP. NO. 107-205, at 2 (2002); H.R. REP. NO. 107-414, at 18–19 (2002).

4. Sarbanes-Oxley Act of 2002 § 307, 15 U.S.C.A. § 7245.

5. Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 47,276, 68 Fed. Reg. 6296 (Feb. 6, 2003) (codified at 17 C.F.R. pt. 205 (2003)) (hereinafter "Part 205 Release").

destructive to the attorney-client relationship and duplicative of state regulation.[6] Several scholars and the plaintiff's bar, on the other hand, have expressed approval of the rules or protested that they do not go far enough.[7]

In the debate, however, comprehensive analysis of the precise nature of Part 205's departure from preexisting legal regimes has been scarce.[8] This Note seeks to fill this void by analyzing the various provisions of Part 205 in light of, and in contrast to, the primary[9] preexisting bases of legal responsibility. These legal bases include section 10(b) of the Securities Exchange Act of 1934 (section 10(b)),[10] SEC Rule 10b-5 (Rule 10b-5),[11] SEC Rule of Practice 102(e) (Rule

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6. Terry Carter, *Going Before the SEC: ABA, Others Criticize Proposed Lawyer Regs*, A.B.A. J. E-REPORT (Dec. 20, 2002), *at* http://www.abanet.org/journal/ereport/d20sec.html (on file with the *Duke Law Journal*).

7. *Id.*; Jonathan D. Glater, *A Legal Uproar over Proposals to Regulate the Profession*, N.Y. TIMES, Dec. 17, 2002, at C1.

8. Indeed, discussion has generally assumed a radical departure and continued from there. *See, e.g.*, Letter from Richard W. Painter to Jonathan G. Katz, Secretary, SEC (Dec. 12, 2002), *available at* http://www.sec.gov/rules/proposed/s74502/rwpainter1.htm (on file with the *Duke Law Journal*) ("[The proposed rules] will allow honest lawyers and clients to thrive in a legal and economic system that values disclosure—including disclosure by lawyers to their own clients—over deceit."); Letter from Sullivan & Cromwell to Jonathan G. Katz, Secretary, SEC (Dec. 18, 2002), *available at* http://www.sec.gov/rules/proposed/s74502/sullivanc1.htm (on file with the *Duke Law Journal*) ("[T]he adoption of noisy withdrawal rules by the Commission would represent such a radical departure from the traditional standards of behavior for attorneys and the expectations of their clients that it should be deferred.").

9. This Note's use of the term "primary" here is meant to exclude claims that are generally not brought by third parties. Lawyer liability predicated on such claims, including malpractice, negligence, contract, or other common-law claims, is severely restricted by the lack of privity between the lawyer and the third party. *See* Nancy Lewis, *Lawyer's Liability to Third Parties: The Ideology of Advocacy Reframed*, 66 OR. L. REV. 801, 804–06 (1987) (discussing the privity doctrine and its narrowly interpreted exceptions).

10. 15 U.S.C. § 78j(b) (2000).

11. Manipulative and Deceptive Devices and Contrivances, 17 C.F.R. § 240.10b-5 (2003). There are, of course, a plethora of securities laws violations other than those based on Rule 10b-5. However, given the far greater extent to which Rule 10b-5 case law has been developed and the breadth of Rule 10b-5 antifraud provisions, this Note will use Rule 10b-5 as a proxy for the securities laws generally. Key points in this development have included, *inter alia*, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (requiring that a party be a purchaser or seller of affected securities to have standing to bring a suit under Rule 10b-5); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (requiring scienter as an element of a Rule 10b-5 violation); *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) (requiring misrepresentation or omission as an element of a Rule 10b-5 violation); *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (requiring reliance or fraud-on-the-market as an element of a Rule 10b-5 violation); *Chiarella v. United States*, 445 U.S. 222 (1980) (applying Rule 10b-5 to insider trading); and *United States v. O'Hagan*, 521 U.S. 642 (1997) (extending reach of insider trading liability under Rule 10b-5 to misappropriation theories).

102(e)),[12] and the Model Rules of Professional Conduct (Model Rules).[13] Part I briefly explores the history and roles of these legal regimes as a basis of attorney conduct. Understanding these regimes is crucial to understanding Part 205, for these preexisting regimes represent both the source of the Part 205 concepts and the status quo on which Part 205 was intended to improve. Part II then compares the key features of section 307 and Part 205 to the corresponding features of the preexisting regimes. To do so, it develops and applies an analytical model examining the position of each of the regimes along four general dimensions.[14] Disaggregation of the inquiry into these four parts will demonstrate that in each dimension, Part 205 essentially incorporated some of the most expansive preexisting notions of a lawyer's duty, and merged these notions into a single regulatory scheme. Finally, Part III briefly analyzes the consequences of Part 205 from a policy perspective, using the analysis of Part II to examine both the benefits and concerns, and concludes that Part 205 is likely to create a fundamental and needed shift in the role of corporate attorneys.

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12. Appearance and Practice Before the Commission, 17 C.F.R. § 201.102(e) (2003).

13. MODEL RULES OF PROF'L CONDUCT (2002). Although the Model Rules in themselves are merely precatory, forty-one states and the District of Columbia have enacted binding professional responsibility codes based on the Model Rules. E. Norman Veasey, *Chair's Introduction and Executive Summary to the Report of the Commission on Evaluation of the Rules of Professional Conduct*, *at* http://www.abanet.org/cpr/e2k-report.html (Aug. 2001) (on file with the *Duke Law Journal*). Also, the scope of this Note includes only those legal regimes that apply at a more or less national level; as such, there is no analysis of either specific state professional responsibility codes or state blue-sky laws.

14. The four dimensions are (1) to whom the regime applies, (2) the triggering standard for the regime's duties, (3) the duties imposed, and (4) the enforcement mechanisms of the regime. By essentially asking who, when, what, and why, these dimensions are intended to cover all aspects of each legal regime while permitting careful analysis through disaggregation. The choice of these dimensions and the dimensionality approach generally are explained *infra* notes 43–46 and accompanying text. Although this Note is not unique in asking what changes section 307 brings, earlier scholarship focuses on general conclusions or specific aspects to illuminate policy analysis or political conclusions. *See, e.g.*, David J. Beck, *The Legal Profession at the Crossroads: Who Will Write the Future Rules Governing the Conduct of Lawyers Representing Public Corporations?*, 34 ST. MARY'S L.J. 873, 900–14 (2003) (discussing the federalism, disclosure, and liability concerns created by section 307 generally); John C. Coffee, Jr., *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293, 1303–10 (2003) (discussing the appropriateness of the general gatekeeping role imposed on attorneys by section 307); Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons?*, 48 VILL. L. REV. 1097, 1126–30 (2003) (examining the incentive structure for lawyers and managers created by the general section 307 scheme); Susan P. Koniak, *When the Hurlyburly's Done: The Bar's Struggle with the SEC*, 103 COLUM. L. REV. 1236, 1270–78 (2003) (characterizing specific language of section 307's triggering standard as a thinly disguised product of successful lobbying by the organized bar).

I. Preexisting Legal Regimes

This Note examines section 307 and Part 205 in light of the three primary, preexisting legal regimes: (1) section 10(b) and Rule 10b-5; (2) Rule 102(e); and (3) the Model Rules. These regimes were established long before section 307 was enacted, and thus constituted the backdrop against which section 307 and Part 205 were formulated.[15] Examination of these regimes serves two purposes. First, as will be seen, these regimes were the immediate sources of all the essential concepts of lawyer responsibility that the SEC used in drafting Part 205. Second, and perhaps more importantly, the collapse of corporate governance that spurred the Sarbanes-Oxley Act clearly demonstrated some form of failure, whether inherent or in enforcement, of these regimes. Accordingly, these regimes are the foils against which Part 205 must necessarily be tested to determine its efficacy and appropriateness. Parts II and III specifically focus on exactly this comparison. In turn, this Part will briefly describe the nature, history, and role of these preexisting legal regimes.

A. *Section 10(b) and Rule 10b-5*

Section 10(b)[16] was enacted, like the rest of the Securities Exchange Act of 1934,[17] in response to the massive loss in value of outstanding securities in the Great Crash of 1929 (and the first years of the Great Depression).[18] In 1942, the SEC promulgated Rule 10b-5 as a general mechanism to effectuate the broad mandate of section 10(b).[19] Together, section 10(b), Rule 10b-5, and the jurisprudence surrounding these provisions form a comprehensive, if complex, antifraud scheme that prohibits the use of any fraudulent or manipulative devices that affect the trading of securities.[20] Moreover, despite the absence of any express intent of Congress or the SEC to

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15. Securities lawyers are usually subject to all three of these legal regimes simultaneously, and though this Note focuses on the distinctions, the responsibilities implied by these regimes overlap significantly. *See generally infra* Part II (comparing and contrasting these legal regimes).

16. 15 U.S.C. § 78j(b) (2000).

17. Pub. L. No. 291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78mm (2000)).

18. Katharine J. Fick, *Such Stuff as Laws Are Made on: Interpreting the Exchange Act to Reach Transnational Fraud*, 2001 U. CHI. LEGAL F. 441, 445.

19. Exchange Act Release No. 3230, 7 Fed. Reg. 3804 (May 21, 1942); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 729 (1975).

20. *See* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 471–77 (1977) (describing development and operation of Rule 10b-5).

provide for a private right of action arising under Rule 10b-5, an implied private right of action was first recognized in 1946,[21] and was confirmed by the Supreme Court in 1971.[22] Largely due to this development, Rule 10b-5 has become perhaps the foremost vehicle for enforcing the securities laws.[23]

Until fairly recently, Rule 10b-5 liability could attach for either a primary violation of the Rule or for aiding and abetting such a primary violation.[24] Several cases made clear that a wide range of attorney activities could give rise to aiding and abetting liability.[25] However, in 1994, the liability standards were thrown into great confusion when the Supreme Court eliminated any private right of action for aiding and abetting a Rule 10b-5 violation,[26] though the SEC's right to pursue such actions was subsequently preserved by statute.[27] Thus, attorneys who engage in securities fraud are still privately liable under Rule 10b-5 as primary participants if their conduct meets the test for primary violations, and are also subject to SEC enforcement actions as either primary participants or aiders and abettors.

B. Rule 102(e)

Rule 102(e) was also promulgated by the SEC, but it was promulgated as a Rule of Practice rather than as a substantive regulation.[28] Subsection (1) of the rule allows the SEC to censure or prohibit an attorney from further practice before the SEC for

21. Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946).

22. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971).

