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THE LEGAL PROFESSION AT THE CROSSROADS: WHO WILL WRITE THE FUTURE RULES GOVERNING THE CONDUCT OF LAWYERS REPRESENTING PUBLIC CORPORATIONS?

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I. Introduction

"The American economy—our economy—is built on confidence."[1]

Taken from a speech given just weeks before the enactment of sweeping reforms in the area of corporate governance and securities regulation, this simple quoted statement expresses the overriding principle driving widespread calls for reform to the current system of corporate governance. These calls for reform reflect the public's reaction to both real and perceived corporate abuses and corporate misfeasance at some of our nation's largest public companies. Though much of the public criticism has focused on the conduct of corporate officers and managers, criticism also has been leveled at outside directors, accountants, and attorneys for failing to discover, disclose, or prevent corporate misconduct.

On July 30, 2002, the public's cry for reform of our system of corporate governance produced the Sarbanes-Oxley Corporate

1. George W. Bush, President Announces Tough New Enforcement Initiatives for Reform, (July 9, 2002), http://www.whitehouse.gov/news/releases/2002/07/print/20020709-4.html.

Fraud Act of 2002 ("Sarbanes-Oxley").[2] In addition to imposing increased penalties and fines for violations of *existing* federal securities laws, section 307 of Sarbanes-Oxley required the Securities and Exchange Commission (SEC) to promulgate rules within 180 days of the enactment of the Act, establishing minimum standards of conduct for attorneys representing public companies before the SEC.[3] Section 307 is a direct response to claims that the current rules governing the conduct of SEC counsel have turned a blind eye to corporate fraud.

But even before the enactment of Sarbanes-Oxley, segments of the legal profession, including the organized bar, individual practitioners, and academics, had proposed and commented on various reforms to the system of corporate governance and the rules governing attorneys representing and advising public companies.[4] Sarbanes-Oxley and the proposed and adopted SEC rules that followed are especially significant since they mark the first time the federal government has given the SEC authority to regulate directly the professional conduct of attorneys.[5] Traditionally, the responsibility for establishing standards of conduct for attorneys has been left to the state judiciaries and their adoption of disciplinary rules.[6] Sarbanes-Oxley and the new SEC rules therefore have broader implications beyond merely imposing "up-the-ladder" dis-

2. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified at 15 U.S.C. §§ 7201-7266). Although the Sarbanes-Oxley Act was passed just over eight months after Enron filed for bankruptcy protection, by March 8, 2002 alone, over thirty individual "Enron inspired" bills had been introduced in Congress. HAROLD S. BLOOMENTHAL, SECURITIES LAW HANDBOOK 26 (Jason Conklin et al., eds., Thompson West 2003).

3. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (2002) (codified at 15 U.S.C. § 7245).

4. *See* Renee Deger, *Law Professors Led Fight for New SEC Rules*, THE RECORDER, Dec. 2, 2002, at 1, WL 12/2/2002 RECORDER-SF 1 (discussing the letter signed by forty academics and professors to the SEC calling for the SEC to exercise greater authority over securities lawyers); Paul F. Roye, Keynote Address at the Meeting of the Business Law Section of the American Bar Association (Nov. 22, 2002), http://www.sec.gov./news/speech/spch112202pfr.htm (noting that the "up-the-ladder" reporting requirements proposed by the SEC embody principles that the ABA has been considering for several years).

5. SEC Chairman Harvey L. Pitt, Remarks Before the Annual Meeting of the American Bar Association's Business Law Section (Aug. 12, 2002), http://www.sec.gov./news/speech/spch579.htm (stating that regulation of attorney behavior is "unchartered territory for the SEC").

6. *See id.* (noting that the SEC has been "circumspect" in sanctioning the conduct of lawyers, preferring to leave the task of disciplining attorneys to the state bar associations and committees).

closure requirements or changing the dynamic of the relationship between outside counsel and the corporation's officers, managers, and directors.[7] Indeed, Sarbanes-Oxley and the contemporaneous debate as to the proper duties of attorneys representing public companies have brought the legal profession to a crossroad. Who will write the future rules governing the conduct of attorneys in corporate representation—agencies of the federal government or the organized bar and the state judiciaries? Or will courts write these new rules through their adjudication of private lawsuits by injured shareholders?

Part II of this Article evaluates how section 307 of Sarbanes-Oxley will impact the practice of attorneys representing and advising public companies. Next, Part III discusses how Sarbanes-Oxley and the current public debate regarding "up-the-ladder" reporting may have broader implications as to the attorney's exposure to civil liability to shareholders and other nonclients. Finally, Part IV discusses how section 307 and the new SEC rules governing the conduct of attorneys represent an important milestone in the history of the legal profession.

II. How the Recent Revelations of Corporate Misconduct Will Affect Lawyers Who Represent and Advise Public Companies

A. *Section 307 of Sarbanes-Oxley: An Overview*

Section 307 of the Sarbanes-Oxley Act required that within 180 days from its enactment, the SEC must adopt rules establishing minimum standards of professional conduct for attorneys appearing and practicing before the SEC.[8] Moreover, the new standards must require an attorney representing a public company "to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by [an employee or agent of] the company . . . , to the chief legal counsel or the chief executive officer [(CEO)] of the company."[9] Further, section 307 mandated that the new rule must require that, if the chief legal counsel or

7. *See id.* (proposing that legislation, such as the Sarbanes-Oxley Act, will help restore public confidence in the markets).

8. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (2002) (codified at 15 U.S.C. § 7245).

9. *Id.*

CEO does not adequately respond to the reported violation, the attorney must report evidence of the violation to the company's audit committee, another committee of independent directors, or the full board of directors.[10] An "appropriate response" by the chief legal counsel or CEO is defined as "appropriate remedial measures or sanctions with respect to the violation."[11] The requirement that the attorney continue to report evidence of a violation to higher levels of independent authority within the corporation until adequate action is taken is commonly referred to as "up-the-ladder" reporting or as a "friendly" disclosure.

On January 23, 2003, the SEC adopted rules implementing section 307 of Sarbanes-Oxley and setting forth the standards of professional conduct for attorneys representing an issuer before the SEC.[12] Among other things, SEC Rule 205.3 requires the attorney representing the issuer to report evidence of a material violation to the issuer's chief legal officer or the equivalent.[13] If the attorney reasonably believes that the chief legal officer has not provided the reporting attorney with an "appropriate response within a reasonable time" the attorney must continue to report the evidence of the material violation "up-the-ladder"—that is, to the audit committee of the issuer's board of directors, or in certain circumstances, to the full board of directors.[14] The SEC also voted to postpone the adoption of the originally proposed "noisy withdrawal" provision and also proposed an alternative "noisy withdrawal" provision.[15] The comment period for both the original and alternative "noisy withdrawal" provision was extended for a sixty day period.[16]

Section 307 and Rule 205.3 will impact dramatically the way outside counsel interact with representatives of the client corporation. For example, by requiring outside attorneys to engage in up-the-ladder reporting,[17] section 307 and Rule 205.3 emphasize that outside counsel's duties run to the corporation itself, and not to the

10. *Id.*

11. *Id.*

12. 17 C.F.R. pt. 205 (2002); Press Release, SEC Adopts Attorney Conduct Rule Under Sarbanes-Oxley Act (Jan. 23, 2003), http://www.sec.gov./news/press.2003-13.htm.

13. 17 C.F.R. § 205.3(b)(1) (2002).

14. *Id.* § 205.3(b)(3)(i), (iii).

15. Press Release, SEC Adopts Attorney Conduct Rule Under Sarbanes-Oxley Act (Jan. 23, 2003), http://www.sec.gov./news/press.2003-13.htm.

16. *Id.*

17. 17 C.F.R. § 205.3(b) (2002).

general counsel, individual officers, managers, or directors, with whom the attorney regularly interacts.[18] Accordingly, effective compliance with any up-the-ladder reporting provision will require that attorneys representing public companies have a plan for effectively reporting evidence of corporate misfeasance.

B. *The Organization As Client*

In representing a corporation, the attorney must always be aware that he represents the corporation itself and not any of the individuals through which the corporation acts.[19] This basic principle is embodied in Rule 1.13 of the ABA Model Rules of Professional Conduct, which provides that "[a] lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents."[20] This principle awareness is occasionally forgotten, particularly when the attorney's contacts with the client are solely through the general counsel or some other corporate representative. Rule 1.13 goes even further: it establishes that the lawyer's duty to protect the client corporation from harm requires the lawyer to serve the interests of the corporation and its shareholders rather than the interests of the individual officers or employees who may purport to act in the best interests of the corporation.[21] Similarly, Canon 5 of the Model Code of Professional Conduct advises that:

> A lawyer employed or retained by a corporation or similar entity owes his allegiance to the entity and not to a stockholder, director, officer, employee, representative, or other person connected with the entity. In advising the entity, a lawyer should keep paramount its interests and his professional judgment should not be influenced by the personal desires of any person or organization.[22]

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18. SEC Chairman Harvey L. Pitt, Remarks Before the Annual Meeting of the American Bar Association's Business Law Section (Aug. 12, 2002), http://www.sec.gov./news/speech/spch579.htm (discussing the role of lawyers with regard to the corporation as a whole and its shareholders).

19. *See* MODEL RULES OF PROF'L CONDUCT R. 1.13(a) (2002) (stating the responsibilities of a lawyer representing an organization); MODEL CODE OF PROF'L RESPONSIBILITY EC 5-18 (1983) (commenting on lawyers' duties owed to the entity).

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

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

22. MODEL CODE OF PROF'L RESPONSIBILITY EC 5-18 (1983).

The disciplinary rules of professional conduct adopted by the states similarly recognize that when an attorney is employed or retained by a corporation or other organization, the attorney represents the entity.[23]

But the recent corporate scandals highlight the fact that the current system failed to properly emphasize to the corporate representatives that outside counsel's professional responsibilities are to the corporation, and not to individual corporate managers, officers, and directors. In a recent speech before the annual meeting of the American Bar Association's Business Law Section, SEC Chairman Harvey Pitt stressed that lawyers representing public companies face unique difficulties not faced by lawyers representing individuals in that "[l]awyers for public companies represent the company as a whole and its shareholder-owners, not the managers who hire and fire them."[24] Similarly, the Preliminary Report by the ABA Task Force on Corporate Responsibility observed that "the lawyer's duty to protect the corporate client from harm requires the lawyer to serve the interests of the corporation and its shareholders rather than the interests of the individual officers or employees who are acting for the corporation."[25]

Although the basic principle that the attorney retained by the corporation represents and owes his duties to the corporation itself is universally recognized, attorneys sometimes forget this principle in day-to-day practice. Part of the reason is that in actual practice, attorneys representing a corporate client interact with the client only through individual representatives acting for the corporation. The "corporation" itself is a legal fiction. The attorney representing a corporation, therefore, must separate the interests of the corporation from those of the individual representatives with whom

23. *See* TEX. DISCIPLINARY R. PROF'L CONDUCT 1.12(a), *reprinted in* TEX. GOV'T CODE ANN., tit. 2, subtit. G app. A (Vernon 1998) (TEX. STATE BAR R. art. X, § 9) (stating that "[a] lawyer employed or retained by an organization represents the entity").

24. SEC Chairman Harvey L. Pitt, Remarks Before the Annual Meeting of the American Bar Association's Business Law Section (Aug. 12, 2002), http://www.sec.gov./news/speech/spch579.htm.

