

January 2003

## Lawyer Liability after Sarbanes-Oxley - Has the Landscape Changed

Marc I. Steinberg

Follow this and additional works at: <https://scholarship.law.uwyo.edu/wlr>

---

### Recommended Citation

Steinberg, Marc I. (2003) "Lawyer Liability after Sarbanes-Oxley - Has the Landscape Changed," *Wyoming Law Review*. Vol. 3: No. 2, Article 3.

Available at: <https://scholarship.law.uwyo.edu/wlr/vol3/iss2/3>

This Article is brought to you for free and open access by the UW College of Law Reviews at Law Archive of Wyoming Scholarship. It has been accepted for inclusion in Wyoming Law Review by an authorized editor of Law Archive of Wyoming Scholarship.

---

# WYOMING LAW REVIEW

VOLUME 3

2003

NUMBER 2

---

## LAWYER LIABILITY AFTER SARBANES-OXLEY – HAS THE LANDSCAPE CHANGED?

*Marc I. Steinberg\**

I.	SARBANES-OXLEY AND THE SEC’S RESPONSE .....	372
II.	STATE ETHICAL RULES .....	375
III.	FEDERAL SECURITIES LAW STANDARDS .....	378
IV.	STATE SECURITIES AND COMMON LAW .....	379
V.	THE ROLE OF CIRCUMSTANTIAL EVIDENCE .....	382
VI.	RECOMMENDED COURSE OF ACTION.....	384

Largely due to massive corporate debacles that wreaked havoc on investors and the integrity of the U.S. securities markets,<sup>1</sup> Congress enacted the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley or SOA).<sup>2</sup> Among its many significant provisions,<sup>3</sup> Congress mandated that the Securities and Exchange Commission (SEC) promulgate a rule focusing on attorney “up the ladder” reporting with respect to a corporate client when faced with a material violation of fiduciary duty, securities law, or similar violation by a

---

\* Rupert and Lillian Radford Professor of Law, Dedman School of Law, Southern Methodist University. This Article was presented in April 2003 as the Winston S. Howard Distinguished Lecturer at the University of Wyoming College of Law. © Copyright 2003 by Marc I. Steinberg. All rights reserved.

1. See, e.g., Laura S. Egodigwe et al., *A Year of Scandals & Sorrow*, WALL ST. J., Jan. 2, 2003, at R10; Carol Hymowitz, *How to Fix A Broken System*, WALL ST. J., Feb. 24, 2003, at R1; William S. Lerach, *Plundering America: How American Investors Got Taken for Trillions by Corporate Insiders*, 8 STAN. J. L. BUS. & FIN. 69 (2002).

2. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745. See generally Neil H. Aronson, *Preventing Future Enrons: Implementing The Sarbanes-Oxley Act of 2002*, 8 STAN. J. L. BUS. & FIN. 127 (2002).

3. For a description of the Act’s provisions, see, H. BLOOMENTAL, *SARBANES-OXLEY ACT IN PERSPECTIVE* (2002); J. HAMILTON & T. TRAUTMANN, *SARBANES-OXLEY ACT OF 2002: LAW AND EXPLANATION* (2002).

subject corporate constituent (such as a director, officer or employee).<sup>4</sup> Following Congress' directive, the SEC in 2003 adopted standards of professional conduct.<sup>5</sup>

These standards as well as those proposed (but not yet adopted<sup>6</sup>) have generated zealous responses from the practicing securities bar, corporate executives, and academicians.<sup>7</sup> Much of the discussion has dealt with whether the SEC should require counsel to make a "noisy withdrawal" when faced with client fraud (or similar material violation).<sup>8</sup> At this time, the Commission is still considering such a provision (as well as alternatives).<sup>9</sup>

The premise of this Article is that, while whatever actions the SEC elects to implement are relatively significant, the grave importance attached to such actions is exaggerated. As a general proposition, the promulgation of SEC standards in this context will not greatly impact counsel's obligations under applicable state ethical rules as well as liability exposure under federal and state law.<sup>10</sup>

## I. SARBANES-OXLEY AND THE SEC'S RESPONSE

The following discussion provides a succinct overview relating to attorney standards under Sarbanes-Oxley and the SEC's promulgation of applicable standards thereunder. Under Section 307 of the SOA, Congress directed the SEC to adopt a rule:

(1) requiring [a subject] attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and (2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring [such] at-

---

4. See Sarbanes-Oxley Act of 2002 § 307; *infra* notes 11-23 and accompanying text. Of course, "A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents." MODEL RULES OF PROF'L CONDUCT R. 1.13(a) (2003).