23. Then-Justice Rehnquist famously wrote that private actions under Rule 10b-5 are a "judicial oak which has grown from little more than a legislative acorn." *Blue Chip Stamps*, 421 U.S. at 737.

24. *See, e.g.*, Roberts v. Peat, Marwick, Mitchell & Co., 857 F.2d 646, 652 (9th Cir. 1988) (setting forth the elements of an aiding and abetting violation).

25. *See, e.g.*, SEC v. Coven, 581 F.2d 1020, 1021 (2d Cir. 1978) (imposing liability on an attorney for false statements in an opinion letter); SEC v. Nat'l Student Mktg. Corp., 457 F. Supp. 682, 712–15 (D.D.C. 1978) (imposing liability on attorneys for failing to suspend merger closing in the face of questionable accounting representations). The availability of aiding and abetting liability may have helped slow the development of case law on an attorney's primary participant liability for Rule 10b-5 violations.

26. Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 177 (1994).

27. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 104(2), 109 Stat. 737, 757 (codified at 15 U.S.C. § 78t(f) (2000)).

28. Appearance and Practice Before the Commission, 17 C.F.R. § 201.102(e) (2003).

unethical conduct or violation of the securities laws.[29] Traditionally, the SEC chose to apply Rule 102(e) against accountants. However, in 1981, the SEC announced a sweeping new interpretation of the rule, stating that an attorney who realized that his advice on compliance with the securities laws was being ignored or not sought in good faith had a duty to take some affirmative action to correct the underlying problem.[30] But the SEC's expansive interpretation of Rule 102(e) was quickly scaled back, when in a 1982 address, the then-general counsel of the SEC expressed his opinion that the SEC should bring Rule 102(e) administrative proceedings only against those attorneys found to have violated section 10(b) by a judicial tribunal.[31] The SEC has since exercised its prosecutorial discretion in accordance with that policy,[32] so that as a practical matter, the importance of Rule 102(e) is diminished because it does not require a response by an attorney in any contexts where such action is not required by Rule 10b-5. Nonetheless, Rule 102(e) as it was interpreted by *In re Carter & Johnson*[33] remains influential and was cited as a basis for section 307 by one of that section's authors.[34]

C. The Model Rules

The Model Rules of Professional Conduct were developed by the American Bar Association (ABA). The ABA has taken the lead in establishing national ethical norms since 1908, when it adopted the Canons of Professional Ethics.[35] Eventually, these broad aspirational

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29. *Id.*

30. *In re* Carter & Johnson, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,172 (March 25, 1981).

31. Edward F. Greene, Remarks to the New York County Lawyer's Association, Fed. Sec. L. Rep. (CCH) ¶ 83,089, at 84,802 (Jan. 18, 1982). One possible reason for the retreat was continuing doubt over whether the SEC's interpretation of Rule 102(e) was properly authorized by the congressional grant of authority to the SEC, despite unanimous lower court rulings holding that such authorization existed. Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8150, Exchange Act Release No. 46,868, 67 Fed. Reg. 71,670, 71,671 n.13 (proposed Dec. 2, 2002) (hereinafter "Part 205 Proposal"). Obviously, the explicit authorization of Sarbanes-Oxley eliminates this concern. *See* Sarbanes-Oxley Act of 2002 § 307, 15 U.S.C.A. § 7245 (West Supp. 2003) (describing the scope of SEC authority over an attorney's professional conduct).

32. Part 205 Proposal, *supra* note 31, at 71,672.

33. *In re* Carter & Johnson, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 84,172.

34. 148 CONG. REC. S6524, 6551–52 (daily ed. July 10, 2002) (statement of Sen. Edwards).

35. CANONS OF PROF'L ETHICS (1908); Lawrence W. Kessler, *The Unchanging Face of Legal Malpractice: How the "Captured" Regulators of the Bar Protect Attorneys*, 86 MARQ. L. REV. 457, 459 n.5 (2002).

standards gave way to a more enforcement-based regime in the 1969 Model Code of Professional Responsibility.[36] The Model Rules of Professional Conduct[37] were adopted in 1983 and underwent their last major revision as part of the Ethics 2000 initiative in 2002.[38] The Model Rules, unlike Rule 10b-5 or Rule 102(e), are not administered judicially or on the federal level. Instead, the forty-one states (and the District of Columbia) that have adopted professional responsibility codes based on the Model Rules[39] enforce them through state bar disciplinary committees and various other disciplinary mechanisms.[40]

II. ANALYSIS OF SUBSTANTIVE DUTIES

Legal regimes that originate at different points in time and in response to a variety of concerns naturally differ in language, structure, and interpretation. Unfortunately, this hampers clear and direct comparison, a problem exacerbated by the complexity of the new rules. Section 307 may be only 171 words long,[41] but eighty pages of the Federal Register are devoted to Part 205 in the SEC's promulgating releases alone, published before the rules even took effect.[42] Part 205 itself is a long and complex regulation covering an enormous number of contingencies. It would be extremely difficult simply to take Part 205 as is, hold it up next to three other complex regimes, and start to draw and justify rational conclusions.

To facilitate a clear analysis of the various legal structures, this Note proposes a four-pronged, analytic structure that is based upon the concept of a "corrective action."[43] Corrective action, as defined

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36. MODEL CODE OF PROF'L RESPONSIBILITY (1969); Kessler, *supra* note 35, at 459 n.5.

37. MODEL RULES OF PROF'L CONDUCT (1983).

38. Center for Professional Responsibility, American Bar Association, Model Rules of Professional Conduct, *at* http://www.abanet.org/cpr/mrpc/mrpc_home.html (last visited August 19, 2003) (on file with the *Duke Law Journal*).

39. Veasey, *supra* note 13.

40. *See, e.g.*, Fred C. Zacharias, *What Lawyers Do When Nobody's Watching: Legal Advertising as a Case Study of the Impact of Underenforced Professional Rules*, 87 IOWA L. REV. 971, 988–95 (2002) (identifying disciplinary actions in several states).

41. Sarbanes-Oxley Act of 2002 § 307, 15 U.S.C.A. § 7245 (West Supp. 2003).

42. *See* Part 205 Release, *supra* note 5 (adopting the final rule establishing minimum standards of professional conduct for attorneys appearing before the SEC); Part 205 Proposal, *supra* note 31, at 71,671 (proposing the same); Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8186, Exchange Act Release No. 47,282, 68 Fed. Reg. 6324 (proposed Feb. 6, 2003) (hereinafter "Noisy Withdrawal Proposal") (proposing a rule specifically regarding "noisy withdrawal" provisions).

43. This dimensional approach permits a more careful and detailed analysis by temporarily

here, is an action intended to prevent or limit the effect of a violation of securities law.[44] Corrective actions could conceivably take many forms, including the reporting of the violation to others in the corporation, resignation, or disaffirmance of work product.[45] One can then develop four dimensions of inquiry, posed in the form of questions to be asked of each legal regime: (1) Who may be required to take a corrective action?; (2) What knowledge or actions trigger the duty to take a corrective action?; (3) What corrective actions are required or permitted?; and (4) What enforcement mechanisms are in place to ensure compliance?[46] The following four Sections address each of these dimensions in turn.[47]

A. Who May Be Required to Take a Corrective Action?

The threshold question for any legal regime is the scope of the regime's application. Within the universe of attorneys practicing securities law, the Model Rules would appear to have the broadest applicability. Because the Model Rules are implemented through state bars, they apply to every licensed attorney in the country.[48] The

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eliminating from our view information extraneous to the particular question being asked. In comparing apples and bananas, it is difficult simply to say which is larger; but if length, width, and height are examined in turn, the understanding of both objects is far greater than even an answer to the initial inquiry would have provided.

44. I use the term and definition of "corrective action" here as a logical synthesis of concepts implicitly used in several other analyses, especially those of the SEC. *See, e.g.*, *In re* Carter & Johnson, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,172 (March 25, 1981) ("What is required, in short, is some prompt action that leads to the conclusion that the lawyer is engaged in efforts to correct the underlying problem, rather than having capitulated to the desires of a strong-willed, but misguided client."). *See generally* Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission, 17 C.F.R. pt. 205 (2003) (structuring the regulatory scheme around action by the lawyer to correct a violation of the securities laws or to fulfill fiduciary duties to the corporation).

45. *E.g.*, *In re* Carter & Johnson, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 84,172.

46. Or more briefly: (1) Who?; (2) When?; (3) What?; and (4) Why?

47. The reader may note that splitting the analytical inquiry along these dimensions gives rise to the danger that interdependencies between these dimensions may be lost. For example, after *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), the extent of attorney liability under Rule 10b-5 depends on whether the violative activity can be characterized as a primary violation or an aiding and abetting violation. *See id.* at 191 (holding that no private civil action can be maintained against an attorney for aiding and abetting a section 10(b) violation). Thus, under *Central Bank*, the answer to the fourth question (what enforcement mechanisms apply) varies based on the answer to the second (what triggers a duty to take corrective action). This Note will endeavor to point out these interdependencies wherever relevant.

48. More precisely, they apply to every attorney in the forty-two jurisdictions that have adopted some form of the Model Rules. Veasey, *supra* note 13.

exception to this principle is Model Rule 1.13, which applies only to those lawyers representing organizational entities rather than natural persons.[49] As a practical matter, however, such representation would include the vast majority of securities and corporate lawyers.

The applicability of Rule 10b-5 has a scope similar to, but not quite coextensive with, Model Rule 1.13. Rule 10b-5 proscribes certain activities in connection with the purchase or sale of securities.[50] The vast majority of transactional securities and corporate lawyers, whether representing public or private corporations, are subject to Rule 10b-5, because their work is connected with the purchase or sale of securities. Some securities litigation attorneys who are subject to Model Rule 1.13, however, are unlikely to encounter a personal, Rule 10b-5 problem because their practice tends to address past and publicly known securities laws violations and misrepresentations, on which investors will no longer reasonably rely in making decisions to purchase or sell securities.

The scope of Rule 102(e) is also narrower than that of the Model Rules. By its terms, Rule 102(e) applies to all attorneys, but the sanctions specified therein will have an effect only on attorneys appearing and practicing before the SEC.[51] In this context, practicing includes transacting business with the SEC and preparing any document filed with the SEC.[52] Thus, Rule 102(e), though almost certainly applicable to transactional securities attorneys representing a public company, probably would not apply to a securities litigation attorney not actually appearing in an SEC hearing or to an attorney representing a private company.[53] Rule 102(e) is accordingly narrower in scope than the Model Rules and similar, but not coextensive in scope, with Rule 10b-5.