25. ABA TASK FORCE ON CORPORATE RESPONSIBILITY, PRELIMINARY REPORT 27 (2002), *available at* http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf.

the attorney interacts and to whom the attorney must answer.[26] As one commentator aptly summarized:

> [W]e have the perverse situation in which the lawyer who represents a publicly held corporation is selected and retained by, and reports to and may be fired by, the principal officers and directors of the corporation—*who are not his clients*. Moreover, the shareholders of a corporation, who, collectively, are the owners of the mythical beast, typically do not participate in the process by which the lawyer is selected, retained, or fired.[27]

To address this unique situation, the SEC made its Rule 205.3 "the core of the proposed rule."[28] Rule 205.3 reaffirms that an attorney representing a public corporation represents the corporation itself rather than the individual officers or representatives of the corporation and that the attorney has the duty "to act in the best interests of the [company]" and, accordingly, its shareholders.[29] Compliance with the up-the-ladder reporting provision will require that outside counsel remain vigilant in their role, and that their unbridled duties of care and loyalty are to the corporation.[30] But it is not enough that the attorney be aware of these professional responsibilities. The attorney now must strive to make the corporation's officers, managers, and directors understand that the attorney's duties run *solely* to the corporation itself.

C. *Being Prepared to Make Up-the-Ladder Disclosures*

One major criticism of the legal profession that has emerged in the last year is that, even if corporate attorneys did not actively participate or know about any corporate fraud or misconduct, they nevertheless failed to discover and disclose the corporate misfeasance, or worse, turned a blind eye to evidence of such fraud and

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26. H. Lowell Brown, *The Dilemma of Corporate Counsel Faced with Client Misconduct: Disclosure of Client Confidences or Constructive Discharge*, 44 BUFFALO L. REV. 777, 779-80 (1996) (discussing the inherent difficulties and ambiguities faced by attorneys representing the corporate entity).

27. *Id.* at 781 n.8 (quoting Ralph Jonas, *Who Is the Client?: The Corporate Lawyer's Dilemma*, 39 HASTINGS L.J. 617, 617 (1988)) (alteration in original).

28. Press Release, U.S. Securities and Exchange Commission, SEC Proposes Rules to Implement Sarbanes-Oxley Act Provisions Concerning Standards of Professional Conduct for Attorneys (Nov. 6, 2002), http://www.sec.gov./news/press/2002-158.htm.

29. *Id.*

30. *Id.*

misconduct.[31] To address this specific concern, section 307 required that the SEC promulgate rules imposing a duty upon attorneys to report evidence of corporate misconduct to higher authorities within the corporation.[32]

The duty of the attorney to dissuade the client from committing fraud is not new. Indeed, in its Preliminary Report issued just weeks prior to the enactment of Sarbanes-Oxley, the ABA Task Force on Corporate Responsibility noted that forty-one states, including Texas,[33] already "permit or require disclosure [of client confidences] to prevent a client from perpetrating a fraud that constitutes a crime, and eighteen states permit or require disclosure [when necessary] to rectify substantial loss resulting from client crime or fraud" where the attorney's services were involved or used.[34] For instance, in the context of a witness who intends to give false testimony to a tribunal, Rule 3.03 of the Texas Disciplinary Rules of Professional Conduct requires the attorney to take every action in his power to persuade the witness from giving false testimony.[35] Section 307 merely established a specific manner—up-the-ladder disclosures—by which the attorney can fulfill this duty to dissuade the client from committing the crime or fraud where the client is a corporate entity.[36] Thus, section 307 can be analogized to the general premise that the attorney should attempt to dissuade a client from making misrepresentations to a tribunal or from com-

31. ABA TASK FORCE ON CORPORATE RESPONSIBILITY, PRELIMINARY REPORT 35 (2002), *available at* http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf.

32. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (2002) (codified at 15 U.S.C. § 7245).

33. ABA TASK FORCE ON CORPORATE RESPONSIBILITY, PRELIMINARY REPORT 32 (2002), *available at* http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf; *see also* TEX. DISCIPLINARY R. PROF'L CONDUCT 1.02(d) (stating that "[w]hen a lawyer has confidential information clearly establishing that a client is likely to commit a criminal or fraudulent act that is likely to result in substantial injury to the financial interests or property of another, the lawyer shall promptly make reasonable efforts under the circumstances to dissuade the client from committing the crime or fraud").

34. ABA TASK FORCE ON CORPORATE RESPONSIBILITY, PRELIMINARY REPORT 32 (2002), *available at* http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf.

35. *See* TEX. DISCIPLINARY R. PROF'L CONDUCT 3.03 cmt. 6 (explaining the duties owed by a lawyer).

36. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (2002) (codified at 15 U.S.C. § 7245).

mitting a crime or fraud that will likely result in substantial financial injury.[37]

The first step in complying with section 307 and the new SEC Rules is establishing to whom the corporation disclosure is going to be made if the attorney obtains evidence of corporate misfeasance.[38] As a practical matter, the attorney will have to be aware of how to voice concerns when he believes that the corporate client is involved in a potential material violation of law or in a breach of duty that will adversely and materially affect the corporation. In simple terms, this means being familiar with the corporation's chief legal officer or the chief executive officer and the corporate chain of authority. Additionally, it means understanding the client corporation well enough, including the client corporation's governance structure, to fully assess whether the corporation has made an adequate response to a report by the attorney. Equally important, the attorney should make the corporation's officers, managers, or directors, with whom the outside attorney regularly interacts, aware that he has a duty to disclose within the corporation evidence of misconduct or misfeasance by employees or representatives of the corporation.[39] Problems regarding the conflict between the lawyer's ethical obligations and his role as zealous advocate for the client are far less likely to occur if the client is aware that the lawyer must strictly adhere to the rules of professional conduct and simply cannot fail to disclose misconduct to higher authorities within the corporation.

To satisfy these professional duties, the ABA Task Force recommends that outside counsel establish two things at the outset of the engagement by the corporation:

> (1) [A] direct line of communication between outside counsel and the corporation's general counsel; and (2) the understanding that

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37. *Id.* (requiring an attorney who represents issuers before the commission to report any evidence of breach of fiduciary duty or material violations of the securities laws by the company or its agents).

38. *See id.* (requiring that all violations first be reported to the company's chief legal counsel, chief executive officer, or the equivalent thereof). If this person does not respond appropriately, by either adopting remedial measures or issuing sanctions, the attorney is then required to report the evidence to either "the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors." *Id.*

39. *Id.*

outside counsel [is] obliged to apprise the general counsel, through [a] direct line of communication, of violations or potential violations of law by the corporation or of violations or potential violations of duties to the corporation.[40]

III. Does Sarbanes-Oxley Represent a Major Shift in Public Policy?

In addition to influencing the practice of attorneys who represent and advise public companies, Sarbanes-Oxley and the public's clamor for requiring attorneys to report evidence of corporate misfeasance could indirectly impact the exposure of attorneys and law firms representing public companies to lawsuits by injured shareholders or other third parties. Sarbanes-Oxley does not itself create a new private cause of action against attorneys who fail to comply with the requirements of section 307 or the new SEC rules.[41] However, Sarbanes-Oxley and the new SEC rules do signal a significant public policy shift away from the almost absolute deference to the attorney-client privilege and towards a uniform rule requiring (or at least permitting) the disclosure of client confidences for the protection of shareholders. Furthermore, injured shareholders are likely to doggedly pursue recovery through private lawsuits against corporations and their auditors and attorneys. Thus, even without expressly creating a new cause of action, Sarbanes-Oxley has the potential to affect adversely attorneys' exposure to private lawsuits by shareholders by altering the public policies that have driven the traditional protections insulating attorneys from such lawsuits.

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40. ABA Task Force on Corporate Responsibility, Preliminary Report 36-37 (2002), *available at* http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf.

41. *See* 15 U.S.C.A. § 7242 (West Supp. 2002) (acknowledging that the SEC retains exclusive authority to prosecute violations of the Sarbanes-Oxley Act). Similarly, a violation of the Texas Disciplinary Rules of Professional Conduct does not itself create a private cause of action. Tex. Disciplinary R. Prof'l Conduct preamble ¶ 15 (violating a rule "does not give rise to a private cause of action nor does it create any presumption that a legal duty to a client has been breached"). However, disciplinary rules can be considered by the trier of fact as evidence of a violation of an existing duty of care for claims of legal malpractice or breach of fiduciary duty. Two Thirty Nine Joint Venture v. Joe, 60 S.W.3d 896, 905 (Tex. App.—Dallas 2001, pet. granted).

A. *The Case Law Limiting the Liability of Outside Attorneys to Private Lawsuits by Shareholders and Other Third Parties*

Historically, it has been very difficult for injured shareholders and other third parties to impose civil liability on outside attorneys in connection with the attorney's representation of the corporation.[42] This is not to say that attorneys are or have been immune from liability to shareholders as a result of their rendition of legal services to public companies.[43] Nevertheless, courts have been reluctant to impose civil liability on attorneys for "assisting" or "facilitating" a client corporation's conduct (even fraudulent conduct) when the attorney was working in his capacity as an attorney.[44] This reluctance to impose civil liability on the corporation's outside counsel is reflected in the case law generally shielding the attorney from liability to nonclients, limiting the attorney's duty to disclose confidential information of client fraud,[45] and circumscribing liability for aiding and abetting securities fraud violations.[46]

1. Privity Requirement for Legal Malpractice Claims

The special protection afforded to attorneys from lawsuits by nonclients, such as corporate shareholders, originated in the widely accepted rule that an attorney is generally not liable for injuries

42. *See In re* Towers Fin. Corp. Noteholders Litig., No. 93CIV 0810(WK)(AJP), 1995 WL 571888, at *14 (S.D.N.Y. Sept. 20, 1995) (noting that even prior to the passage of the Private Securities Litigation Reform Act, which imposed heightened pleading requirements for securities fraud suits, such suits against attorneys rarely survived summary judgment in New York district courts). Indeed, even in disciplinary proceedings before the SEC, the Commission has been reluctant and circumspect in using its disciplinary authority to sanction lawyers. SEC Chairman Harvey L. Pitt, Remarks Before the Annual Meeting of the American Bar Association's Business Law Section (Aug. 12, 2002), http://www.sec.gov./news/speech/spch579.htm.

43. *See* Molecular Tech. Corp. v. Valentine, 925 F.2d 910, 917-18 (6th Cir. 1991) (discussing potential primary liability of attorneys for securities fraud); *In re* Dublin Sec., Inc., 197 B.R. 66, 73 (S.D. Ohio 1996) (stating that "[i]n sum, the defrauded investors in the instant case have direct avenues of relief against the defendant attorneys").

44. *See In re* Towers, 1995 WL 571888 at *14 (acknowledging the difficulty in proving aiding and abetting liability when there is no fiduciary relationship between the plaintiff and the lawyer).

45. *See* Schatz v. Rosenberg, 943 F.2d 485, 490 (4th Cir. 1991) (finding no liability for a lawyer's failure to disclose information when no duty to do so is present).

46. Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 176-77 (1994) (rejecting a private cause of action for aiding and abetting securities fraud).

caused by the attorney's negligent rendition of legal services to a party not in privity with the attorney.[47] The Texas Supreme Court adopted this "bright line" rule in *Barcelo v. Elliott.*[48] *Barcelo* involved a claim for legal malpractice brought by beneficiaries of a will against the attorneys who negligently drafted a will and *inter vivos* trust agreement.[49] The intended beneficiaries of the trust were the decedent's grandchildren;[50] however, the trust was declared invalid and unenforceable after the trust was challenged.[51] Upon reaching a settlement with the challenging beneficiaries, the decedent's grandchildren—the intended beneficiaries of the will and trust—brought a legal malpractice suit against the attorney and the law firm that drafted the will and trust.[52]

Even after recognizing that the majority of states allow liability to third parties in the limited context of estate planning and to intended beneficiaries of the attorney's representation,[53] the Texas Supreme Court refused to deviate from the bright-line rule that a party not in privity with the attorney was barred from any recovery for legal malpractice.[54] In rejecting the plaintiff's alternative theory of recovery under the third-party-beneficiary contract theory,[55] the court affirmed the long-standing principle that a negligence claim, regardless of how it is pleaded, against an attorney is a legal malpractice claim, not a breach of contract claim.[56]

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47. *See* Barcelo v. Elliott, 923 S.W.2d 575, 577-79 (Tex. 1996) (reaffirming the bright-line rule that an attorney is not liable to a third-party for legal malpractice because "the lawyer's professional duty should [not] extend to persons whom the lawyer never represented"); Gamboa v. Shaw, 956 S.W.2d 662, 664 (Tex. App.—San Antonio 1997, no pet.) (recognizing the well-established principle "that Texas does not recognize a cause of action for legal malpractice asserted by a party not in privity with the offending attorney"). In *Gamboa*, the court of appeals held that the attorney's duty to his corporate client did not extend to the beneficiaries of the corporation, namely shareholders and creditors. *Id.* at 665.

48. Barcelo v. Elliott, 923 S.W.2d 575, 578 (Tex. 1996).

49. *Id.* at 576-77.

50. *Id.* at 576.

51. *Id.*

52. *Id.*

53. *See Barcelo*, 923 S.W.2d at 577-78 (noting that the majority of states have relaxed the privity requirement regarding estate planning).

54. *See id.* at 578 (promulgating a bright-line privity rule to be used in Texas).

55. *See id.* at 579 (asserting the character of a Texas legal malpractice claim to be that of tort).

56. *See id.* (stating that in Texas, "a legal malpractice action sounds in tort and is governed by negligence principles"). The court seems to have drawn on the principle that

When applied to the situation of the attorney whose "client" is the corporation, Texas courts have generally held that the attorney's liability for the negligent performance of his duties to the corporation does not create liability to the corporation's shareholders or creditors, even when the groups are characterized as beneficiaries of the corporation.[57] In the context of lawsuits brought by a corporation's shareholders, the adherence to this bright-line rule is based, in part, on the policy concern that in the absence of a privity requirement, attorneys would face "almost unlimited liability" for legal malpractice and for any injury occurring in the course of rendering legal services to the corporate client.[58] Moreover, allowing third parties or nonclients to recover against an attorney for legal malpractice would compromise the attorney's duty to zealously ad-

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a legal malpractice claim cannot be fractured into separate claims for breach of contract, fraud, or the like. *See* Greathouse v. McConnell, 982 S.W.2d 165, 172 (Tex. App.—Houston [1st Dist.] 1998, pet. denied) (holding that any claim that an attorney failed to provide adequate and proper representation is a claim for legal malpractice). Although Texas courts have accepted the general proposition that legal malpractice is not the only theory upon which an injured client can recover from his attorney, the prevailing view is that an injured client may not divide or "fracture" a legal malpractice claim into separate causes of action. *See* Kahlig v. Boyd, 980 S.W.2d 685, 688 (Tex. App.—San Antonio 1998, pet. denied) (accepting that legal malpractice is only one theory of recovery for an injured client to pursue); *cf.* Goffney v. Rabson, 56 S.W.3d 186, 190 (Tex. App.—Houston [14th Dist.] 2001, pet. denied) (stating that a legal malpractice claim cannot be fractured); *Greathouse*, 982 S.W.2d at 172 (agreeing that a legal malpractice plaintiff cannot fracture the claim). The *Kahlig* court summarized: "A claim based upon the failure to exercise that degree of care, skill, and diligence that a lawyer of ordinary skill and knowledge commonly possesses and exercises, despite its labeling, is a malpractice claim." *Kahlig*, 980 S.W.2d at 689. Accordingly, claims for fraud, breach of contract, and breach of fiduciary duty that stem from the attorney's failure to provide adequate representation are simply a claim for legal malpractice and generally may not be considered separate or brought separately from the claim for legal malpractice. *See Greathouse*, 982 S.W.2d at 172 (holding that summary judgment on claim for legal malpractice disposed of individual claims for breach of contract, breach of fiduciary duty, and negligence arising from legal malpractice); *see also* Sledge v. Alsup, 759 S.W.2d 1, 2 (Tex. App.—El Paso 1988, no writ) (announcing that "[i]f a lawyer's error or mistake is actionable, it should give rise to a cause of action for legal malpractice with one set of issues").

57. *See* Gamboa v. Shaw, 956 S.W.2d 662, 665 (Tex. App.—San Antonio 1997, no pet.) (declining to adopt plaintiff's theory that attorney can be held liable to corporation's shareholders for the negligent performance of duties owed to the corporation itself).

58. *Id.*; *see also* Villasana v. Patout, Cannon & Co., No. 01-98-00109-CV, 1999 WL 1018160, at *3 (Tex. App.—Houston [1st Dist.] Nov. 10, 1999, no pet.) (not designated for publication) (expressing that without a privity requirement, "corporate attorneys would be subject to almost unlimited liability, as the shareholders of any given corporation can number in the hundreds of thousands").

vocate the client's interests.[59] The potential conflict of interest that could arise from these competing interests is especially acute in the context of the corporation, where in the absence of a bright-line privity requirement, the attorney's duty to act in the best interests of the corporation could be compromised vis-à-vis a potentially conflicting duty to shareholders.[60] As one Texas Court of Appeals has recognized, discarding the bright-line privity rule, even if only for the benefit of shareholders, would create a situation in which "attorneys representing corporations would owe a duty to both sides of the litigation in any type of derivative suit brought against the corporation by a shareholder."[61]

2. Negligent Misrepresentation

Injured shareholders may try to impose civil liability on attorneys using the theory of negligent misrepresentation. Texas courts have recognized that an attorney may be held liable to nonclients under a theory of negligent misrepresentation.[62] In *McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests*,[63] the Texas Supreme Court followed the majority of states and recognized that an attorney is not immune from liability for negligent misrepresentations made to and relied upon by nonclients.[64] Indeed, "[a] negligent misrepresentation claim is not equivalent to a professional malpractice claim."[65] Under the theory of negligent misrepresentation, the attorney's liability is not based on the performance of a professional duty. Rather, liability is predicated on the independent duty to avoid negligent misstatements intended to induce reliance by the receiving party.[66] Additionally, the protection from liability to nonclients that is generally afforded to attorneys does

59. *Gamboa*, 956 S.W.2d at 665.

60. *Id.*

61. *Id.*

62. McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests, 991 S.W.2d 787, 791 (Tex. 1999).

63. 991 S.W.2d 787 (Tex. 1999).

64. *See* McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests, 991 S.W.2d 787, 792 (Tex. 1999) (stating that negligent misrepresentation differs from a breach of professional duty, and as such, an attorney may be liable to a nonclient for negligent misrepresentation).

65. Safeway Managing Gen. Agency, Inc. v. Clark & Gamble, 985 S.W.2d 166, 169 (Tex. App.—San Antonio 1998, no pet).

66. *Id.*

not apply where there exists an independent duty to refrain from certain conduct, such as fraud.[67]

Texas law recognizes a cause of action against an attorney for negligent misrepresentation and fraud separate and apart from the limitation of liability applicable to a cause of action for legal malpractice.[68] But recognizing the important public policy ramifications resulting from the wholesale imposition of liability on attorneys to nonclients, the Texas Supreme Court made clear in *McCamish* that liability for negligent misrepresentations would apply only in very limited circumstances.[69] Indeed, the court set forth a fairly easy protocol for attorneys to follow that would allow them to limit the potential liability to nonclients for negligent misrepresentation.[70] Even before *McCamish*, the Fifth Circuit recognized the difficulty in holding an attorney civilly liable to nonclients for statements made or opinions given by the attorney:

> [T]he law, as a general rule, only rarely allows third parties to maintain a cause of action against lawyers for the insufficiency of their legal opinions. In general, the law recognizes such suits only if the non-client plaintiff can prove that the attorney prepared specific legal documents that represent explicitly the legal opinion of the attorney preparing them, for the benefit of the plaintiff.
>
> In practice, this rule has meant that an attorney is rarely liable to any third party for his or her legal work unless the attorney has prepared a signed "opinion" letter designed for the use of a third party.[71]

In short, aggrieved shareholders are unlikely to succeed in a suit against the corporation's outside attorneys under a theory of negligent misrepresentation absent representations by the attorney that were intended to be relied upon by shareholders.

67. *See id.* (indicating that "[f]raud is based on a similar duty").

68. *See id.* (stating that "an attorney can be subject to a negligent misrepresentation or fraud claim in a case in which the attorney is not subject to a professional malpractice claim").

69. *See McCamish*, 991 S.W.2d at 794 (identifying the limited situations as one where the attorney provides information to the nonclient intending the nonclient to rely on the information provided).

70. *Id.* (addressing two methods which allow lawyers to minimize the risk of liability).

71. Schatz v. Rosenberg, 943 F.2d 485, 491 (4th Cir. 1991) (quoting Abell v. Potomac Ins. Co., 858 F.2d 1104, 1124-25 (5th Cir. 1988), *vacated on other grounds*, 492 U.S. 914 (1989)).

3. Derivative Nature of Actions Inhibits Shareholder Lawsuits

The ability of aggrieved shareholders to pursue claims against the corporation's outside counsel is further reduced because those causes of action are generally derivative in nature. A corporation's shareholders ordinarily cannot bring an individual suit to recover for a wrong committed solely against the corporation, even if the shareholders also suffer damages as a result of the wrong.[72] To bring an individual lawsuit, the shareholder must establish a personal cause of action and an individual injury separate from injury suffered by the corporation.[73] Thus, individual shareholders do not have a separate cause of action for injuries to the corporation that result in the depreciation in the value of shareholders' stock.[74] In most instances, shareholders simply do not have a direct cause of action against a corporation's attorneys for injuries suffered, even where the shareholders suffer damages in the form of decreased share price.[75] Similarly, individual shareholders do not have a cause of action for breach of the attorney's fiduciary duty, as those fiduciary duties run to the corporation alone.[76]

More often than not, it is the shareholders who suffer injury in the form of lost investments. For example, the corporation's share price may decrease as a result of the attorney's negligence or breach of fiduciary duty in failing to prevent or disclose misconduct by the corporation's employees or representatives. Although the

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72. Murphy v. Campbell, 964 S.W.2d 265, 268 (Tex. 1997).