5. See Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 47,276, Fed. Sec. L. Rep. (CCH) ¶ 86,823 (January 29, 2003) (to be codified at 17 C.F.R. pt. 205).

6. See *id.* See also, Exchange Act Release No. 47,282, Fed. Sec. L. Rep. (CCH) ¶ 86,824 (January 29, 2003).

7. See, e.g., Mitchell Pacelle & Michael Schroeder, *Proposed SEC Rules Could Turn Lawyers Into Whistle-Blowers*, WALL ST. J., Jan. 9, 2003, at A1.

8. See, e.g., Pamela Atkins, *Attorneys Call for Delay, More Discussion of SEC Rule Proposals on Noisy Withdrawal*, 34 Sec. Reg. & L. Rep. (BNA) 2045 (2002).

9. See Exchange Act Release No. 47,282.

10. See *infra* notes 24-35, 48-66 and accompanying text.

torney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.<sup>11</sup>

Section 307 and a large part of the SEC's response closely resemble existing ethical standards as set forth by the American Bar Association,<sup>12</sup> the American Law Institute,<sup>13</sup> and the states.<sup>14</sup> Responding to Congress' directive, the SEC adopted standards implementing "up the ladder" reporting and recognized the legitimacy of a Qualified Legal Compliance Committee (QLCC) to serve as an alternative.<sup>15</sup> In its January 2003 rule adoption, how-

11. Sarbanes-Oxley Act of 2002 § 307.

12. See MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2003).

13. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 96(2)-(3) (2000).

14. See, e.g., WYOMING RULES OF PROF'L CONDUCT R. 1.13(b).

15. Implementing Standards of Professional Conduct for Attorneys, Exchange Act Release No. 47,276, Fed. Sec. L. Rep. (CCH) ¶ 86,823 (January 29, 2003) (to be codified at 17 C.F.R. pt. 205). The SEC Standards define evidence of a material violation as meaning "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or about to occur." 17 C.F.R. § 205.2(e). Under the SEC standard, subordinate lawyers generally may satisfy this obligation by informing their supervisory attorney of evidence of material violation(s). See *id.* § 205.5(c). For all of its emphasis on "plain English" (see, e.g., Plain English Disclosure, Securities Act Release No. 7497 (Jan. 28, 1998) (codified at 17 C.F.R. pt. 228, 229), the SEC should do better when adopting standards that regulated persons must follow. See Floyd Norris, *No Positives in This Legal Double Negative*, N.Y. TIMES, Jan. 24, 2003, at C1 (criticizing language and context of definition of "evidence of a material violation").

As defined in Section 205.2(k) of the SEC Standards, a Qualified Legal Compliance Committee (QLCC) is a committee of a publicly-held issuer (which committee may also be the audit or other committee of the issuer) that:

(1) Consists of at least one member of the issuer's audit committee (or, if the issuer has no audit committee, one member from an equivalent committee of independent directors) and two or more members of the issuer's board of directors who are not employed, directly or indirectly, by the issuer and who are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19));

(2) Has adopted written procedures for the confidential receipt, retention, and consideration of any report of evidence of a material violation under § 205.3;

(3) Has been duly established by the issuer's board of directors, with the authority and responsibility:

(i) To inform the issuer's chief legal officer and chief executive officer (or the equivalents thereof) of any report of evidence of a material violation (except in the circumstances described in § 205.3(b)(4));

(ii) To determine whether an investigation is necessary regarding any report of evidence of a material violation by the issuer, its officers, direc-

ever, the Commission declined to adopt the attorney “noisy withdrawal” provisions as proposed by the SEC in an earlier release.<sup>16</sup> Under this proposal, if the corporate client refused to take appropriate corrective action after counsel dutifully went “up the ladder,” counsel was obliged to make a “noisy withdrawal,” notifying the SEC that such counsel disaffirmed documents that he or she had prepared during the course of the representation.<sup>17</sup>

The making of a noisy withdrawal, of course, sounds a siren that fraud or other grievous misconduct likely is afoot. Corporate fiduciaries and the securities bar (as well as such groups as the American Bar Association) reacted with alarm, asserting that such a noisy withdrawal mandate would

---

tors, employees or agents and, if it determines an investigation is necessary or appropriate, to:

(A) Notify the audit committee or the full board of directors;

(B) Initiate an investigation, which may be conducted either by the chief legal officer (or the equivalent thereof) or by outside attorneys; and

(C) Retain such additional expert personnel as the committee deems necessary; and

(iii) At the conclusion of any such investigation, to:

(A) Recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and

(B) Inform the chief legal officer and the chief executive officer (or the equivalents thereof) and the board of directors of the results of any such investigation under this section and the appropriate remedial measures to be adopted; and

(4) Has the authority and responsibility, acting by majority vote, to take all other appropriate action, including the authority to notify the Commission in the event that the issuer fails in any material respect to implement an appropriate response that the qualified legal compliance committee has recommended the issuer to take.