Turning now to Part 205, it first appears that its scope, defined as "appearing and practicing before the Commission,"[54] is coextensive

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49. MODEL RULES OF PROF'L CONDUCT R.1.13(a) (2002).

50. Manipulative and Deceptive Devices and Contrivances, 17 C.F.R. § 240.10b-5 (2003).

51. Appearance and Practice Before the Commission, 17 C.F.R. § 201.102(e) (2003).

52. *Id.* § 201.102(f).

53. Of course, the exact application of Rule 102(e) will depend on specific facts that may contradict these general characterizations. For example, the question of whether a specific SEC filing is required does not turn solely on the question of whether a company is public or private, but rather on an analysis of whether the issuer or the transaction falls under any of dozens of statutory categorizations. *See, e.g.*, 15 U.S.C. § 77c–d (2000) (listing categories of issuers and securities exempted from registration of newly issued securities).

54. Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. pt. 205.3(a) (2003).

with the narrower reach of Rule 102(e). However, Part 205 adopts a much more expansive definition of "appearing and practicing," extending the Rule 102(e) definition to include any representation in connection with a SEC hearing or investigative procedure and, more broadly, advising any party that any document need not be filed with the SEC.[55] Attorneys retained or instructed by the chief legal officer (CLO) or a qualified legal compliance committee (QLCC) of a company to assert a colorable defense regarding a material violation are excepted from the Part 205 requirements.[56] In general, though, the SEC intends that Part 205 reach any attorney who adds, excludes, or characterizes information for a document intended to be filed with the SEC.[57] Thus the "appearing and practicing" definition expands the reach of Part 205 significantly, at least to that of Rule 10b-5 applicability, and probably to that of Model Rule 1.13.[58] Indeed, the proposed definition would have gone even further by including foreign attorneys and those members of the bar not acting in their

55. *Id.* pt. 205.2(a). Thus, attorneys advising private or foreign corporations with no obligations to the SEC would be included in this definition, but not in the Rule 102(e) definition. 17 C.F.R. § 201.102(e).

56. 17 C.F.R. pt. 205.3(b)(6)–(7). To cease their corrective actions, attorneys may rely on the assertion of a colorable defense by some other attorney retained by the board of directors or QLCC. *Id*. Professor Koniak interprets this section as creating a broad exemption requiring only the imagination of, rather than the assertion of, a colorable defense. Koniak, *supra* note 14, at 1275–77. It seems more consistent with the language, the regulatory scheme generally, and the comments of the SEC to read the exemption narrowly as applying only during actual assertion of a defense during investigations or litigations. *See* 17 C.F.R. pt. 205.2(b)(3) (defining an appropriate response to an attorney's report as "retain[ing] or direct[ing] an attorney to review the reported evidence of a material violation and . . . such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer . . . in any investigation or judicial or administrative proceeding"); Part 205 Release, *supra* note 5, at 6300 n.37 ("[A]sserting a colorable defense on an issuer's behalf in an investigation or administrative proceeding may constitute an appropriate response."). Furthermore, Professor Koniak's analysis does not recognize that if an attorney has been retained by the board or QLCC to imagine a colorable defense to a possible violation, then the board or QLCC has been informed of the possible violation. The logical purpose of a reporting requirement is to make the recipient of the report aware of the information reported. Thus, retention of an attorney by the board or QLCC indicates that the board or QLCC is aware of the problem necessitating such retention, which appears to fulfill the purpose of the reporting requirement. The role of the CLO and QLCC are further discussed *infra* notes 119–22.

57. Part 205 Proposal, *supra* note 31, at 71,676.

58. To be sure, Model Rule 1.13, unlike Part 205, would apply to an attorney representing a small business or other entity that never even considered the possibility of filing documents with the SEC. *See* MODEL RULES OF PROF'L CONDUCT R. 1.13 (2002) (extending the obligations of the Rule to all attorneys representing an organization). Even leaving aside the inadvisability of such a negligent approach, this Note focuses on the responsibilities of securities lawyers, making this distinction largely irrelevant to the discussion.

capacity as attorneys, but the SEC in its final rules retreated from this position.[59]

B. What Triggers the Duty to Take a Corrective Action?

The three preexisting regimes further differ with respect to what knowledge and actions are required of an attorney before he is obligated to take a corrective action. Rule 10b-5 is subject to the greatest ambiguity in its triggering mechanism, but may be the most permissive. Rule 10b-5 violations take two forms: primary violations and aiding and abetting violations.[60] To commit a primary violation under Rule 10b-5, a lawyer would have to make a material misstatement or omission in the face of a duty to disclose.[61] To commit an aiding and abetting violation under Rule 10b-5, a lawyer would have to take some action to specifically and substantially assist a primary violation by another party, usually an officer or director of the represented entity.[62] No Rule 10b-5 violation, either primary or aiding and abetting, exists where the conduct in question is merely negligent; some element of scienter must exist.[63] Finally, the deception must be material; that is, it must be sufficiently important so as to "alter[] the 'total mix' of information made available" to an investor.[64] Thus, in either the primary or the aiding and abetting case, it is clear that a lawyer must knowingly participate in a material deception to violate Rule 10b-5.

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59. Part 205 Release, *supra* note 5, at 6298.

60. *Compare* Ziemba v. Cascade Int'l, Inc., 256 F.3d 1194, 1205 (11th Cir. 2001) (applying a primary violator test to secondary actors), *with* SEC v. Fehn, 97 F.3d 1276, 1288 (9th Cir. 1996) (applying elements of aiding and abetting violations).

61. Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 473–74 (1977). There is some debate over whether the misstatement or omission must be publicly attributable to a secondary actor to establish that actor's primary violation of Rule 10b-5. *Compare* Wright v. Ernst & Young L.L.P., 152 F.3d 169, 175 (2d Cir. 1998) (holding that, in order for a secondary actor to incur primary liability, "the misrepresentation must be attributed to that specific actor at the time of public dissemination"), *with* Carley Capital Group v. Deloitte & Touche, L.L.P., 27 F. Supp. 2d 1324, 1334 (N.D. Ga. 1998) (holding that primary liability is not limited "to those individuals who sign documents or are otherwise identified to investors").

62. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 104(2), 109 Stat. 737, 757 (codified at 15 U.S.C. § 78t(f) (2000)). After *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), the degree of liability differs sharply for primary and aiding and abetting violations, a distinction discussed *infra* Part II.D.

63. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212–14 (1976).

64. TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). There are other elements of a Rule 10b-5 violation, most notably reliance, *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988), and standing, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730–31 (1975). However, these are beyond the control of an attorney, whose decisions and responsibilities must therefore rest on other grounds.

In effect, lawyers first becoming aware of a material deception are required under Rule 10b-5 to avoid: (1) making a misstatement in furtherance of the deception, (2) if under a duty to disclose, failing to correct a material omission, and (3) assisting in furtherance of the deception.[65] As a practical matter, however, a lawyer becoming aware of a deception is probably being asked to do exactly one of these three things. Therefore, the triggering mechanism for some affirmative corrective action on the part of the lawyer is simply awareness of a deception and a request by the client to further that deception.

However, despite the apparent simplicity of this standard, courts diverge sharply on what kinds of behavior give rise to the duty to act preventatively. At one extreme stands *Schatz v. Rosenberg*.[66] In *Schatz*, the law firm Weinberg & Green knew of numerous misrepresentations made to the plaintiffs and of a continuing scheme to siphon off the resources of companies whose debt was held by the plaintiffs.[67] The facts of the case were anonymously submitted to Maryland's State Bar Committee on Ethics, which concluded that Weinberg & Green had an ethical duty to either disclose the true facts or withdraw from representing the client.[68] Nonetheless, the Fourth Circuit Court of Appeals held that the firm had no legal duty to disclose, relieving Weinberg & Green of primary violator liability under 10b-5.[69] Further, the Fourth Circuit held that the absence of a duty to disclose mandated a heightened standard of scienter for aider and abettor liability.[70] Thus, under the standard described in *Schatz*, only a request for active, affirmative participation in the fraud would trigger a duty to take corrective action.

At the other end of the spectrum stands *SEC v. Frank*.[71] In that case, Frank, an attorney, had seen some letters concerning tests of a

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65. *See, e.g.*, Rubin v. Schottenstein, Zox & Dunn, 143 F.3d 263, 268 (6th Cir. 1998) ("[The attorney] assumes a duty to provide complete and nonmisleading information with respect to subjects on which he undertakes to speak."); SEC v. Fehn, 97 F.3d at 1293–94 (imposing liability on a lawyer who edited a disclosure statement for failing to correct material omissions).

66. 943 F.2d 485 (4th Cir. 1991).

67. *Id.* at 488.

68. *Id.* at 492.

69. *Id*. ("An ethical duty of disclosure does not create a corresponding legal duty under the federal securities laws.").

70. *Id.* at 496. This holding spurred one commentator to label the *Schatz* decision as "clearly wrong." Geoffrey C. Hazard, Jr., *Lawyer Liability in Third Party Situations: The Meaning of the Kaye Scholer Case*, 26 AKRON L. REV. 395, 400 n.17 (1993).

71. 388 F.2d 486 (2d Cir. 1968).

chemical additive designed to reduce the curing time of rubber products.[72] Some of these letters, and some comments made to Frank, may have indicated that use of the additive sometimes resulted in "sulphur bloom" and could not be guaranteed to work in all instances.[73] Frank helped to edit and circulate an offering statement that claimed, among other things, extensive and successful testing of the additive.[74] The SEC successfully sued for an injunction against Frank on the basis of a section 10(b) violation.[75] The Second Circuit held that a lawyer could not circulate information "simply because his client has furnished it to him," and that Frank had a duty not to circulate the statement to the extent that he, as a layman, could reasonably detect misrepresentations.[76] The court further left open the possibility that a lawyer might have an affirmative duty to investigate possible discrepancies.[77] Under this standard, even knowledge of evidence of deceptions would serve to trigger a duty to take corrective action. The precise level of attorney knowledge required to trigger Rule 10b-5's duties of corrective action thus varies widely from the permissive standard in *Schatz* to the highly stringent standard of *Frank*.

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72. *Id.* at 489.

73. *Id*.

74. *Id.* at 487.

75. *Id*. The decision does not specify whether the SEC was pursuing a theory of primary or aiding and abetting liability. This is not surprising, as prior to *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A*, 511 U.S. 164 (1994), the distinction between the two theories was poorly defined. *See* James D. Cox, *Just Deserts for Accountants and Attorneys after Bank of Denver*, 38 ARIZ. L. REV. 519, 521 (1996) ("There is reason to believe that after *Bank of Denver* courts will reconsider the liability of professionals as primary participants, even though prior to *Bank of Denver* their liability was customarily regarded as that of an aider and abettor to their client's violation.").