73. *Id.*

74. *Id.*

75. *See* FDIC v. Shrader & York, 777 F. Supp. 533, 535 (S.D. Tex. 1991) (agreeing with contention that the plaintiff lacked standing to sue a third party law firm), *aff'd*, 991 F.2d 216 (5th Cir. 1993); Gamboa v. Shaw, 956 S.W.2d 662, 666 (Tex. App.—San Antonio 1997, no pet.) (noting that the cause of action against one who has injured the corporation belongs to the corporation and not the individual shareholders even where the wrongful conduct causes a depreciation in the value of the shareholders' investment in the corporation).

76. *See* Scherrer v. Haynes & Boone, L.L.P., No. 01-99-01164-CV, 2002 WL 188825, at *2-3 (Tex. App.—Houston [1st Dist.] Feb. 7, 2002, no pet.) (not designated for publication) (refusing to extend a breach of fiduciary duty claim against a corporation to attorneys that represented the corporation in decisions and actions allegedly constituting the breach of fiduciary duty and noting that no Texas case had created such an extension); *see also* Atkins v. Hibernia Corp., 182 F.3d 320, 323 (5th Cir. 1999) (surveying Louisiana jurisprudence to find that, unless shareholder suffered injury personally, cause of action for loss to corporation caused by breach of fiduciary duty owed to corporation must be brought as derivative suit).

decision to pursue a claim against the corporation's outside counsel is given to corporate management, the aggrieved shareholder also has an incentive to pursue legal action to hold corporate counsel accountable.[77] However, if the corporation's board of directors chooses not to pursue remedies against its attorneys, the shareholders can bring, at best, a derivative suit in the name of the corporation.[78] Even then, the shareholders must establish that the board of directors' decision not to bring suit fell outside the protection of the "business judgment" rule.[79] These procedural obstacles create obvious hurdles and disincentives to shareholders' lawsuits against attorneys representing and advising corporations.

B. *The Limitations on Private Causes of Action for Securities Fraud Against Attorneys*

1. No Civil Liability for Aiding and Abetting

In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,[80] the Supreme Court declared that civil liability under section 10(b) of the Securities Exchange Act of 1934 does not extend to those secondary actors who "aid and abet" a violation of the Act.[81] The Court reasoned that "Congress has not enacted a general civil aiding and abetting statute . . . for suits by private parties."[82] Thus, when a congressional statute allows a person to sue a private defendant and recover damages from the defendant for the defendant's violation of a statutory provision, "*there is no general presumption that the plaintiff may also sue aiders and abettors.*"[83] Although the Supreme Court in *Central Bank* held that

77. *See* TEX. BUS. CORP. ACT ANN. art. 5.14(B) (Vernon Supp. 2003) (identifying the requirements needed to bring a derivative suit); *Scherrer*, 2002 WL 188825, at *3 (holding that shareholders cannot assert a derivative claim against the officers and directors of the corporation for failing to sue attorneys for the malpractice committed).

78. *See* DeWoody v. Rippley, 951 S.W.2d 935, 949 (Tex. App.—Fort Worth 1998, pet. dism'd by agr.) (explaining when a shareholder can bring a derivative suit).

79. Langston v. Eagle Pub. Co., 719 S.W.2d 612, 616 (Tex. App.—Waco 1986, writ ref'd n.r.e.).

80. 511 U.S. 164 (1994).

81. *See* Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 175-76 (1994) (concluding that Congress did not intend to create liability for aiding and abetting a violation of section 10b).

82. *Id.* at 182.

83. *Id.* (emphasis added); Melder v. Morris, 27 F.3d 1097, 1104 n.9 (5th Cir. 1994) (recognizing that "[t]o the extent the complaint alleges aiding and abetting liability under

banks, accountants, lawyers, or other secondary actors could not be sued for securities fraud violations by private litigants under a theory that the secondary actor aided and abetted the primary violators, the Court also expressly warned,

> Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met.[84]

Nevertheless, most federal courts have adopted the position that post-*Central Bank*, there is no cause of action for civil conspiracy to violate Rule 10b-5.[85]

Even though *Central Bank* clarifies that attorneys are not provided wholesale protection from liability for securities fraud merely by their status as attorneys, *Central Bank* and its progeny have raised the question of what conduct, if any, by an attorney is sufficient to create primary liability under section 10(b) and Rule 10b-5.[86] Section 10(b) of the Securities Exchange Act of 1934 prohibits any person from using or employing "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of a security.[87] Rule 10b-5, which was promulgated by the SEC pursuant to section 10(b), makes it unlawful for any person, in connection with the purchase or sale of a security:

> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

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§ 10(b) of the Exchange Act . . . , this form of liability has been foreclosed to private plaintiffs").

84. *Cent. Bank*, 511 U.S. at 191; *see also* United States v. O'Hagan, 521 U.S. 642, 664 (1997) (recognizing that aiders and abettors may be held primarily liable).

85. *See* Dinsmore v. Squadron, Ellenoff, Plesent, Sheinfeld & Sorkin, 135 F.3d 837, 841 (2d Cir. 1998) (noting that every court that has addressed the viability of a civil conspiracy claim post-*Central Bank* has found that there is no cause of action for conspiracy to commit securities fraud under Rule 10b-5).

86. *See* Ziemba v. Cascade Int'l, Inc., 256 F.3d 1194, 1204-05 (11th Cir. 2001) (noting that as long as all elements for liability are met, even attorneys may be primarily liable).

87. 15 U.S.C.A. § 78j(b) (West 1997 & Supp. 2002) (making manipulative or deceptive contravention of SEC rules and regulations enacted pursuant to this Act unlawful).

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[88]

To state a claim against a primary violator for securities fraud under section 10(b) and Rule 10b-5, the injured shareholder must establish that the defendant "(1) made an untrue statement of material fact or omitted a material fact that rendered the statements misleading, (2) in connection with the purchase or sale of a security, (3) with scienter, and (4) which caused plaintiff's losses."[89] The critical distinction separating liability as a primary violator from merely aiding and abetting a securities law violation is the existence of a representation or omission made by the defendant that is relied upon by the aggrieved plaintiff.[90]

The federal circuits, however, are split as to the threshold standard applicable for imposing primary liability on secondary actors such as attorneys and accountants.[91] For example, the Ninth Circuit has imposed liability on attorneys as secondary actors where the attorneys played a substantial role in editing and reviewing the allegedly fraudulent public statements and the issuer's letter to the SEC.[92] In contrast, the Tenth Circuit rejected a similar rule and instead adopted the more stringent standard requiring that the secondary actor "must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors."[93] The Tenth Circuit emphasized that for such a misrepresentation to be actionable "there must be a showing that [the defendant] knew or should have known that his representation would be communicated to investors because § 10(b) and Rule 10b-5 focus on fraud made 'in connection with the sale or purchase'

88. 17 C.F.R. § 240.10b-5 (2002).

89. Schatz v. Rosenberg, 943 F.2d 485, 489 (4th Cir. 1991).

90. Anixter v. Home-Stake Prod. Co., 77 F.3d 1215, 1225 (10th Cir. 1996).

91. *Ziemba*, 256 F.3d at 1205; *see also* Wright v. Ernst & Young LLP, 152 F.3d 169, 175 (2d Cir. 1998) (surveying the variations in case law interpreting primary liability after *Central Bank*).

92. *In re* Software Toolworks, Inc., 50 F.3d 615, 628 n.3, 629 (9th Cir. 1994).

93. *Anixter*, 77 F.3d at 1226; Wenneman v. Brown, 49 F. Supp. 2d 1283, 1288 (D. Utah 1999) (citation omitted) (stating that "[t]he test to hold an accountant or an attorney primarily liable for misrepresentations, therefore, has become whether the defendant 'knew or should have known that his misrepresentation would be communicated to investors'").

of a security."[94] Similarly, though less stringent, other circuits have allowed the imposition of liability against an individual when he did not actually make the misrepresentation, but where the false or misleading statement was attributable to the defendant at the time the statement was disseminated.[95]

Aggrieved shareholders looking to hold the corporation's outside counsel liable for securities violations are also hampered by the fact that even before the Supreme Court's decision in *Central Bank*, courts traditionally have been reluctant to impose civil liability on lawyers acting in their capacity as lawyers especially in the context of securities fraud violations by the corporation.[96] Indeed, most securities fraud cases involving lawyers have required an actual representation by the attorney to the plaintiffs, either by statement or omission.[97]

The likelihood of a successful private lawsuit against the corporation's outside attorneys is further limited by the type of legal services typically rendered by those attorneys. Outside counsel rarely have a direct role in any statements or misstatements regarding the corporation that frequently form the basis for securities fraud suits. More typically, the attorney provides legal services or advice in the form of drafting or reviewing public statements, but the actual statements are released by and attributed to corporate officers or the corporation itself, and not to the drafting or reviewing attorney. Indeed, outside counsel are rarely asked to make a public statement on behalf of the corporation either in annual reports or

94. *Anixter*, 77 F.3d at 1226 (holding that for liability to attach, the misrepresentation must be attributed to a specific actor when disseminated to the public).

95. *Wright*, 152 F.3d at 175; *see also Ziemba*, 256 F.3d at 1205 (adopting the approach taken by the Second Circuit that a secondary actor can be liable for securities fraud for statements or omissions "publicly attributable to the defendant at the time that the plaintiff's investment decision was made").

96. *See In re* Towers Fin. Corp. Noteholders Litig., No. 93CIV 0810(WK)(AJP), 1995 WL 571888, at *12-14 (S.D.N.Y. Sept. 20, 1995) (noting that "even with the reduced showing of involvement in fraud that was necessary under an 'aiding and abetting' theory, judges in the Southern District of New York were reluctant to find lawyers liable for aiding and abetting under § 10(b)"); *cf.* Abell v. Potomac Ins. Co., 858 F.2d 1104, 1124-25 (5th Cir 1998) (finding that "the law, as a general rule, only rarely allows third parties to maintain a cause of action against lawyers for the insufficiency of their legal opinions"), *vacated on other grounds*, 492 U.S. 914 (1989).

97. *See* Lewis D. Lowenfels & Alan R. Bromberg, *Liabilities of Lawyers and Accountants Under Rule 10b-5*, 53 BUS. LAW. 1157, 1179 (1998) (recognizing that most circuit case holdings require an actual misrepresentation by the lawyer upon which the plaintiff relied).

press releases. Even when attorneys do make public statements or issue opinions, they can usually limit their exposure by including language in those statements expressly limiting to whom the attorneys' representations or opinions are directed.[98] In the absence of actual public statements by the attorney or any duty on the part of the attorney to speak, disgruntled shareholders are usually limited to arguing that the attorney had a substantial role in drafting or advising the corporation on its public statements and that role is sufficient to impose primary liability for violation of section 10(b) and Rule 10b-5. Nevertheless, difficulty remains in imposing securities fraud liability on attorneys for legal services rendered to the corporation, even if the attorneys' role in preparing the public statements or filings was substantial.[99] Thus, the absence of aiding and abetting and civil conspiracy liability for a securities fraud violation under Rule 10b-5 poses a substantial barrier to successful shareholders' security fraud actions against attorneys representing corporations that engage in actionable conduct.

