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Lawyers as Whistleblowers

How increased SEC oversight of the bar could change the client relationship.

BY ARTHUR D. BURGER

Ethics

All right, lawyers, you can open your eyes now. What exactly does that new securities law say about your professional responsibilities?

One of the amendments that made it into the final version of the Sarbanes-Oxley Act of 2002 requires that the Securities and Exchange Commission adopt "minimum standards of professional conduct for lawyers appearing and practicing" before it. This provision, found in Section 307 of the act, was proposed by Sen. John Edwards (D-N.C.) and was initially suggested by professor Richard Painter of the University of Illinois Law School.

The provision specifies that these SEC standards must include a rule requiring attorneys to make certain internal disclosures within a corporate client's organization. These required disclosures, while to some degree not dramatically different from what is already required for corporate lawyers under American Bar Association Rule 1.13, have created controversy and uncertainty among legal commentators about their ultimate consequences.

The act requires a two-tiered disclosure obligation. First, an attorney must "report evidence of a material violation of securities law or breach of fiduciary duty or similar violation" to the company's in-house counsel or CEO.

Second, if the counsel or CEO "does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation)," the lawyer must then report this to the audit committee of the board of directors or directly to the board.

Similar in general concept to ABA Rule 1.13, the rule would not require an attorney to make any disclosures beyond the corporate client, so the central controversy over the new requirements is not primarily one of client confidentiality.

The disclosures required here are sometimes known as "friendly disclosures" because they remain internal to the organizational client. The definition of the event that triggers the obligation, however, is more rigid under Sarbanes-Oxley than under Rule 1.13. Rule 1.13 allows more discretion to the attorney and balances the attorney's obligation to disclose with an assessment, for example, of the "seriousness of the violation and its consequences."

Sarbanes-Oxley is also more rigid about what steps a lawyer must take when he or she spots a problem. This rigidity, however, also brings uncertainty. What kind of "evidence" must a lawyer have? What is a "similar violation"? Perhaps these will be defined in the SEC's rules.

According to ethics commentator Lawrence J. Fox of Drinker, Biddle & Reath, the greatest concern with this provision is that it will create civil liability for a lawyer who is alleged to have failed to discover, and then failed to disclose, a violation. Fox calls the new law the "Unlimited Lawyers' Liability Act of 2002." He says the provision "turns the lawyer into a regulator. The lawyer will be expected to discover what he is required to report."

Barry Cohen, an ethics expert at Crowell & Moring, disagrees to an extent. In Cohen's view, "There is certainly no intention expressed to benefit third parties. If anything, the intent seems to be to protect the issuer from misconduct by its employees."

In support of Cohen's somewhat less concerned approach, it can be noted that Congress did not approve the amendment offered by Sen. Richard Shelby (R-Ala.), which would have frontally overridden the 1994 U.S. Supreme Court ruling in *Central Banking of Denver, N.A. v. First Interstate Bank of Denver, N.A.* That decision has prevented suits against lawyers and accountants for aiding and abetting securities violations. [See "Senate Puts Corporate Bar in Its Sights," *Legal Times,* July 15, 2002, Page 1.]

While I am inclined to agree with Cohen on the issue of civil liability for lawyers, I agree with Fox that the rigid obligations under Sarbanes-Oxley will create a worry factor that is likely to cause counsel to err on the side of over-reporting as a preventive measure.

While Congress, in passing the legislation, obviously envisioned a scenario of clear-cut violations, the real world is more often coated in shades of gray. The new law will inevitably lead to tenser communications between corporate counsel and corporate personnel. The trust and openness of client communications may suffer. How freely can a corporate official confer with an attorney who must report, even internally, any evidence of a material violation of law? Will such disclosures be discoverable in civil litigation?

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Another concern, one on which Fox and Cohen agree, is the federalization of standards for attorney conduct. While the SEC already has general rules relating to practice before it (providing for discipline for an attorney's willful violation of securities laws or for aiding and abetting such violations) and other federal agencies have rules of conduct for lawyers, a concern arises when there is a disparity between a lawyer's obligations under a state's rules of conduct and under those of a federal agency. A related concern is that statutorily created rules of conduct diminish the traditional role of courts in establishing standards for attorney conduct.

Everyone wants to avoid circumstances in which corporate malfeasance is left unaddressed and allowed to cause harm to others. What is not so clear at present is why Rule 1.13 as presently constituted (and left virtually unchanged by the ABA Ethics 2000 Commission) was found wanting.

The SEC must issue its implementing rules within 180 days. We will soon know whether the Edwards Amendment to Sarbanes-Oxley will help or hinder the goal of preventing corporate meltdowns.

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