76. *Frank*, 388 F.2d at 489; *see also* Kline v. First W. Gov't Sec., Inc., 24 F.3d 480, 487 (3d Cir. 1994) ("[P]rofessionals and others with similar access to information must disclose data that calls into question the accuracy of an opinion.").

77. *Frank*, 388 F.2d at 489; *cf.* SEC v. Nat'l Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978) (holding that where attorney was on notice of possible infirmities of financial statements, attorney was required to delay closing until the financial statements could be verified). Some cases based on state fraud laws may go even further. *See* FDIC v. O'Melveny & Myers, 969 F.2d 744, 748–49 (9th Cir. 1992), *rev'd on other grounds*, 512 U.S. 79 (1994), *adopted in relevant part*, 61 F.3d 17 (9th Cir. 1995) (imposing a duty under state law for a lawyer to "act competently to avoid public harm when he learns that his is a dishonest client" and to conduct a "reasonable, independent investigation" of facts given him by the client).

Rule 102(e)[78] theoretically imposes a triggering event similar to that of *Frank*. In *In re Carter & Johnson*,[79] the SEC prospectively created a rule that where an attorney's advice is not being followed or is not being sought in good faith, the attorney is required to take corrective action.[80] This standard is analytically distinct from the Second Circuit's holding in *Frank*, but as a practical matter may not differ much. Presumably, an attorney who notices evidence of a misrepresentation will first approach his client with advice before taking any more drastic corrective actions, and will proceed to such actions only after being rebuffed. In the end, however, the SEC's use of its prosecutorial discretion to refrain from pursuing Rule 102(e) actions in the absence of a judicial determination of a violation of the securities laws[81] has rendered the precise scope of Rule 102(e) unimportant.

The Model Rules, however, do impose a broader set of triggering events, at least in some instances. Model Rule 1.13 states unequivocally that when a lawyer represents an organization, the organizational entity, and not its constituents, is the client.[82] Analytically, this would imply that where the lawyer knows that an officer or director, or any group thereof, is pursuing a course of action likely to be harmful to the corporation, the lawyer has a duty to prevent that course of action or, failing that, to limit its consequences.[83] This is indeed the standard set forth in Model Rule 1.13,[84] though it is subject to two important qualifications. First, Model Rule 1.13 contains a materiality standard, which requires that the violative activity be likely to result in substantial injury to the organization.[85] This standard is similar in degree, though not in focus, to the "significant propensity to affect [investors]" materiality standard in Rule 10b-5 jurisprudence.[86] The second qualification is an

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78. Rule 102(e) was originally numbered as Rule 2(e), Rules of Practice, Exchange Act Release No. 35,833, 60 Fed. Reg. 32,738, 32,822 (June 23, 1995), and many of the sources cited in this Note refer to the latter.

79. *In re* Carter & Johnson, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847 (March 25, 1981).

80. *Id.* at 84,172.

81. *See* discussion *supra* note 31 and accompanying text.

82. MODEL RULES OF PROF'L CONDUCT R. 1.13 (2002).

83. 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, 638 (1998).

84. MODEL RULES OF PROF'L CONDUCT R. 1.13(b).

85. *Id*.

86. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 439 (1976) (quoting Mills v. Electric Auto-Lite Co., 396 U.S. 375, 384 (1970)).

ambiguous scienter requirement. Model Rule 1.13 mandates corrective action when the attorney "knows" of violations,[87] but no guidance is given in either the Rule or its comments as to whether actual knowledge is required, or whether a recklessness standard, or even a negligence standard, applies. Notwithstanding this ambiguity, the Rule 1.13 trigger is significantly broader than any interpretation of Rule 10b-5, as it encompasses not only deceptive practices, but also any violation of law likely to cause the organization substantial harm.

However, the actions that a lawyer may take under Rule 1.13 are limited to in-house, corrective actions.[88] Rule 1.16 also includes a triggering event for withdrawal from representation when continued representation would result in violation of the law or ethical duties.[89] The language of Rule 1.16 is somewhat ambiguous as to whether the representation itself must violate the law to trigger the duty to withdraw, or whether it is sufficient that the representation will assist violation of the law.[90] The comments shed some light on this ambiguity, but do not resolve it.[91] Comment 2 to Rule 1.16 states that withdrawal is mandated when the client demands that the lawyer engage in illegal conduct.[92] On the other hand, comment 15 to Rule 1.6 and comment 10 to Rule 1.2 state that withdrawal under Rule 1.16(a)(1) is required when the lawyer's services will be used to further or assist criminal or fraudulent conduct.[93] The distinction is akin to that between primary violations and aiding and abetting violations of Rule 10b-5,[94] but is dissimilar in that the primary route is triggered by any violation of law or professional responsibility, while the indirect route is triggered only by criminal or fraudulent behavior.[95]

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87. MODEL RULES OF PROF'L CONDUCT R. 1.13(b).

88. *Id*.

89. *Id.* R. 1.16(a)(1).

90. Rule 1.16 reads in relevant part that "a lawyer shall not represent a client or, where representation has commenced, shall withdraw from the representation of a client if the representation will result in violation of the rules of professional conduct or other law." *Id*.

91. Comments to the Model Rules are guides for interpretation, but the text of the rules is authoritative. *Id*., *Scope*, ¶ 21.

92. *Id.* R. 1.16 cmt.

93. *Id.* R. 1.2 cmt., 1.6 cmt.

94. *See* discussion *supra* notes 25–27 and accompanying text.

95. One area of the Model Rules not immediately relevant to this discussion is that of *permissive* triggers for corrective action, especially withdrawal. There are a number of circumstances that permit, but do not require, the withdrawal of the attorney. These include an attorney's reasonable belief that the client's course of action is criminal or fraudulent, past use

Turning to Part 205, one sees that it has adopted the most expansive components of the preexisting regimes. Part 205 first repeats the principle, also found in Model Rule 1.13(a) and with similar implications, that when representing an organization, the client is the organization and not its constituents.[96] It then requires an attorney to take corrective action whenever he becomes aware of evidence of a material violation of the securities laws or of a fiduciary duty.[97] The concept of "evidence of a material violation" is confusingly defined as "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur."[98] This definition seems to merge the triggering events of section 10(b), Rule 102(e), and Model Rule 1.13, expanding upon each. First, materiality remains an element that, although not defined in Part 205, is presumably comparable to the similar standards of both section 10(b) and the Model Rules.[99] Second, the level of knowledge required, stripped of its double negative, is awareness of information that would lead a prudent attorney to believe that a violation exists,[100]

of an attorney's services to perpetrate a crime or fraud, distaste for client objectives, or unreasonable difficulty or financial burden in the attorney-client relationship. MODEL RULES OF PROF'L CONDUCT R. 1.16(b). However, since these rules are permissive, they are not apposite to the discussion of attorney responsibilities. These provisions are discussed again briefly in the context of noisy withdrawal, *infra* Part II.C.2.

96. Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. pt. 205.3(a) (2003); MODEL RULES OF PROF'L CONDUCT R. 1.13(a).

97. 17 C.F.R. pt. 205.3(b)(1). Ethical violations do not require corrective action under Part 205. *Id*.

98. *Id.* pt. 205.2(e).

99. In securities law, "materiality" is a central term of art that has a consistent meaning across all areas and usages. COX, HILLMAN & LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 39–40 (2001). There is no reason to think that its usage in Part 205 was accidental or intended to have a different interpretation.

100. 17 C.F.R. pt. 205.2(e). Professor Koniak interprets this language differently, arguing that the standard is equivalent in practice to an actual knowledge standard, because, in practice, the factfinder tasked with finding actual knowledge must determine "what any reasonable person would have to have known in this situation." Koniak, *supra* note 14, at 1275–76. However, a subjective standard does not hinge on what a reasonable person would have to have known; rather, it hinges on what that particular person in fact knew. Furthermore, although it is certainly possible to read the double negative as heightening the triggering standard beyond the *Frank* level, this reading would be inconsistent with the term "prudent," repeated use of the concept of "reasonable," a generally accepted term of art indicating an objective standard, and accompanying SEC comments. 17 C.F.R. pt. 205.2(e); *see* Part 205 Release, *supra* note 5, at 6301–02. Professor Koniak also attributes the poor drafting of this section to political

a standard that mirrors the expansive *Frank* interpretation of Rule 10b-5.[101] The concept of a prudent attorney implies an objective, negligence-like standard of knowledge, which suggests a broader scope of triggering events than does Model Rule 1.13's ambiguous standard of knowledge. In requiring only a level of knowledge, and no action, Part 205 is also analytically broader than Rule 102(e). Third and finally, the scope of qualifying violations includes not only the securities violations contemplated by Rule 10b-5 and Rule 102(e),[102] but also fiduciary duties.[103] For practical purposes, this scope is nearly coextensive with that of Model Rule 1.13.[104] Part 205 thus combines the most expansive notions of triggering events from each of these regimes. In this sense, although no piece of the Part 205 standard is without precedent, Part 205 as a whole is broader than any preceding legal regime.

C. What Corrective Actions Are Required or Permitted?

Once the duty to take corrective action is triggered in any of the legal regimes discussed in this Part, a lawyer's next step is to determine what corrective actions are required. Several of the regimes provide for significant discretion in this step. The SEC's interpretation of Rule 102(e), for example, requires "further, more affirmative steps in order to avoid the inference that he has been co-opted, willingly or unwillingly, into the scheme of non-disclosure," but recognizes that "[t]he lawyer is in the best position to choose his

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compromises essentially designed to give the appearance of a stricter standard while actually permitting the bar free rein. Koniak, *supra* note 14, at 1276–77. With all respect to Professor Koniak, it seems more reasonable to attribute the unarguably poor drafting to the immense number of regulations the SEC had to produce in an extremely short period of time. Sarbanes-Oxley Act of 2002 §§ 101(d), 208(a), 301, 302(c), 303(d), 307, 401(a), 401(b), 406(d), 407(c), 802(a), 116 Stat. 745, 751, 775, 776, 777–78, 778, 784, 786, 786–87, 789–80, 790, 800 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.A. (West Supp. 2003)).

101. SEC v. Frank, 388 F.2d 486, 489 (2d Cir. 1968); *see* discussion *supra* notes 71–77 and accompanying text.

102. Manipulative and Deceptive Devices and Contrivances, 17 C.F.R. § 240.10b-5 (2003); Private Securities Litigation Reform Act of 1995 § 104(2), 15 U.S.C. § 78t(f) (2000); *In re* Carter & Johnson, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,172 (March 25, 1981). Only the latter two sources explicitly contemplate the full range of securities violations, but as mentioned in note 11, *supra*, Rule 10b-5 is to some degree a conceptual representative of the securities laws generally.