2. No Duty to Disclose Corporate Misconduct or Misfeasance

Where no public statements can be attributed to outside counsel, shareholders have tried to impose securities fraud liability on corporate counsel on the theory that the attorneys failed to disclose material information.[100] In *Chiarella v. United States*,[101] the Supreme Court of the United States clarified the relationship between the duty of disclosure and Rule 10b-5 liability by establishing that a defendant's omission or failure to disclose is actionable as securities fraud under section 10(b) and Rule 10b-5

98. McCamish, Martin, Brown & Loeffler v. F.E. Appling Interests, 991 S.W.2d 787, 794 (Tex. 1999) (detailing how a lawyer may limit his liability by setting forth the disclaimers).

99. *In re* Infocure Sec. Litig., 210 F. Supp. 2d 1331, 1350-51 (N.D. Ga. 2002); Ziemba v. Cascade Int'l Inc., 256 F.3d 1194, 1205 (11th Cir. 2001) (stating that "for [a secondary actor, such as a law firm or accounting firm] to be primarily liable under § 10(b) and Rule 10b-5, the alleged misstatement or omission upon which a plaintiff relied must have been publicly attributable to the defendant at the time that the plaintiff's investment decision was made") (alteration in original).

100. *See* Lewis D. Lowenfels & Alan R. Bromberg, *Liabilities of Lawyers and Accountants Under Rule 10b-5*, 53 BUS. LAW. 1157, 1168-69 (1998) (discussing a lawyer's liability to investors regarding the disclosure duty).

101. 445 U.S. 222 (1980).

only if the defendant had a duty to disclose to the plaintiff.[102] Without a duty to disclose, silence—even with knowledge of wrongdoing—does not violate section 10(b) or Rule 10b-5.[103] Thus, the federal circuits and the state courts have uniformly held that liability for securities fraud under Rule 10b-5 does not attach to the attorney in absence of any duty to disclose.[104]

The Eleventh Circuit noted several factors to be weighed in determining whether a professional has a duty to disclose *negative* information about a client to third parties.[105] These factors include:

> [T]he relationship between the [parties], the parties' relative access to the information to be disclosed, the benefit derived by the defendant from the purchase or sale [of the securities in question], defendant's awareness of plaintiff's reliance on defendant in making its investment decisions, and defendant's role in initiating the purchase or sale.[106]

Although courts have routinely stated that the determination of whether a duty to disclose exists is to be determined on a case-by-case basis, most courts have found that attorneys cannot be held liable for failing to disclose corporate information.[107] This is so because they do not have an affirmative duty to disclose information regarding corporate misfeasance or misconduct.[108] Indeed, most

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102. Chiarella v. United States, 445 U.S. 222, 228 (1980).

103. *Id.* at 230; *see also* United States v. O'Hagan, 521 U.S. 642, 665-66 (1997) (stating that a defendant "may not be imprisoned for violating Rule 10b-5 if he proves that he had no knowledge of the Rule"). The Court further acknowledged that *Chiarella* expressly "left open" the misappropriation theory and in turn, explained that the theory is consistent with both the statute as well as the Court's precedent. *Id.*

104. Schatz v. Rosenberg, 943 F.2d 485, 490 (4th Cir. 1991); Lycan v. Walters, 904 F. Supp. 884, 905 (S.D. Ind. 1995).

105. *See* Rudolph v. Arthur Andersen & Co., 800 F.2d 1040, 1043 (11th Cir. 1986) (setting forth the various factors the court considers in determining whether there is a duty to disclose).

106. *Id.*

107. *See* Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 497 (7th Cir. 1986) (recognizing that a lawyer may remain silent, absent some duty to disclose).

108. *Schatz,* 943 F.2d at 490; *see also* Abell v. Potomac Ins. Co., 858 F.2d 1104, 1124-26 (5th Cir. 1988) (explaining that lawyers do not have a duty to disclose client information to investors unless there is some fiduciary or confidential relationship, and that third parties may not generally bring suit against attorneys for insufficient legal opinions), *vacated on other grounds*, 492 U.S. 914 (1989). The court determined that attorneys did not owe a duty to disclose the bondholders by merely including their names in the offering statement to bondholders. *Id.* at 1126.

courts have recognized the difficulty in conceiving a situation where the attorney-client privilege would allow a duty on the part of the attorney to disclose negative information about the corporate client to third parties.[109] The Seventh Circuit held: "Neither lawyers nor accountants are required to tattle on their clients in the absence of some duty to disclose. To the contrary, attorneys have privileges not to disclose."[110]

But even when attorneys representing public companies do not have an affirmative duty to disclose negative information regarding their corporate clients (even information regarding fraudulent conduct) to third parties,[111] where the attorney affirmatively undertakes to make a representation, almost all jurisdictions require that the attorney make a complete and nonmisleading disclosure of information.[112] Thus, the absence of any affirmative duty to disclose information does not create immunity from liability under Rule 10b-5 where the attorney chooses to speak, but the attorney makes an incomplete disclosure or otherwise affirmatively makes a false representation.[113] In short, even post-*Central Bank*, the lack of an

109. *See* Ziemba v. Cascade Int'l, Inc., 256 F.3d 1194, 1206-07 (11th Cir. 2001) (noting that these factors must be weighed in the context of the attorney's fiduciary duties, including a duty of loyalty, to the client). *But see* FDIC v. O'Melveny & Meyers, 969 F.2d 744, 749 (9th Cir. 1992) (holding that law firm was liable for the preparation of documents to investors where law firm had fiduciary duty to investors), *rev'd on other grounds*, 512 U.S. 79 (1994); Molecular Tech. Corp. v. Valentine, 925 F.2d 910, 918 (6th Cir. 1991) (finding that a law firm did have a duty to disclose where the law firm was responsible for editing public documents and the firm knew the documents were false).

110. Barker v. Henderson, Franklin, Starnes & Holt, 797 F.2d 490, 497 (7th Cir. 1986) (citations omitted).

111. *See* Marc I. Steinberg, *Attorney Liability for Client Fraud*, 1991 COLUM. BUS. L. REV. 1, 2 (1991) (stating that a number of courts have rejected the contention that corporate counsel owe the investing public a duty of disclosure).

112. *See* Rubin v. Schottenstein, Zox & Dunn, 143 F.3d 263, 267 (6th Cir. 1998) (reiterating the long established precedent of the Sixth Circuit that one who furnishes misleading information by failing to disclose a material fact is a primary participant).

113. *See id.* at 267-68 (summarizing that "while an attorney representing the seller in a securities transaction may not always be under an independent duty to volunteer information about the financial condition of his client, he assumes a duty to provide complete and nonmisleading information with respect to subjects on which he undertakes to speak"). The Sixth Circuit went on to reject the defendant's argument that an attorney deserved special immunity based on the attorney-client privilege commenting that defendant's argument was "symptomatic of the current debate over the state of legal ethics that the defendants would invoke the attorney's duty of confidentiality to justify what, [is alleged] . . ., amount to outright lies." *Id.* at 269.

independent duty to disclose information does not shield the attorney from securities fraud liability for a material lie.[114]

C. *The Shift in Public Policy Towards Imposing Liability on Attorneys*

The principles insulating attorneys from liability to shareholders for securities fraud—the requirement of privity, the attorney-client privilege, and the absence of any duty to disclose adverse corporate information—are driven by public policy interests in protecting the attorney-client relationship and promoting a free exchange between the attorney and the client corporation, even at the expense of the investing public.[115] For instance, the Texas Supreme Court's decision in *Barcelo*, requiring privity for a legal malpractice claim, clearly explains that defining the boundary of the attorney's duties, and thus, the attorney's liability, is essentially a matter of public policy.[116] As the court summarized, "[T]he ultimate question is whether, considering the competing *policy* implications, the lawyer's professional duty should extend to persons whom the lawyer never represented."[117] Evidently, the Texas Supreme Court has found that public policy justifies limiting the attorney's liability to nonclients and placing a higher priority on protecting the attorney-client relationship with its accompanying privilege.[118]

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114. Ackerman v. Schwartz, 947 F.2d 841, 848 (7th Cir. 1991); *see also Rubin*, 143 F.3d at 267 (holding that an attorney can be held liable as a primary violator where the attorney spoke at great length to injured investors and failed to disclose material details of the proposed investment).

115. *See* Schatz v. Rosenberg, 943 F.2d 485, 490 (4th Cir. 1991) (declining to hold an attorney liable for misrepresentation under Rule 10b-5 for the attorney's failure to disclose information about a client to a third party in the absence of a fiduciary duty to the third party); Lycan v. Walters, 904 F. Supp. 884, 905 (S.D. Ind. 1995) (opining that "[l]awyers are not required to tattle on their clients absent some duty to disclose; rather, attorneys have privileges not to disclose").

116. Barcelo v. Elliott, 923 S.W.2d 575, 577-79 (Tex. 1996) (rejecting the trend by the majority of states to relax the privity requirements for negligence suits brought by will or trust beneficiaries). In Texas, privity is a prerequisite to bringing suit. *Id.*

117. *Id.* at 579 (emphasis added).

118. *Id.* at 578-79. The court stated:

> We believe the greater good is served by preserving a bright-line privity rule which denies a cause of action to all beneficiaries whom the attorney did not represent. This will ensure that attorneys may in all cases zealously represent their clients without the threat of suit from third parties compromising that representation.

Id.

However, the revelations of corporate scandal, the passage of Sarbanes-Oxley, and the public perception that attorneys have conveniently used the attorney-client privilege to excuse their failure to disclose corporate fraud, while shielding them from shareholder lawsuits, may alter the public policy judgment underlying the traditional rules governing attorney conduct. The traditional public policy judgment is exemplified in the Fourth Circuit's decision in *Schatz v. Rosenberg*.[119] In determining that a law firm was not liable to third parties for failing to disclose certain information regarding the corporation that the law firm represented, the Fourth Circuit emphasized that it was *public policy* that counseled against imposing a duty to disclose on attorneys.[120] Now, however, the SEC and others calling for reform to the rules governing attorneys have emphasized that attorneys representing a corporation owe a duty to prevent harm to the corporation *and to the corporation's shareholders*.[121] The critical issue now being debated is whether, as a matter of public policy, the need to protect the investing public by imposing a duty on attorneys to reveal evidence of corporate misfeasance and fraud should outweigh the traditional protections afforded the attorney-client relationship.[122]

Public policy also underscores the historical value accorded the attorney-client privilege. The attorney-client privilege is founded

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119. Schatz v. Rosenberg, 943 F.2d 485, 492 (4th Cir. 1991).

120. *Id.* "[P]ublic policy counsels against imposing such a duty . . . [because such a duty] may prevent a client from reposing complete trust in his lawyer for fear that he might reveal a fact which would trigger the lawyer's duty to the third party." *Id.* at 493.

121. ABA TASK FORCE ON CORPORATE RESPONSIBILITY, PRELIMINARY REPORT 27 (2002), *available at* http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf. "[T]he lawyer's duty to protect the corporate client from harm requires the lawyer to serve the interests of the corporation *and its shareholders* rather than the interests of the individual officers or employers who are acting for the corporation." *Id.* (emphasis added). Attorneys are "obligated to act in the best interests of the issuer *and its shareholders*." Paul F. Roye, Keynote Address at the Meeting of the Business Law Section of the American Bar Association (Nov. 22, 2002), http://www.sec.gov./news/speech/spch112202pfr.htm (emphasis added). Lawyers representing a company represent the entity "as a whole" and not those individuals with whom they interact. SEC Chairman Harvey L. Pitt, Remarks Before the Annual Meeting of the American Bar Association's Business Law Section (Aug. 12, 2002), http://www.sec.gov./news/speech/spch579.htm.

122. Greg Farrell, *SEC Plans New Rules for Lawyers; Now They Can't Tell Regulators of Fraud*, USA TODAY, Sept. 17, 2002, at B3, 2002 WL 4733684 (characterizing the current debate between the SEC and the corporate law community as centering on whether the attorney's duty to disclose evidence of corporate misfeasance should be limited to disclosure within the corporation itself).

on the basic notion that lawyers can best represent the interests of their clients only if clients are free to reveal confidences to the attorney without fear that such confidences will later be disclosed.[123] Although the attorney-client privilege is regarded as sacrosanct, it is not absolute. For instance, under Model Rule 1.6, attorneys are allowed to disclose client confidences where necessary "to prevent reasonably certain death or substantial bodily harm."[124] An attorney is also allowed to reveal client confidences where necessary

> to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client.[125]

Of course, it is difficult for the public to understand why attorneys are allowed to reveal client confidences to protect the interests of the attorney, but not the interests of shareholders.

In response to this criticism, the ABA Task Force recommended in its Preliminary Report that the ABA House of Delegates adopt the previously rejected amendment to Model Rule 1.6 that would allow disclosure of client confidences to prevent or rectify the consequences of crime or fraud where the attorney's services were used and where it was reasonably certain to result or had resulted in substantial financial or property injury.[126] The Task Force noted that forty-one states, including Texas, already permit or require disclosure of client confidences to prevent a client from perpetrating a fraud that constitutes a crime.[127] Additionally, eighteen states permit or require disclosure where necessary to rectify substantial loss resulting from client fraud where the attorney's services were involved or used.[128]

While the breadth of any new duty to disclose may be unclear, it is plain that social and policy expectations may be changing to the

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123. Kenneth J. Drexler, *Honest Attorneys, Crooked Clients and Innocent Third Parties: A Case for More Disclosure*, 6 GEO. J. LEGAL ETHICS 393, 394-95 (1992).

124. MODEL RULES OF PROF'L CONDUCT R. 1.6(b)(1) (2002).

125. MODEL RULES OF PROF'L CONDUCT R. 1.6(b)(3) (2002).

126. ABA TASK FORCE ON CORPORATE RESPONSIBILITY, PRELIMINARY REPORT 31 (2002), *available at* http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf.

127. *Id.* at 32.

128. *Id.*

point where some form of expanded disclosure will be expected from attorneys representing public companies. This change in public expectation is embodied in section 307 of Sarbanes-Oxley.[129] Accordingly, Sarbanes-Oxley and the shift in public policy toward attorney disclosure, even only limited disclosure, may increase the likelihood for civil liability against attorneys who fail to discharge this duty.

IV. WHO WILL WRITE THE FUTURE RULES GOVERNING THE CONDUCT OF ATTORNEYS REPRESENTING PUBLIC COMPANIES?

The revelations of corporate misconduct at some of our largest corporations have posited a tough question for the legal profession: Where were the lawyers during this critical time?[130] The public outcry for making corporate attorneys responsible for protecting shareholders' interests have pushed the organized bar, the federal government, and academics to consider serious reforms to the rules governing the professional conduct of lawyers representing public companies. The ABA Task Force on Corporate Responsibility issued its preliminary report prior to the enactment of Sarbanes-Oxley and recommended several significant amendments to the ABA Model Rules of Professional Conduct.[131] The national legislative response came in the form of Sarbanes-Oxley and section 307.[132] But, the impetus for section 307, the provision requiring the SEC to establish standards of conduct for attorneys practicing before the SEC, began with a letter written to SEC Chairman Harvey Pitt, dated March 7, 2002, by some forty professors and aca-

129. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (2002) (codified at 15 U.S.C. § 7245).

130. Stephen M. Cutler, Remarks at the University of Michigan Law School (Nov. 1, 2002), http://www.sec.gov./news/speech/spch604.htm (opining that many of the inadequate disclosure statements that have been the center of controversy should have been scrutinized and reviewed by attorneys).

131. ABA TASK FORCE ON CORPORATE RESPONSIBILITY, PRELIMINARY REPORT 45-46 (2002), *available at* http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf.

132. Paul F. Roye, Keynote Address at the Meeting of the Business Law Section of the American Bar Association (Nov. 22, 2002), http://www.sec.gov./news/speech/spch112202pfr.htm.

demics.[133] This letter, which eventually came to the attention of the senators who drafted the amendment that became section 307, urged the SEC to use its disciplinary powers under Rule 102(e) to require up-the-ladder reporting of securities law violations by attorneys practicing before the SEC.

Along with the general public's belief that attorneys representing public companies failed to protect the public's interests, widespread calls came for changes to the current rules governing the conduct of those attorneys and calls for federal regulation. With the passage of Sarbanes-Oxley, the legal profession now must address a fundamental question: Who will write the rules that will govern the ethical conduct of lawyers—the federal government, the state and national bar associations, or the courts through the adjudication of civil suits?

A. *The Role of the Federal Government in Regulating the Conduct of Attorneys: The SEC and Section 307 of Sarbanes-Oxley*

1. Increasing the Role of the SEC Under Section 307: What Will It Mean for Attorneys?

With the prospects of successful civil litigation against secondary actors, including banks, accountants, and attorneys, sharply reduced by *Central Bank* and its progeny, Congress has given greater authority to the SEC to regulate the conduct of attorneys who render assistance to public corporations.[134] In response to *Central Bank*'s ruling that section 10(b) and Rule 10b-5 do not allow for a private cause of action for aiding and abetting a securities fraud violation,[135] Congress passed the Private Securities Litigation Reform Act (PSLRA),[136] giving the SEC authority to prosecute secondary actors, such as attorneys, for aiding and abetting a violation

133. Renee Deger, *Law Professors Led Fight for New SEC Rules*, THE RECORDER, Dec. 2, 2002, at 1, WL 12/2/2002 RECORDER-SF 1.

134. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (2002) (codified at 15 U.S.C. § 7245) (requiring the SEC to issue rules setting forth professional conduct standards for attorneys who represent public corporations).

135. Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164, 191 (1994).

136. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 107, 109 Stat. 737, 758 (1995) (codified in various sections of 15 U.S.C. § 78).

of federal securities law.[137] With the enactment of section 307 of Sarbanes-Oxley, Congress has sought to increase the role of the SEC in governing the conduct of attorneys by expressly giving the SEC authority to regulate the conduct of attorneys representing public companies before the SEC.[138] In fact, the SEC itself views section 307 as expressing a mandate by Congress for the SEC to do just that.[139]

Section 307 required that the SEC adopt, within 180 days of Sarbanes-Oxley's enactment, rules establishing "minimum standards of professional conduct for attorneys appearing and practicing before the Commission."[140] Specifically, the new standards must require an attorney "to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by [an employee or agent of] the company . . . , to the chief legal counsel or the chief executive officer [(CEO)] of the company."[141] Section 307 further mandates that the new rule require that if the chief legal counsel or CEO does not appropriately respond, then the attorney must report the evidence of the violation to the audit committee, another committee of independent directors, or the full board of directors.[142] An "appropriate response" is defined as "appropriate remedial measures or sanctions with respect to the violation."[143] This last requirement is commonly referred to as "up-the-ladder" reporting. If the attorney ultimately determines that the corporation has failed to appropriately respond, the attorney may

137. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 104, 109 Stat. 737, 759 (1995) (codified at 15 U.S.C. § 78t). As one SEC Director Stephen Cutler recognized, the passage of the Private Securities Litigation Reform Act of 1995 codified Congress's confirmation that liability for aiding and abetting a securities violation could only be pursued by the SEC. Stephen M. Cutler, Remarks at the University of Michigan Law School (Nov. 1, 2002), http://www.sec.gov./news/speech/spch604.htm.

138. 15 U.S.C.A. § 7245 (West Supp. 2002).

139. SEC Chairman Harvey L. Pitt, Remarks Before the Annual Meeting of the American Bar Association's Business Law Section (Aug. 12, 2002), http://www.sec.gov./news/speech/spch579.htm (noting that "Sarbanes-Oxley reflects some skepticism about the degree to which the legal profession can police itself, by making explicit the Commission's ability, *and our obligation,* to regulate how lawyers appear and practice before us, including minimum standards of professional conduct for corporate lawyers").

140. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (2002) (codified at 15 U.S.C. § 7245).

141. *Id.*

142. *Id.*

143. *Id.*

be required: (1) to withdraw from the representation of the company; (2) effectuate a "noisy withdrawal"—that is, the attorney must notify the SEC that the attorney is withdrawing from representing the company for "professional considerations;" and (3) disaffirm any tainted documents filed with the SEC.[144]

Prior to the enactment of Sarbanes-Oxley, the primary tool used by the SEC to police the conduct of attorneys appearing and practicing before it has been Rule 102(e) of the SEC's Rules of Practice.[145] Rule 102(e)(1) states:

> The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice and opportunity for hearing in the matter:
>
> (i) Not to possess the requisite qualifications to represent others; or
> (ii) To be lacking in character or integrity or to have engaged in unethical or improper professional conduct; or
> (iii) To have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder.[146]
>
> . . . .

Under Rule 102(e), the SEC can initiate disciplinary proceedings against attorneys who lack integrity, competence, engage in improper professional conduct, or who are determined to have violated federal securities laws.[147] The disciplinary sanctions available include censure, temporary suspension, a cease and desist order, and permanent disbarments from practice before the SEC.[148] However, before section 307, the SEC never had *express* statutory authority to promulgate rules and regulations directly establishing standards of conduct for attorneys representing issuers or otherwise practicing before the SEC.[149] Rather, the SEC had only the

144. Implementation of Standards for Professional Conduct for Attorneys, 67 Fed. Reg. 71,670, 71,705-06 (proposed Dec. 2, 2002) (specifying a "noisy withdrawal" in § 205.3(d)(1)(i) of the original proposed rules in this proposed release).
145. 17 C.F.R. § 201.102 (2002).
146. *Id.* § 201.102(e).
147. *Id.* § 201.102(e)(1)(i)-(iii).
148. 17 C.F.R. § 201.102(e)(1) (2002).
149. Press Release, U.S. Securities and Exchange Commission, SEC Proposes Rules to Implement Sarbanes-Oxley Act Provisions Concerning Standards of Professional Con-

authority to discipline attorneys insofar as the attorneys' conduct violated federal securities laws.[150]

On November 6, 2002, pursuant to its authority under section 307, the SEC proposed rules setting forth *minimum* standards of conduct for attorneys appearing or practicing before the SEC on behalf of an issuer in any way, including attorneys communicating with the SEC and any conduct relating to the preparation of filing with the SEC.[151] Among other things, the proposed rules would implement a rigorous "'up the ladder' reporting requirement,"[152] as well as imposing a duty on the attorney to make a "noisy withdrawal" and to notify the SEC of what they have done, upon the occurrence of certain events.[153]

On January 23, 2003, the SEC adopted Rule 205 implementing "up the ladder" procedures for attorneys representing an issuer before the SEC in any way.[154] In addition, the SEC voted to postpone its decision regarding the adoption of its original "noisy withdrawal" provision to allow further comment.[155] The SEC also proposed an alternative "noisy withdrawal" provision for consideration and public comment.[156]

2. A More Vigilant SEC

Section 307 of Sarbanes-Oxley not only gives the SEC greater authority to regulate the conduct of attorneys, but its rules also signal a greater intention by the SEC to regulate the conduct of

duct for Attorneys (Nov. 6, 2002), http://www.sec.gov./news/press/2002-158.htm; *see also White Collar Crime—Maximum Security*, THE LAW., Sept. 16, 2002, at 29, 2002 WL 24528161 (observing that for twenty years, the SEC has not attempted to regulate the conduct of attorneys, except to the extent that the attorney's conduct otherwise violated federal securities laws).