103. 17 C.F.R. pt. 205.2(e).

104. *See* MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2002) (covering fiduciary duties and violations of securities law under the rubric of any "violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization").

next step."[105] Similarly, Rule 10b-5 cases, regardless of where they fall on the spectrum of the scope of trigger conditions, are largely silent on what a lawyer may do, except for stating that the lawyer must not take any action to perpetrate or substantially assist a deception.[106] This requirement, combined with the silence on any specific actions, may imply a preference for resignation. Although they are far more specific in their requirements for corrective action, the Model Rules also include a number of permissive rules allowing significant attorney discretion.[107]

Part 205, in contrast, is highly specific and offers very little discretion to the attorney.[108] It prescribes a rigorous, step-by-step path of corrective actions for attorneys to follow, and only permits discretion in specific circumstances that may justify disclosure of client confidences.[109] In addition to this up-the-ladder reporting, the SEC also considered further noisy withdrawal requirements.[110] The following Sections consider these devices.

1. *Up-the-Ladder Reporting and Monitoring*. The obligation to report the actions of corporate constituents to their superiors, known as up-the-ladder reporting,[111] had little formal basis in case law or legal academic literature prior to the corporate derailments that led

105. *In re* Carter & Johnson, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 84,172.

106. *See* Ziemba v. Cascade Int'l, Inc., 256 F.3d 1194, 1205 (11th Cir. 2001) (refusing to impose primary Rule 10b-5 liability where no misstatement relied on by plaintiffs could be identified); Camp v. Dema, 948 F.2d 455, 460–61 (8th Cir. 1991) (using a severe recklessness test to determine whether attorneys' actions constituted substantial assistance of the primary violation for the purposes of Rule 10b-5). *But see* SEC v. Nat'l Student Mktg. Corp., 457 F. Supp. 682, 713 (D.D.C. 1978) (imposing on attorneys a duty to shareholders to interfere with the consummation of a merger until financial statements brought into question by a "comfort letter" could be verified).

107. *See, e.g.*, MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (requiring that a "lawyer shall proceed as is reasonably necessary in the best interest of the organization" and suggesting referral to higher authority "unless the lawyer reasonably believes that it is not necessary in the best interest of the organization"); *id.* R. 1.6 cmt. (permitting but not requiring disclosure of client confidences to prevent or rectify crime or fraud).

108. Part 205 primarily gives responsibilities to "supervisory" attorneys, and allows "subordinate" attorneys to simply report evidence of a material violation to their supervising attorney and cease their efforts there. 17 C.F.R. pt. 205.4–.5. Because this distinction does not change the overall structure of the regulatory scheme, this Note will address only the more stringent "supervisory" requirements.

109. *Id.* pt. 205.3.

110. Part 205 Proposal, *supra* note 31, at 71,688–91. Noisy Withdrawal Proposal, *supra* note 42, at 6326.

111. Part 205 Release, *supra* note 5, at 6296 (Feb. 6, 2003).

to the enactment of the Sarbanes-Oxley Act. Commentary since then has identified either Rule 102(e), as interpreted by *In re Carter & Johnson*,[112] or Model Rule 1.13(b)[113] as the source of the concept.

Up-the-ladder reporting is certainly present in both of these rules, but the recommendation to pursue such reporting is weak in both cases. *In re Carter & Johnson*, as mentioned above, gives lawyers a free rein to deal with a client who is ignoring their advice.[114] Rather than dictating a precise course of conduct, it merely provides three suggestions: resignation, direct approach to the board of directors, or enlisting the aid of other managers.[115] Of these, only directly approaching the board of directors is analogous to up-the-ladder reporting, while enlisting the aid of managers is similar in spirit but not operation. Model Rule 1.13 is similarly merely suggestive. It first gives a general mandate to proceed as necessary in the best interests of the organization while minimizing disruption.[116] It then suggests as nonexclusive examples the following options: requesting reconsideration, advising a second legal opinion, or referring the matter to higher authority, potentially up to the highest authority, in the organization.[117] This latter option is more explicitly similar to up-the-ladder reporting, but the suggestion is weakened even further by the preceding admonition to minimize disruption to the client organization. There are few organizations where accusing a CEO of questionable conduct before the board of directors will not create significant organizational disruption.

These meek suggestions stand in stark contrast to the mandate for up-the-ladder reporting set forth by section 307 and implemented in Part 205. Under the new regulations, an attorney who becomes

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112. *E.g.*, Part 205 Proposal, *supra* note 31, at 71,671–72. The SEC also cited *In re* Gutfreund, Strauss & Meriwether, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,067 (Dec. 3, 1992), as an example of a recommendation of up-the-ladder reporting outside the Rule 102(e) context. Part 205 Proposal, *supra* note 31, at 71,672.

113. *E.g.*, Letter from Richard W. Painter to Harvey Pitt, Chairman, SEC (Mar. 7, 2002), *available at* http://www.abanet.org/buslaw/corporateresponsibility/pitt.pdf (on file with the *Duke Law Journal*).

114. *In re* Carter & Johnson, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,172 (March 25, 1981).

115. *Id*.

116. MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2002).

117. *Id*. Note that the first suggestion here would have already been exhausted by a lawyer facing a choice governed by *In re Carter & Johnson*. The Rule 102(e) triggering event includes being repeatedly rebuffed by the client, and such rebuffs could only have come in response to a lawyer's request for reconsideration.

aware of evidence of a material violation has two reporting paths that he may follow.[118] First, he may report the evidence to the CLO or to both the CLO and chief executive officer (CEO).[119] If he does not receive an appropriate response within a reasonable time, he must then report the evidence to the audit committee or, if no audit committee exists, to another committee composed entirely of directors not employed by the company or, if no such committee exists, to the full board of directors.[120] Alternatively, if the company has established a qualified legal compliance committee (QLCC),[121] the attorney may simply report the evidence to the QLCC.[122] Part 205 has borrowed a suggested corrective action and turned it into a rigorous regulation.

Up-the-ladder reporting can clearly be quite burdensome for an outside lawyer, and perhaps even more so for an in-house lawyer. However good his reasons are for doing so, an outside lawyer who appears before the board regularly to tell them of more evidence of violations is likely to lose that company's business. To be sure, an in-house lawyer could not be terminated for complying with his legal duties,[123] but "ratting" on peers tends to lead to an unpleasant working environment and to foreclose many possibilities of career advancement.

Adding to this burden, significant monitoring duties may be implicitly imposed by Part 205. Specifically, an attorney who makes a report under the up-the-ladder requirement does not escape liability until the officer makes an appropriate response within a reasonable time.[124] Thus, unless the attorney is reporting to a QLCC, he must follow every report by monitoring the passage of time and assessing the reasonableness of any response under an elaborate and complex standard.[125] It can be argued, of course, that any up-the-ladder system,

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118. Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. pt. 205.3(b), (c) (2003).

119. *Id.* pt. 205.3(b)(1).

120. *Id.* pt. 205.3(b)(4).

121. A QLCC is a committee of directors tasked with investigating evidence of material violations. *Id.* pt. 205.2(k). It is composed of at least one audit committee member and at least two directors not employed by the company and not "interested persons" as that term is defined by the Investment Company Act of 1940, 15 U.S.C. § 80a-2(a)(19) (2000). 17 C.F.R. pt. 205.2(k). An existing committee whose members meet these requirements may serve as the QLCC. *Id*.

122. *Id.* pt. 205.3(c).

123. *Id.* pt. 205.3(b)(10).

124. *Id.* pt. 205.3(b)(3).

125. *Id.* pt. 205.2(b), (c).

such as that suggested by *In re Carter & Johnson* or Model Rule 1.13, necessarily includes some duty to monitor the results to determine when the next step must be taken. But this argument overlooks the true import of the monitoring requirement, which is the deprivation of security for an attorney. The up-the-ladder suggestions of the pre-Sarbanes-Oxley regimes were accompanied by the granting of wide discretion to attorneys, so that any corrective action would largely shield them from liability.[126] Under Part 205, however, attorneys who take corrective action by reporting up to a CLO must subsequently make a series of additional judgment calls,[127] possibly including assessment of business judgments, expert credibility, and colorable defenses. These assessments are well beyond the scope of the traditional practice of securities law and thus impose significant new burdens on the attorney. Indeed, in the case of business judgments, corporate law jurisprudence has long recognized that the bar is not well suited to make or second-guess these judgments.[128]

2. *Noisy Withdrawal*. Noisy withdrawal, although much more controversial than up-the-ladder reporting, has a significant basis in legal academic and practice literature.[129] Simple resignation is

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126. *See* discussion *supra* notes 105–07, 114–17and accompanying text.

127. *See* 17 C.F.R. pt. 205.2(b)(3) (requiring attorney to assess implementation of remedial recommendations, reasonableness of the investigation, and quality of proposed defenses). One potential objection to this characterization of the attorney's burden is that Part 205 does offer a safe harbor even more secure than discretion, in the form of the QLCC. *Id.* pt. 205.3(c). However, this overlooks the problem that the decision to form the QLCC rests with the company, not the attorney. *See id*. Thus, unless attorneys collectively have sufficient market power to demand that their clients form QLCCs many securities lawyers will continue to find themselves with exactly the burden described here. *But see* Letter from Susan P. Koniak to Jonathan G. Katz, Secretary, SEC (Dec. 17, 2002), *available at* www.sec.gov/rules/proposed/s74502/spkoniak1.htm (on file with *Duke Law Journal*) (opining that the majority of companies will promptly form QLCCs).

128. *See, e.g.*, Shlensky v. Wrigley, 237 N.E.2d 776, 780 (Ill. App. Ct. 1968) (stating that it is "beyond our jurisdiction and ability" to review whether corporate directors made a correct business decision); Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("The judges are not business experts.").