150. *White Collar Crime—Maximum Security*, THE LAW., Sept. 16, 2002, at 29, 2002 WL 24528161.

151. Press Release, U.S. Securities and Exchange Commission, SEC Proposes Rules to Implement Sarbanes-Oxley Act Provisions Concerning Standards of Professional Conduct for Attorneys (Nov. 6, 2002), http://www.sec.gov./news/press/2002-158.htm.

152. *Id.*

153. 17 C.F.R. §§ 205.3(b), 205.3(d)(1)(i) (2002).

154. Press Release, U.S. Securities and Exchange Commission, SEC Adopts Attorney Conduct Rule Under Sarbanes-Oxley Act (Jan. 23, 2003), http://www.sec.gov./news/press/2003-13.htm.

155. *Id.*

156. *Id.*

attorneys.[157] Traditionally, the SEC has been circumspect in using its enforcement and disciplinary powers under Rule 102(e) against attorneys, preferring instead to defer to disciplinary actions by the states or to private civil suits.[158] However, the SEC recently expressed its intention to play a far more aggressive role in regulating the conduct of attorneys. In fact, the rules first proposed by the SEC went beyond the substantial mandate of section 307. For instance, the SEC's previously proposed Rule 205 would have required the attorney to effectuate a "noisy withdrawal" if the outside attorney did not receive a satisfactory response after reporting corporate misconduct.[159] The SEC's first "noisy withdrawal" provision would have required the attorney to notify the SEC that he is withdrawing for "professional" considerations and disaffirming certain types of documents.[160] Moreover, SEC staff members have voiced their opinion that attorneys failed to fulfill a gatekeeper function to prevent securities fraud violations because, in part, the SEC has declined to use its disciplinary powers preferring to leave the regulation of attorney conduct to state disciplinary committees.[161]

157. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (2002) (codified at 15 U.S.C. § 7245).

158. SEC Chairman Harvey L. Pitt, Remarks Before the Annual Meeting of the American Bar Association's Business Law Section (Aug. 12, 2002), http://www.sec.gov./news/speech/spch579.htm (indicating that "[b]y and large, the Commission has been circumspect about using its self-created ability to review and sanction the conduct of lawyers, preferring to leave this task to professional organizations, like the various state bar committees"); *see also* Stephen M. Cutler, Remarks at the University of Michigan Law School (Nov. 1, 2002), http://www.sec.gov./news/speech/spch604.htm (stating that "[t]hrough the exercise of its prosecutorial discretion, the Commission generally has reserved suing both [attorneys and accountants] for only the most egregious cases").

159. Press Release, U.S. Securities and Exchange Commission, SEC Proposes Rules to Implement Sarbanes-Oxley Act Provisions Concerning Standards of Professional Conduct for Attorneys (Nov. 6, 2002), http://www.sec.gov./news/press/2002-158.htm (recognizing that the "noisy withdrawal" provision of the SEC's proposed Rule 205 is not specifically mandated by section 307 of Sarbanes-Oxley).

160. Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71,670, 71,704-06 (proposed Dec. 2, 2002) (noting this as the first proposed release).

161. *See* Stephen M. Cutler, Remarks at the University of Michigan Law School (Nov. 1, 2002), http://www.sec.gov./news/speech/spch604.htm (opining that outside board members, accountants, and lawyers have failed to perform gatekeeper functions in ensuring corporate responsibility); SEC Chairman Harvey L. Pitt, Remarks Before the Annual Meeting of the American Bar Association's Business Law Section (Aug. 12, 2002), http://www.sec.gov./news/speech/spch579.htm (noting that the Sarbanes-Oxley Act reflects the skepticism Congress has about the legal profession's ability to police itself).

Increased disciplinary actions by the SEC against attorneys will have an important impact on attorneys representing public companies. As noted above, the SEC has a variety of powerful sanctions available to it in prosecuting disciplinary actions against attorneys appearing before the SEC, including censure, temporary suspension, a cease and desist order, and permanent disbarments from practice before the SEC.[162] But even if no disciplinary sanctions are imposed by the SEC, the specter of alleged disciplinary action by the SEC carries its own costs in terms of the damage to the attorney's reputation, regardless of the outcome. As one commentator noted: "The reputational paradigm in the legal profession is thus particularly sensitive to an allegation of improper professional conduct, and a lawyer who has been sued or named as a respondent in a SEC disciplinary proceeding has a lot more to worry about than monetary loss."[163] Consequently, the legal profession should have cause for concern that the SEC—a federal agency that historically has deferred to the states to discipline attorneys—now believes it has a mandate to regulate the conduct of attorneys through enforcement actions.[164]

B. *The Risk of Allowing the Federal Government to Regulate the Conduct of Attorneys*

1. Federalizing the Disciplinary Rules of Professional Conduct

Even beyond the specter of increased disciplinary actions by the SEC, section 307 is of tremendous significance to the legal profession because the federalization of the standards for attorney conduct threatens to compromise several fundamental principles that have long been an integral part of the legal profession. For instance, the legal profession is essentially a self-regulated profession. For the first time, an agency of the federal government has

162. 17 C.F.R. § 201.102(e)(1) (2002).

163. Richard W. Painter & Jennifer E. Duggan, *Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation*, 50 SMU L. REV. 225, 239 (1996).

164. *See* SEC Chairman Harvey L. Pitt, Remarks Before the Annual Meeting of the American Bar Association's Business Law Section (Aug. 12, 2002), http://www.sec.gov./news/speech/spch579.htm (observing that the SEC was indeed entering into "unchartered territory"). In fact, Chairman Pitt readily admitted that "there are risks inherent in giving an agency that sometimes faces corporate lawyers as adversaries the ability to regulate whether and how they satisfy our notions of appropriate professional behavior." *Id.*

been given statutory authority to write rules governing the conduct of lawyers. Traditionally, the responsibility for promulgating the rules governing the professional conduct of attorneys has been entrusted to the highest courts of each state. Furthermore, the rules adopted by the states are often modeled after the ABA Model Rules—rules developed by the national organized bar. In other words, the rules governing the professional and ethical conduct of attorneys are primarily written, revised, and promulgated by members of the legal profession. Section 307 alters this tradition by authorizing a federal agency to promulgate rules governing the conduct of attorneys, while affording the organized bar and attorneys only a limited opportunity to comment on these rules.[165]

The drawbacks to shifting responsibility for drafting the professional rules of conduct governing attorneys away from the legal profession and the states' judiciaries to the federal government is aptly demonstrated by the types of regulations and rules proposed by the SEC pursuant to Sarbanes-Oxley. For instance, almost by definition, federal regulation is prescriptive in nature, abrogating the attorney's discretionary judgment to determine the most appropriate course of action. As noted above, section 307 mandates that the SEC establish rules that would *require* the outside attorney to make an up-the-ladder reporting if the attorney had evidence of a material violation of securities law while limiting the ability of the attorney to use his own professional judgment as to the proper course of action in representing the best interests of the client.[166] If the attorney did not receive an adequate response to the reported evidence, the attorney then is *required* to make additional up-the-ladder reporting to the audit committee, and if necessary, to the entire board of directors.[167] Rule 205 clarifies that the attorney's up-the-ladder reporting obligation would be triggered only after an

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165. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (2002) (codified at 15 U.S.C. § 7245). Because section 307 mandated that the new rules of conduct be enacted by the SEC within 180 days from the passage of the Sarbanes-Oxley Act—that is, by January 26, 2003—the SEC shortened the time period in which the general public was allowed to provide comment to the SEC regarding proposed Rule 205. *Id.*; *see also* Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71,670, 71,670 (proposed Dec. 2, 2002) (stating that "[c]omments should be received on or before December 18, 2002").

166. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (2002) (codified at 15 U.S.C. § 7245).

167. *Id.*

attorney becomes aware of "evidence of a material violation by its issuer or by an officer, director, employee, or agent of the issuer."[168] Thus, Rule 205.3 does not require that the attorney actually know that a violation has occurred; rather the attorney's reporting obligations would be triggered merely when the attorney *reasonably believes* that a material violation has occurred, is occurring, or is about to occur.[169] The previously proposed Rule 205.3(b)(8)(ii) would have even prescribed the documentation that the attorney would have had to keep in fulfilling its reporting obligations under section 307 and Rule 205.[170] And, under the previously proposed Rule 205.3(b), if the attorney did not receive a reasonable response, the attorney then would be *required* to engage in a noisy withdrawal, including sending notification to the SEC that the attorney is withdrawing for "professional reasons" and disaffirming any documents prepared by the attorney.[171]

However, in light of the substantial criticism that the SEC received on its original "noisy withdrawal" provision, the SEC delayed taking action on this provision.[172] Instead, the SEC proposed an alternative "noisy withdrawal," whereby the attorney would still be required to withdraw, in certain circumstances, from the representation of the issuer where the attorney does not receive an appropriate response to a report of evidence of a material violation.[173] Under the alternative proposal, the attorney would still be required to notify the issuer, in writing, that his withdrawal is based on "professional considerations."[174] However, in contrast to the earlier proposed "noisy withdrawal" provision, this alternative provision would require the issuer (as opposed to the attorney) to notify the SEC within two business days of the attorney's with-

168. 17 C.F.R. § 205.3(b)(1) (2002); Press Release, U.S. Securities and Exchange Commission, SEC Proposes Rules to Implement Sarbanes-Oxley Act Provisions Concerning Standards of Professional Conduct for Attorneys (Nov. 6, 2002), http://www.sec.gov./news/press/2002-158.htm.

169. Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6324, 6326 (proposed Feb. 6, 2003) (amending the first proposed release).

170. Implementation of Standards for Professional Conduct for Attorneys, 67 Fed. Reg. 71,670, 71,705 (proposed Dec. 2, 2002) (noting that this is the first proposed release).

171. *Id.* at 71,704-06.

172. Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6324, 6325 (proposed Feb. 6, 2003) (amending the first proposed release).

173. *Id.*

174. *Id.*

drawal for "professional considerations."[175] The SEC's comments regarding the proposed "noisy withdrawal" provisions being considered by the SEC could very well lead to a federal regulatory system where attorneys would be subject to a *mandatory* set of bureaucratic obligations and regulations.

The Model Rules and disciplinary rules adopted by the states have generally allowed the attorney to assess a proper response within a scope of reasonable options in dealing with the client's misuse of the attorney's legal services. The prescriptive measures proposed by the SEC include regulations removing altogether the discretion of attorneys, such as reporting evidence of fraud or criminal activity, deferring to the judgment of the corporation's chief legal officer when this officer's decision fell within a range of reasonableness, and even allowing the attorney to decide whether withdrawal from the representation of the client was warranted or appropriate, and, if so, the manner by which withdrawal should be accomplished.