129. *E.g.*, ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 366, at 3 (1992) (approving noisy withdrawal when a lawyer's continued representation will perpetrate fraud); H. Lowell Brown, *The Dilemma of Corporate Counsel Faced with Client Misconduct: Disclosure of Client Confidences or Constructive Discharge*, 44 BUFF. L. REV. 777, 819–24 (1996) (discussing whether noisy withdrawal would have been permissible or appropriate in the Kaye Scholer incident discussed *infra* note 166); Lisa H. Nicholson, *A Hobson's Choice for Securities Lawyers in the Post-Enron Environment: Striking a Balance Between the Obligation of Client Loyalty and Market Gatekeeper*, 16 GEO. J. LEGAL ETHICS 91, 129–34 (2002) (examining the disclosure and duty problems surrounding the precise timing of a noisy withdrawal).

frequently considered an alternative to participation in or furtherance of a course of action to which an attorney cannot reconcile himself.[130] In a noisy withdrawal, however, an attorney goes further than simply resigning by notifying third parties of his resignation and publicly disaffirming some or all of his work product.[131] Noisy withdrawal has its strongest roots in the Model Rules, as it is essentially a compromise between a lawyer's ethical duty of client confidentiality and his duty to avoid assisting a client in a criminal or fraudulent course of action.[132] In this sense, it is a highly artificial device that effectively informs third parties that the client may be engaged in questionable activity while permitting the lawyer to technically maintain client confidences.[133]

The text of the Model Rules at no time mentions noisy withdrawal or disaffirmance of work product. However, while Model Rule 1.6 sets forth the lawyer's duty of confidentiality, comment 14 to that Rule explicitly contemplates and permits giving notice of a withdrawal and disaffirmance of opinions, documents, and affirmations.[134] Comments to Model Rules 1.2 and 4.1 further clarify that such measures are justified where necessary to prevent assisting a client's ongoing crime or fraud.[135] The ABA has offered a further interpretation of the Model Rules through a formal ethics opinion issued in 1992.[136] In that opinion, the ABA concluded that if a client is perpetrating an ongoing fraud, an attorney *has to* resign and is *permitted to* disaffirm any work product he believes is being or will be

130. *See, e.g.*, MODEL RULES OF PROF'L CONDUCT R. 1.16(b) (2002) (permitting withdrawal in various specific situations where the attorney and client can no longer agree or work together).

131. *See* ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 366, at 3 (1992).

132. *Id.*; MODEL RULES OF PROF'L CONDUCT R. 1.2(d), R. 1.6, R. 1.16(d).

133. *See* ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 366, at 7 n.9 ("[A] 'noisy' withdrawal may result in a disclosure of 'information relating to representation' that is generally prohibited by [Model] Rule 1.6."). Many commentators have taken the position instead that the Model Rules are simply incorrect in disallowing disclosure of constituent activity harmful to the corporation, before or after resignation. *See, e.g.*, Stephen Gillers, *Model Rule 1.13(c) Gives the Wrong Answer to the Question of Corporate Counsel Disclosure*, 1 GEO. J. LEGAL ETHICS 289, 295–97 (1987) (analyzing the distinctions between corporate clients and identically situated, individual clients to highlight the ethical difficulties for corporate lawyers); Harris, *supra* note 83, at 639 (analogizing activities of corporate constituents that harm the corporation to activities of a guardian that harm his ward).

134. MODEL RULES OF PROF'L CONDUCT R. 1.6 cmt.

135. *Id.* R. 1.2 cmt., R. 4.1 cmt.

136. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 366 (1992).

used to perpetrate the fraud, or as necessary to effect withdrawal.[137] If, however, the fraud is completed, resignation is permitted, but disaffirmation is not.[138] Thus, under the Model Rules and ABA interpretation, the concept of noisy withdrawal exists, but it is qualified by numerous conditions.[139] Most notably, at no time is noisy withdrawal mandated under the Model Rules.

As with up-the-ladder reporting and monitoring, a proposed provision of Part 205 also takes the basic concept of a noisy withdrawal and strengthens it. Under a provision currently tabled by the SEC for further consideration, an outside lawyer who goes up the ladder to the board of directors and still receives no satisfactory response to an ongoing or future violation is required to resign, give notice of the resignation to the SEC within one business day, and promptly disaffirm any work product that may be misleading.[140] An inside lawyer is required to give notice of intent to disaffirm within one business day, and similarly disaffirm his work product.[141] If the violation is completed, the lawyer is permitted, but not required, to proceed in the same manner as if the violation were ongoing.[142] An alternative proposal advanced by the SEC would require an attorney to withdraw but not to disaffirm work product.[143] However, the client entity would be required to notify the SEC of the attorney's

137. *Id.* at 3.

138. *Id*.

139. *Id*.; MODEL RULES OF PROF'L CONDUCT R. 1.2, R. 1.6. These restrictions may account for the fact that in the last ten years, the ABA has approved noisy withdrawal as a response to specific fact situations in only two other opinions. *See* ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 375, at 6 (1993) (approving noisy withdrawal to prevent bank examiners from relying on a lawyer's opinion where the lawyer discovered that his opinion was predicated on false information); ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 376, at 8 (1993) (discussing, and implicitly authorizing, noisy withdrawal in hypotheticals involving false replies to discovery requests). Nonetheless, this is still the most expansive pre-Sarbanes-Oxley view. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 366, at 3 (1992) (approving noisy withdrawal when a lawyer's continued representation will perpetrate an ongoing or future fraud). In contrast, *In re Carter & Johnson* discourages even simple resignation except where continued representation would be utterly futile. *See In re* Carter & Johnson, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,172–73 (March 25, 1981) ("We would anticipate that cases where a lawyer has no choice but to resign would be rare and of an egregious nature.").

140. Noisy Withdrawal Proposal, *supra* note 42, at 6326. The comment period for this proposal closed April 7, 2003, *id.* at 6324, but at the time of writing, the SEC had not yet released any final rule or decision on noisy withdrawal.

141. *Id*.

142. *Id.* at 6326–27.

143. *Id.* at 6328.

withdrawal, and should they not do so, the attorney would be permitted to call attention to the deficiency.[144] The purpose of the change, like the purpose of the noisy withdrawal proposal, would presumably be to alert the SEC to the possibility of wrongdoing while technically not violating any client confidences. In light of this purpose, it is important to note that the rule currently finalized by the SEC with respect to QLCCs permits exposure of confidential client information.[145] Under these final rules, if the company has established a QLCC and the reporting lawyer has chosen to report to the QLCC instead of the CLO, then noisy withdrawal is neither mandated nor permitted under Part 205.[146] However, the QLCC itself has the authority, but not the mandate, to notify the SEC if the corporation does not make a reasonable response to the reported evidence of a violation.[147] Furthermore, an attorney may reveal any information to the SEC as is reasonably necessary to prevent or rectify substantial injury to the client or its investors, or to prevent perjury or other fraud on the SEC.[148] This ability to reveal information reaches significantly farther than disaffirmation alone, essentially permitting an attorney to make "noise" whenever the substantial injury test is met.[149] Interestingly, this rule is not tied to withdrawal in any way,

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144. *Id.* at 6329–30.

145. Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. pt. 205.2(k)(4) (2003). Of course, at this time only the finalized rule applies, but the two proposed alternatives may be indicative of future revisions to Part 205 or the enforcement direction of the SEC.

146. 17 C.F.R. pt. 205.3(b)–(c). On the surface, this may appear to provide companies with some incentive to establish QLCCs to avoid potential embarrassment. However, such embarrassment would be expected only in the unlikely case that the company expected to continue obstinately in a course of action that its lawyers thought to be illegal. Furthermore, QLCCs are also permitted, though not required, to report company inaction to the SEC. *Id.* pt. 205.2(k)(4). The incentive to establish QLCCs would thus have to come from some other source.

147. 17 C.F.R. pt. 205.2(k).

148. 17 C.F.R. pt. 205.3(d)(2).

149. *See id.* ("An attorney . . . may reveal to the Commission . . . confidential information . . . to the extent the attorney reasonably believes necessary: . . . [t]o 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."). The perjury or fraud on the SEC triggering test is more properly analogized to Model Rule 3.3, which prohibits a lawyer making a false statement to a tribunal or offering evidence the lawyer knows to be false. *Compare* 17 C.F.R. pt. 205.3(d)(2) (identifying client perjury, subornation of perjury, and perpetration of fraud on the SEC as warranting the revelation of confidential information by an attorney), *with* MODEL RULES OF PROF'L CONDUCT R. 3.3 (2002) (requiring lawyers appearing before a tribunal who know that a person intends to engage in criminal or fraudulent conduct to take remedial measures, possibly including disclosure to the tribunal). Although the focus of Model Rule 3.3 is largely

though presumably withdrawal would be appropriate in many of the situations to which this rule might apply.

Clearly, each of these regimes—the noisy withdrawal and withdrawal-with-notice proposals and the finalized noisy QLCC and client confidence rule—imply different, specific duties and different degrees of modification from the prior, existing regimes. But common ground between the regimes and the finalization of the client confidence and noisy QLCC rules allow certain general conclusions to be drawn. Specifically, these provisions expand on the Model Rules in two ways. First, they reject the narrow crime or fraud trigger of the Model Rules, allowing instead for the rule to be triggered by the more liberal standard of any violation of securities law or duty, or in the case of the client confidence rule, by a likelihood of substantial injury.[150] Second, the force of the device remains at least equal to the Model Rules; where the Model Rules permit disaffirmance, Part 205 may require disaffirmance.[151]

D. What Enforcement Mechanisms Exist to Ensure Compliance?

Up to this point, the analysis has largely focused on the duties imposed by each legal regime. However, the force of any rule is determined in large part by the enforcement mechanism that stands behind it. This Section will therefore examine the sanctions that attach to an attorney's failure to comply with his duties.

As discussed above, the Model Rules have broad triggering mechanisms and are the source of many of the specific responsibilities of lawyers, including up-the-ladder reporting and noisy withdrawal.[152] At the same time, although the Model Rules sometimes require attorneys to take general action, specific failure to go up the ladder or to execute a noisy withdrawal would never be a basis for

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preventative, comments to the rule indicate that learning of the falsity of testimony later may require disclosure of the falsehood to the tribunal. *See* MODEL RULES OF PROF'L CONDUCT R. 3.3 cmt. Here too, the Part 205 standard is significantly broader in that it requires only reasonable belief of perjury, rather than actual knowledge that testimony is false. Part 205 Release, *supra* note 5, at 6305 (Feb. 6, 2003) (codified at 17 C.F.R. pt. 205). A full discussion of the effect of expanding Model Rule 3.3 is for the most part incidental to, and outside the scope of, this Note.

150. *See supra* Part II.B.

151. *See supra* notes 133–48 and accompanying text.