In contrast, the current professional rules governing the conduct of attorneys generally rely on the professional judgment of attorneys as to the proper response in situations involving potential corporate misconduct. For instance, many states' professional rules permit the attorney to disclose client confidences in order to prevent financial injury or injury to property.[176] However, only one state—Hawaii—*requires* disclosure.[177] In most jurisdictions as well as under the Model Rules, the disclosure of client confidences is required only when the attorney is aware of evidence clearly establishing that a client is likely to commit an act that is likely to result in death or substantial bodily harm to a person.[178] Even though attorneys are permitted to disclose client confidences to prevent financial injury, attorneys typically are not required to disclose client confidences to third parties to avert nonviolent, financial injury

175. *Id.* at 6328.

176. ABA TASK FORCE ON CORPORATE RESPONSIBILITY, PRELIMINARY REPORT 32 (2002), *available at* http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf.

177. Douglas McCollam, *Corporate Lawyers Hope SEC Will Blunt Sarbanes Impact*, THE RECORDER, Oct. 1, 2002, at 3, WL 10/1/2002 RECORDER-SF 3.

178. TEX. DISCIPLINARY R. PROF'L CONDUCT 1.05(e) & cmt. 19.

caused by the client's fraud.[179] In short, by allowing the federal government to write the rules governing the conduct of attorneys, there is the risk that attorneys will be subjected to prescriptive regulations and rules of disciplinary conduct rather than relying on the considered judgment of attorneys.

2. Invading the Protection of the Attorney-Client Privilege

Another critically important concern raised by the federal government writing rules governing the conduct of attorneys is that the SEC continues to consider a "noisy withdrawal" provision that would require attorneys to disclose client confidences otherwise protected by the attorney-client privilege. Under either proposed "noisy withdrawal" provision being considered, an attorney who has reported evidence of a material violation but does not receive an appropriate response in a reasonable time must (1) withdraw from his or her representation of the corporation, (2) give notice to the client or to the SEC of the attorney's withdrawal, including indicating that the withdrawal is based on "professional considerations", (3) disaffirm any "opinion, document, affirmation, representation, characterization" or other document submitted to the SEC that the attorney prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading.[180] The noisy withdrawal provision would require attorneys, by words and actions, to blow the whistle on their clients based upon the confidential information learned by the attorneys through their representation. For instance, in disaffirming any documents submitted to the SEC, the attorney will necessarily be required to communicate his or her belief that the documents *may be* materially false or misleading. Such information (or work product) protected by the attorney-client privilege is usually privileged. Consequently, a "noisy withdrawal" would require attorneys to

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179. *See* Bernstein v. Portland Sav. & Loan Ass'n, 850 S.W.2d 694, 701 (Tex. App.—Corpus Christi 1993, writ denied) (holding that under the Texas Disciplinary Rules of Professional Conduct, the attorney is permitted, in certain circumstances, to disclose client confidences in order to prevent the client from committing a crime or fraud that is likely to result in substantial financial injury); *see also* TEX. DISCIPLINARY R. PROF'L CONDUCT 1.02(d).

180. Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71,670, 71,704-06 (proposed Dec. 2, 2002) (noting this as the first proposed release) (setting forth the proposed steps of the "noisy withdrawal" in § 205.3(d)(i)(A-C)).

make constructive disclosure even if they are forbidden to do so under the applicable state rules of professional conduct and even where the client's conduct may not actually violate any securities laws.

The notion that a "noisy withdrawal" would not constitute a breach of the attorney-client privilege is unsupportable. The fact that the attorney who is withdrawing pursuant to Rule 205 is *required* to state that his withdrawal is for "professional considerations" itself shows that the noisy withdrawal provision does in fact seek and require the disclosure of client confidences. If the SEC, under Rule 205.3(d), is seeking no information, why require attorneys to state the reason for their withdrawal? The only conceivable purpose for requiring a noisy withdrawal is to bring the withdrawing attorney's former corporate client to the attention of the SEC. In short, it defies common sense to pretend that a "noisy" withdrawal would not effectuate a disclosure of client confidences or that such a requirement would not have the potential for triggering an investigation of the client corporation by the SEC.

The SEC attempts to address this concern by noting that proposed subsection 205.3(e)(3) provides that the corporation does not waive any applicable privileges by sharing confidential information regarding misconduct by the corporation's officers or employees with the SEC pursuant to any confidentiality agreement.[181] Stating that Rule 205.3(e)(3) purports to preserve applicable privileges for information provided to the SEC relating to a material violation should give little comfort to attorneys or corporations that disclose otherwise privileged communications to the SEC. Even if such information is provided pursuant to a confidentiality agreement, there is no guarantee that courts will uphold such agreements, which are known as selective waiver agreements, in later civil lawsuits. In fact, several jurisdictions have declined to uphold such selective waiver agreements and have instead found a

181. *See* Press Release, U.S. Securities and Exchange Commission, SEC Proposes Rules to Implement Sarbanes-Oxley Act Provisions Concerning Standards of Professional Conduct for Attorneys (Nov. 6, 2002), http://www.sec.gov./news/press/2002-158.htm (expressing the belief that allowing corporations to produce confidential and privileged information to the Commission without the risk of waiving the privilege will assist to expedite SEC investigations).

waiver of the attorney-client privilege.[182] Moreover, the SEC's alternative "noisy withdrawal" provision still raises serious concerns regarding the failure to give due consideration to protecting attorney-client communications. Several groups and practitioners, including the New York County Lawyers' Association Task Force on Corporate Responsibility, have argued that the alternative "noisy withdrawal" provision, which requires the issuer rather than the attorney himself to notify the SEC of the attorney's withdrawal for "professional considerations," is no less offensive because both threaten to erode the candor and protection accorded to attorney-client communications.[183] Accordingly, despite reassurances embodied in Rule 205 and the proposed versions of the "noisy withdrawal" provision, the proposed federal regulation of the conduct of attorneys representing public companies would also ultimately threaten the time-tested protections of the attorney-client privilege.

C. *The Specter of Civil Liability*

In examining who should write the future rules governing the conduct of attorneys representing public companies, the role of civil suits must be considered. There can be no doubt that the conduct of attorneys is naturally shaped by the fear that his or her

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182. *See* David M. Zornow & Keith D. Krakaur, *On the Brink of a Brave New World: The Death of Privilege in Corporate Criminal Investigations*, 37 AM. CRIM. L. REV. 147, 153 n.31 (2000), 37 AMCRLR 147 (citing cases); Jennifer A. Hardgrove, Note, *Scope of Waiver of Attorney-Client Privilege: Articulating a Standard That Will Afford Guidance to Courts*, 1998 U. ILL. L. REV. 643, 654-55 (1998) (discussing the case law concerning implied waivers resulting from disclosures made to a governmental agency). The SEC's inclusion of a provision codifying the notion of selective waiver is puzzling since the trend in federal courts is against recognizing a selective waiver, even where disclosure is made pursuant to valid confidentiality agreement purporting to protect the privileges. *See* David M. Greenwald & Matthew J. Thomas, *Selective Waiver of Privileges,* FOR THE DEFENSE, Dec. 2002, at 10, 12 (noting the trend against the recognition of selective waiving). In fact, many of the cases where courts have declined to recognize selective waiver concern disclosures made to the SEC. *Id.* at 11-12 (citing the SEC's recently filed amicus brief in a state court proceeding arguing that disclosures made to the SEC pursuant to a confidentiality agreement did not waive privileges as to third parties).

183. Letter from Edwin David Robertson, Chair, Task Force on Corporate Responsibility, New York County Lawyer's Association to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Apr. 1, 2003), http://www.sec.gov/rules/proposed/s74502/edrobertson1.htm.

rendition of legal services will result in civil liability.[184] Indeed, one of the greatest concerns about section 307 is the prospect that it will create a cause of action against outside counsel who fail to discover or disclose a violation of federal securities law or other evidence required by the new SEC regulations.[185] The fear that the federal regulation of attorneys will spawn an increased number of private actions against attorneys for securities fraud is understandable. A statistical study of securities fraud class action settlements showed that from 1989 to 1993, law firms and attorneys were named as defendants in sixty-one class action lawsuits that were eventually settled.[186] Settlements totaling $134.91 million came from thirty-four of these settlements.[187] Most recently, several law firms have been named as defendants in some of the most high-profile securities fraud lawsuits stemming from the collapse of Enron.[188]

But even if the risk of judgment against law firms is discounted by the low probability of success based on the bars to recovery discussed above, the specter of being named in a securities fraud lawsuit remains costly to the law firm because of the risk of loss of the firm's "reputational capital,"[189] as well as the financial exposure to the firm. As one commentator observed:

> Whereas for a large accounting firm a securities suit is simply one more suit to be settled or litigated, for most law firms any lawsuit is a crisis calling into question the integrity of the firm's lawyers. The

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184. Nathan Koppel, *A Timely Niche*, THE AM. LAW., Oct. 10, 2002, at 20, WL 10/2002 AMLW 20. "With the bar now obsessed about all things Sarbanes-Oxley, it's easy to forget about the lethal private regulators, a.k.a. the plaintiffs bar, who stand ever ready to blame lawyers for corporate malfeasance." *Id.*

185. *See* Arthur D. Burger, *Lawyers as Whistleblowers: How Increased SEC Oversight of the Bar Could Change the Client Relationship*, LEGAL TIMES, Aug. 12, 2002, at 22, WL 8/12/2002 LEGALTIMES 22 (reporting the view of one ethics commentator that the greatest concern of Sarbanes-Oxley is that it would expose attorneys to civil liability for failing to discover or failing to report a violation of securities law by the client corporation).

186. Richard W. Painter & Jennifer E. Duggan, *Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation*, 50 SMU L. REV. 225, 238-39 (1996).

187. *Id.*

188. *See In re* Enron Corp. Sec. Derivitive & ERISA Litig., 235 F. Supp. 2d 549, 560-63 (S.D. Tex. 2002) (listing the numerous firms named as defendants in investors' actions involving securities fraud).

189. Richard W. Painter & Jennifer E. Duggan, *Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation*, 50 SMU L. REV. 225, 239 (1996).

> [attorney's reputation] in the legal profession is thus particularly sensitive to an allegation of improper professional conduct, and a lawyer who has been sued or named as a respondent in a SEC disciplinary proceeding has a lot more to worry about than monetary loss.[190]

V. Conclusion

Sarbanes-Oxley has important implications for the legal profession. In addition to shaping the day-to-day practice of attorneys representing public companies, Sarbanes-Oxley and the SEC's new rules bring to the forefront the question of whether the current disciplinary rules of professional conduct governing the conduct of attorneys are sufficient to address the unique contemporary challenges of corporate governance.

Plainly, a need to restore integrity in our corporations and financial markets exists.[191] The legal profession, therefore, must relay to the public its sensitivity and awareness that attorneys have a role to play in ensuring responsible corporate governance. But so long as a public perceives the profession's disciplinary rules as lax, such as to allow attorneys representing public companies to ignore or even knowingly assist in corporate misfeasance, the legal profession stands to lose its ability to remain a self-regulated industry.

190. *Id.*

191. *See* Letter from Alfred P. Carlton, Jr., President, American Bar Association, to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Dec. 18, 2002), http://www.manningproductions.com/ABA257/ABA_LetterComments.htm (stating that "[t]he ABA joins the Commission in seeking to restore a culture of integrity and confidence in our financial markets that will warrant the trust of the American public").