152. *See supra* Part II.B. Rule 102(e) also mentions a form of up-the-ladder reporting, but as its application is limited to cases where a securities violation has already been found, it is unlikely to be an independent source of responsibility for an attorney. Appearance and Practice Before the Commission, 17 C.F.R. § 201.102(e) (2003).

enforcement.[153] Rather, the Model Rules tend to be enforced only when an attorney pursued corrective actions beyond the allowed scope. Such influence on attorneys' preventative responsibilities is more limiting than enabling.[154]

In theory, the enforcement mechanism is fairly strong, encompassing a number of disciplinary sanctions that include reprimand, suspension, and disbarment.[155] In practice, however, the picture is less clear. Although no statistics are available for violations of specific rules, a 2000 ABA survey shows that only 3.7 percent of lawyers investigated by disciplinary committees for professional responsibility violations are ever formally and publicly charged. Of those charged, however, over one-fourth are voluntarily or involuntarily disbarred.[156] It is unclear whether this rate of enforcement is sufficient to ensure broad compliance with the Model Rules. In conjunction with the potentially limiting nature of enforcement, it seems that the Model Rules are probably not a major force pushing lawyers toward corrective action.

The odd enforcement status of Rule 102(e) has already been mentioned here several times. Even on its face, Rule 102(e) has the weakest (but certainly still nontrivial) sanctions of any of the regimes, as it contemplates barring an attorney from all further practice before the SEC.[157] Given the broad definition of practicing before the SEC,[158] this is effectively a disbarment from the practice of securities law and many forms of corporate law, though not from the practice of law generally. The incentive effects of this sanction are even further weakened due to the SEC's policy of linking prosecution of Rule

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153. *See* MODEL RULES OF PROF'L CONDUCT R. 1.6(b) (permitting lawyers to reveal confidential information to comply with the Model Rules but not detailing consequences of failing to reveal confidential information when the Model Rules would require it); *id.* R. 1.6 cmt. (detailing no sanctions for an attorney's failure to comply with the withdrawal rules); *id.* R. 1.13 (permitting, but not requiring, lawyers to withdraw from representation of clients breaking the law); *id.* R. 1.13 cmt. (justifying lawyer action when client is violating the law, but not establishing punishment for failing to act).

154. *See* ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 366, at 3 (1992) (outlining narrow circumstances in which an attorney should take corrective action).

155. MODEL RULES FOR LAWYER DISCIPLINARY ENFORCEMENT R. 10 (2001).

156. *See id*. (showing 3,360 formal chargings); *see also* http://www.abanet.org/cpr/discipline/sold/00-ch2.xls (last visited Oct. 26, 2003) (on file with the *Duke Law Journal*) (showing 929 disbarments, of which 486 were involuntary and 443 were on consent).

157. 17 C.F.R. § 201.102(e)(i–iii).

158. *See id.* § 201.102(f) (defining practice before the SEC as transacting any business with the Commission or preparing any document filed with it).

102(e) actions to judicial determinations of violations of the securities laws.[159]

Sanctions associated with violations of Rule 10b-5 have much more weight than either the Model Rules or Rule 102(e). How much weight, exactly, depends in turn on whether the violation is a primary or aiding and abetting violation.[160] Modern securities aiding and abetting violations are governed by section 20(f) of the Exchange Act,[161] which specifies that for actions brought by the SEC, an aider and abettor is in violation to the same extent as the primary violator.[162] The range of possible noncriminal sanctions are thus those provided by the Exchange Act: injunctions (in administrative proceedings), cease-and-desist orders, or civil monetary penalties of up to $100,000 for a natural person or $500,000 for an entity.[163] These are clearly more serious penalties than those contemplated by the Model Rules or Rule 102(e).[164] Injunctions can be used to bar attorneys, as with Rule 102(e), from further practice before the SEC;[165] cease-and-desist orders can bring entire law firms to a halt,[166] and the money damages are significant.[167]

Nonetheless, aiders and abettors are exposed to significantly less risk than primary violators of Rule 10b-5.[168] Primary violators are

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159. *See supra* note 31 and accompanying text.

160. *See* Cent. Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 177 (1994) (permitting private actions, including recovery of damages, for primary violations, but blocking such actions for aiding and abetting violations). *But see* 15 U.S.C. § 78t (2000) (imposing joint and several liability on aiders and abettors).

161. 15 U.S.C. § 78t(f).

162. *Id*.

163. 15 U.S.C. § 78u(d).

164. ABA MODEL RULES FOR LAWYER DISCIPLINARY ENFORCEMENT R. 10 (2003); Appearance and Practice Before the Commission, 17 C.F.R. §§ 201.102(e)(1), 201.102(f) (2003).

165. *See, e.g.*, S.E.C. v. Fehn, 97 F.3d 1276, 1296 (9th Cir. 1997) (enjoining a lawyer permanently "from future aiding and abetting violations of sections 10(b) and 15(d) of the Securities Exchange Act of 1934").

166. 15 U.S.C. § 78u(d). The cease and desist power generated great alarm among lawyers when it was used by the Office of Thrift Supervision against Kaye, Scholer, Fierman, Hays and Handler in 1992. *See* Hazard, *supra* note 70, at 397–98 (discussing the bar's "anxious attention" and reaction to the Kaye Scholer cease-and-desist order); Peter C. Kostant, *When Zeal Boils Over: Disclosure Obligations and the Duty of Candor of Legal Counsel in Regulatory Proceedings After the Kaye Scholer Settlement*, 25 ARIZ. ST. L.J. 487, 492–93 (1993) (chronicling Kaye Scholer's failure to meet appropriate standards of professional conduct). The cease-and-desist order froze all assets of the firm and halted business for ten days, at which point Kaye Scholer agreed to a $41 million settlement. *Id*. at 487–89.

167. *See* 15 U.S.C. § 78u(d).

168. *See, e.g.*, Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S.

subject to all the same Exchange Act penalties, but are further subject to private litigation for civil damages.[169] In light of *Central Bank of Denver*,[170] however, it is natural to ask how likely it is that an attorney would be found liable for a primary violation, rather than an aiding and abetting violation. Justice Stevens provides one answer in his dissent: "Indeed, the Court anticipates . . . that many aiders and abettors will be subject to liability as primary violators. For example, an accountant, lawyer, or other person making oral or written misrepresentations . . . may be liable for a primary violation."[171] Although the primary liability test is unquestionably more stringent than the aiding and abetting test,[172] several courts have reiterated that secondary actors can be primarily liable under Rule 10b-5.[173] The debate now seems to center around whether the attorney must make a public misstatement or omission, or whether substantial participation in a deception is sufficient.[174] In other words, the attorney's duty once he becomes aware of the deception is narrow: he must either not make a misstatement or not participate in a deception, depending on which test applies. In either case, this narrow duty is strongly enforced by the threat of both SEC and private litigation.

Part 205 is not as strongly enforced as Rule 10b-5. Instead, sanctions are directly equated to the sanctions that would apply for a violation of the Exchange Act, but the criminal penalties available

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164, 191 (1994) (refusing to recognize a private cause of action for aiding and abetting violations); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730, 755 (1975) (refusing to grant private causes of action to anyone other than buyers and sellers of securities).

169. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971).

170. 511 U.S. 164 (1994).

171. *Id.* at 199 n.10 (Stevens, J., dissenting).

172. *See* David J. Baum, Comment, *The Aftermath of Central Bank of Denver: Private Aiding and Abetting Liability Under Section 10(b) and Rule 10b-5*, 44 AM. U. L. REV. 1817, 1839 (1995) (predicting a significant drop in secondary actor litigation due to the reduced likelihood of recovery).

173. *See, e.g.*, Rubin v. Schottenstein, Zox & Dunn, 143 F.3d 263, 267 (6th Cir. 1998) (imposing liability on an attorney who withheld material information from investors); *see also* Kline v. First W. Gov't Sec., 24 F.3d 480, 492–93 (3d Cir. 1994) (finding that lawyers have "a duty not to omit" because "ethical rules cannot be relied on to perpetrate fraud"). In a case with more public visibility, if less precedential value, Judge Melinda Harmon recently issued an extensive and thoughtful ruling denying a motion to dismiss filed by Enron's accountants and auditors in a class action suit against them. Newby v. Enron Corp., No. H-01-3624, 2003 U.S. Dist. LEXIS 7632 (S.D. Tex. Dec. 20, 2002).

174. *See* Robert A. Prentice, *Locating That "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability Under Section 10(b)*, 75 N.C. L. REV. 691, 723–26 (1997) (outlining the "broad" and "narrow" views of attorney liability under section 10(b)).

under the Exchange Act are specifically excluded.[175] Thus, sanctions would be available for a violation of an attorney's duties under Part 205 to the same extent that civil sanctions would be available for an aiding and abetting violation of Rule 10b-5.[176] The initial proposal of Part 205 engendered widespread concern that there might be room for additional enforcement in the form of a court finding an implied private right of action.[177] However, the SEC in its final release reformed the language of several sections to eliminate possible bases for such a right, and added an explicit prohibition on private rights of action on the basis of section 307 or Part 205.[178] Although this does not completely preclude a court from implying a private right of action, it does make it exceedingly unlikely.[179] In any case, Part 205's enforcement scheme is certainly at least as strong as any of the legal regimes discussed above, other than for private Rule 10b-5 violations and criminal aiding and abetting.

III. POLICY CONSIDERATIONS

In light of the foregoing, Part 205 can be simplistically summarized as an amalgamation of many of the most expansive notions of lawyer responsibility to be found in our legal system prior to the enactment of the Sarbanes-Oxley Act. Informed by this understanding, one is better able to return to the fundamental

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175. *See* Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. pt. 205.6(a) (2003) (defining sanctions as "civil penalties and remedies"); Part 205 Release, *supra* note 5, at 6305, 6314–15 (Feb. 6, 2003) (codified at 17 C.F.R. pt. 205).

176. *Compare* 17 C.F.R. pt. 205.6(a) (establishing civil penalties), *with* 15 U.S.C. § 78u(d) (2000) (granting courts authority to enjoin acts that violate securities laws, prohibit people from serving as officers and directors, or collect fines).

177. *See* Part 205 Release, *supra* note 5, at 6305, 6314–15 (addressing various commenters' concern that a private right of action might be implied). This concern was probably unfounded even with respect to the rules' original form in light of the Supreme Court's current distaste for implying private rights of action. *See* Alexander v. Sandoval, 532 U.S. 275, 286–87 (2001) (articulating the modern restrictive standard for implying private rights of action).

178. 17 C.F.R. pt. 205.7; Part 205 Release, *supra* note 5, at 6315.

179. Legislative history further supports the conclusion that no private right of action should be implied. Senator John Edwards, the primary author of section 307, stated in debate that "nothing in this bill gives anybody a right to file a private lawsuit against anybody." 148 CONG. REC. S6524, 6552 (daily ed. July 10, 2002) (statement of Sen. Edwards). But as the then-general counsel of the SEC once cynically remarked: "As near as I can tell, the basic holding, or the fundamental holding, of *Central Bank* really is that legislative history doesn't matter. The fundamental holding of *Gustafson* [*v. Alloyd Co.*, 513 U.S. 561 (1995),] is that statutory language doesn't matter much either." Simon Lorne, *Comment on "Just Deserts for Accountants*,*"* 38 ARIZ. L. REV. 555, 555 (1996).

question: What are the broader economic, professional, and societal implications of the new regulatory scheme? Because many scholars have already explored this topic,[180] this Note will limit itself to brief observations suggested by the analytical model discussed in Part II. This Part argues that Part 205's expansion of lawyer regulation along each dimension impacts a different aspect of a lawyer's perceived role in corporate governance and works a fundamental change to existing models of the role of the securities lawyer.

First, expanding the reach of Part 205's extensive duties and sanctions may seriously interfere with traditional notions of zealous advocacy expected of a lawyer. Part 205 reaches all attorneys practicing before the SEC, including those involved in adversarial enforcement proceedings or nominally cooperative but fundamentally adversarial investigations.[181] A lawyer who must zealously advocate his client's position while simultaneously being on the lookout for material evidence of a violation may, despite the SEC's colorable defense exemption, find himself in an untenable position.[182] For example, an attorney doing his best to draft a Wells submission defending internal controls[183] could easily come upon evidence of a related breach of *Caremark* duties that he would then have to report up and potentially out.[184]

Second, as perhaps the most obvious and potentially most profound impact of Part 205, the lowered triggering standards may fundamentally change the fiduciary nature of the attorney-client relationship. Part 205 recognizes this fiduciary role,[185] but the

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180. *See supra* note 14 and accompanying text.

181. 17 C.F.R. pt. 205.2(a).

182. *See* Letter from Skadden, Arps, Slate, Meagher and Flom, LLP, to Jonathan G. Katz, Secretary, SEC (Apr. 1, 2003) (opining that requiring documentation of reporting while advocating a defense places attorneys in an untenable position), *available at* http://www.sec.gov/rules/proposed/s74502/skadden1.htm (on file with the *Duke Law Journal*).

183. A Wells submission is essentially a response to an SEC Staff recommendation that an enforcement action be initiated. Arthur B. Laby & W. Hardy Callcott, *Patterns of SEC Enforcement Under the 1990 Remedies Act: Civil Money Penalties*, 58 ALB. L. REV. 5, 8 n.21 (1994). However, drafting a Wells submission can be quite sensitive, because at the time of drafting the attorney would not be aware of the nature or basis for the recommendation, and as an advocate would not want to reveal or characterize damaging evidence in ways that the staff has not thought of.

184. *Caremark* duties refer to Delaware law fiduciary duties to maintain a system of internal controls on management and employees. *In re* Caremark Int'l Derivative Litig., 698 A.2d 959, 968–70 (Del. Ch. 1996). Thus, the duty to reveal or report evidence relevant to a *Caremark* violation could seriously hamper the sensitive drafting of a Wells submission on a similar topic.

185. *See* Mark A. Hall, *Law, Medicine, and Trust*, 55 STAN. L. REV. 463, 521 (2002) (likening the lawyer-client relationship to the parent-child relationship).

attorney's new need to be aware of much more minor indicia of violations than before requires a lawyer to become a policeman as well as a counselor, always on the lookout for evidence that could, from an objective, ex post perspective, be considered indicative of a material violation.[186] On the one hand, this may lead managers to dissemble and attorneys to avoid investigating managerial claims, leading to poorer compliance with the securities laws. On the other hand, this upheaval in the accepted relationship between lawyers and managers may be a necessary first step to achieve real change in the role of corporate lawyers towards what that role was supposed to be all along—that of a fiduciary to the entity rather than its constituents.[187]

Third, these magnified attorney obligations may increase the power of attorneys and shift their role from merely an advisory role to an active and directive role,[188] while at the same time decreasing the influence of the client. If, with Part 205 in effect, managers believe that an attorney will report information up the ladder, they are naturally more likely to abide by the legal opinions of the lawyer.[189] To be sure, the sudden rebalancing of power between the lawyer and

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186. *See* Mark L. Tuft, *For Your Eyes Only: California's Duty of Confidentiality Is Both More Inclusive and More Protective than the Attorney-Client Privilege*, L.A. LAW., Dec. 2002, at 26, 32. ("[T]he client risks the loss of rights without due process at the hands of the lawyer in whom the client has been encouraged by the law to repose trust and confidence."). Lawyers may of course react in exactly the opposite way. By simple human tendency, lawyers may begin to avoid involvement with problems or to develop an unwillingness to pursue topics that they might have to report. If one's eyes are closed, evidence has a tendency to not come to one's attention. However, this is not likely to constitute a successful defense under an objective standard, making the policing consequence far more likely.

187. MODEL RULES OF PROF'L CONDUCT R. 1.13(a) (2002); s*ee* Deborah A. DeMott, *The Lawyer as Agent*, 67 FORDHAM L. REV. 301, 311–12 (1998) (analyzing the duties owed by lawyers to the "wider cast of characters" ignored by the traditional view of lawyer as agent); Harris, *supra* note 83, at 638 (arguing that a lawyer's duty is to do what is best for the corporation to the point of disregarding the instructions of its constituents); Kessler, *supra* note 35, at 472 n.63 (characterizing decisions absolving lawyers of aiding and abetting liability for client fraud as an example of injustice arising from the undue influence of lawyers on the judiciary).

188. The term "directive" is loosely drawn from a symposium featuring Professor Robert Cochran in which Professor Cochran outlined alternative directive, client-centered, and collaborative approaches to moral issues in counseling. Symposium, *Client Counseling and Moral Responsibility*, 30 PEPP. L. REV. 591, 592–96 (2003).

189. A central tenet of applied game theory is that credibly committing to limit one's options ex ante in a strategic interaction can lead one to a much better outcome. *See generally* PANKAJ GHEMAWAT, COMMITMENT: THE DYNAMIC OF STRATEGY (1991). From this perspective, the attorney's new duties counterintuitively become a stick with which the lawyer can drive the client.

client may seriously disrupt their relationship,[190] but Sarbanes-Oxley is here to stay, and managers are going to need lawyers at least as much as before the Act was passed. With their continued participation assured, the greater power of lawyers may effectively lead to precisely the desired result: increased compliance with the securities laws.[191]

Fourth and finally, the increase in the harshness and breadth of sanctions threatens to decrease both the volume and creativity of transactional securities work. A securities lawyer is in at least some capacity a problem solver: given a set of client objectives, the lawyer's job is to devise a legal strategy to accomplish those objectives.[192] But with the consequences of error increased and managerial pressure reduced, innovation is likely to flag and creative methods of reducing transaction costs may be overlooked. The effect of Part 205's sanctions is thus to increase transaction costs by engendering greater attorney conservatism, lowering efficiency, increasing the cost of capital, dampening client growth, and inhibiting the spread of even legitimate innovations. However, efficiencies can be illusory, growth based on falsehoods can be fatal, and innovation can be destructive in the long run.[193] It was unquestionably innovative for Enron, presumably on the advice or at least consent of its lawyers, to obtain off-balance sheet financing by placing its own stock, rather than hard assets, into a securitization vehicle.[194] To the extent that Part 205 prevents such abuses, the dampening of innovation may well be compensated by greater investor trust in, and efficiency of, the

190. Perhaps most disturbing is that the greater power given to the lawyer may allow attorneys to intrude further into business judgments traditionally reserved for business persons. This is of concern because corporate law has long assumed that law should be left to experts in law while business should be left to experts in business. *See supra* note 128 and accompanying text. The erosion of this assumption opens the door further to the trend of major law firms on more business-like functions, such as investment banking, venture capital, or management consulting, which in turn erodes the lawyer's independence and ability to question such business decisions later. *Cf.* ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 410, at 8–12 (1992) (discussing similar concerns when lawyers act as directors of client corporations, but permitting such dual positions).

191. Sarbanes-Oxley Act of 2002 pmbl., Pub. L. No 107-24, 116 Stat. 745 (codified at scattered sections of 11, 15, 18, 28, and 29 U.S.C.A. (West Supp. 2003)).

192. MODEL RULES OF PROF'L CONDUCT R. 1.2 (2002) ("[A] lawyer shall abide by a client's decisions concerning the objectives of representation and . . . shall consult with the client as to the means by which they are to be pursued.").

193. *See In re* Enron Corp. No. 01-16034 (Bankr. S.D.N.Y. Sept. 21, 2002) (on file with the *Duke Law Journal*) (cataloging various abuses of accounting and securitization practices at Enron Corporation preceding its Chapter 11 petition).

194. *Id.* at 37.

securities markets. The primary economic question, which this Note must leave open, is whether the losses on the individual transaction level are sufficiently offset by gains in confidence and accuracy.[195]

CONCLUSION

Section 307 of the Sarbanes-Oxley Act and the SEC rules of Part 205 promulgated thereunder were unquestionably a great departure from other, preexisting regimes concerning the responsibilities of the securities lawyer. Yet these new rules were just as clearly direct descendants of those regimes. Comparison of the new rules to the preexisting regimes along the four dimensions described in Part II—who is required to act, when the duty to act arises, what acts are required or permitted, and why an individual should comply—demonstrates that, along each dimension, Part 205 incorporates some of the most expansive preexisting standards or concepts available. As a consequence of the expansion of each dimension, yet another aspect of the lawyer's role is radically redefined.

On a final note, this may only be the beginning. To utilize the analogy of a bell curve, prior to the enacting of Sarbanes-Oxley, all of the elements of Part 205 were located at one tail of the curve, fairly well removed from the median, mainstream expectations of lawyers. Yet now, through codification, these elements have become the new median, the new starting point, leaving room for even more radical interpretations and redefinitions at the new extremes of the curve. It remains to be seen, therefore, whether the current and continued redefining of the role of the securities attorney will be a destruction or a revitalization.

195. This particular debate may be well summarized by two statements made in a similar debate that took place over the Securities Act of 1933, 15 U.S.C. §§ 77a–77aa, and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78mm. "It has . . . been charged that if the SEC 'had had jurisdiction during the early days of the development of the west we would have had no mining industry in the United States today.'" LOUIS LOSS & JOEL SELIGMAN, 1 SECURITIES REGULATION 169 (3d ed. 1998) (citation omitted). Professor Lowenstein responded: "Don't believe it. The West would have been developed, but many more pine trees would have been felled and financial printers would have prospered mightily." Louis Lowenstein, *Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson*, 89 COLUM. L. REV. 979, 999 (1989).