17 C.F.R. § 205.2(k). At this time, it appears that the QLCC option may not be widely adopted. *See Rachel McTague & Michael Brady, QLCC Option in New Conduct Rule Could Be Disadvantage to Corporate G.C.*, 35 *Sec. Reg. & L. Rep.* (BNA) 354 (2003).

16. *See Exchange Act Release No. 47,276* (extending the comment period with respect to the “noisy withdrawal” provision); *Exchange Act Release No. 46,868, Fed. Sec. L. Rep.* (CCH) ¶ 86,802 (Nov. 21, 2002) (proposing “noisy withdrawal” mandate).

17. *See Exchange Act Release No. 46,868* (setting forth proposed § 205.3(d)). As used in the proposed rule, “disaffirm” means:

Disaffirm to the Commission, in writing, any opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the Commission, or incorporated into such a document, that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading.

*Id.* at ¶ 86,541.

drive a wedge between attorneys and corporate insiders.<sup>18</sup> Afraid that counsel would “blow the whistle” (albeit by action rather than words), constituents of the business enterprise would be reluctant to seek legal advice on troubling subjects.<sup>19</sup> Thus, the proposed provision, according to opponents, would be quite detrimental.<sup>20</sup> Proponents favoring a noisy withdrawal provision, on the other hand, assert that counsel must have this leverage in order to better ensure that corrective action is taken, thereby protecting the corporate client, its shareholders, and creditors. Hence, faced with the reality that counsel must make a noisy withdrawal if appropriate steps are not undertaken, corporate insiders will be “persuaded” to act in compliance with the law.<sup>21</sup>

At this time, the SEC is still considering adoption of the noisy withdrawal provision along with certain alternatives.<sup>22</sup> One of these alternatives would require the affected company (rather than counsel) to notify the Commission of the attorney’s withdrawal from representation on the basis that such counsel did not receive a suitable response to a report concerning a material violation.<sup>23</sup> If the Commission adopts this latter proposal, the rate of corporate adherence thereto may well be problematic.

## II. STATE ETHICAL RULES

Today, at least 42 states, including Wyoming,<sup>24</sup> permit or require an attorney to reveal a client’s crime or fraud that threatens substantial financial loss.<sup>25</sup> Moreover, many states allow a lawyer under certain conditions to reveal client confidences in order to rectify financial harm.<sup>26</sup> In this respect,

---

18. See sources cited *supra* notes 7-8.

19. See, e.g., Thirty Prominent Securities Lawyers Tell SEC Reporting Proposal Threatens Public Firms, 34 Sec. Reg. & L. Rep. (BNA) 1947 (2002).

20. *Id.* at 1947 (asserting that the proposed rule “would impair [the] ability to render independent legal advice”).

21. See Comment Letter to the SEC from Professor Susan P. Koniak, Roger C. Cramton and George M. Cohen (December 2002).

22. See Exchange Act Release No. 47,282, Fed. Sec. L. Rep. (CCH) ¶ 86,824 (January 29, 2003).

23. *Id.* at ¶ 87,117 (setting forth alternative proposal requiring “an issuer (rather than its attorney) to report to the Commission an attorney’s written notice of withdrawal or failure to receive an appropriate response . . .”).

24. See WYOMING RULES OF PROF’L CONDUCT R. 1.6(b)(1) (2003) (allowing such disclosure “to prevent the client from committing a criminal act”).

25. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 67 (2000).

26. See, e.g., TEXAS DISCIPLINARY RULES OF PROFESSIONAL CONDUCT R. 1.05(c)(7)-(8) (2003). The rule states:

A lawyer may reveal confidential information . . . [w]hen the lawyer has reason to believe it is necessary to do so in order to prevent the client from committing a criminal or fraudulent act . . . [or t]o the extent revelation reasonably appears necessary to rectify the consequences of a client’s criminal or fraudulent act in the commission of which the lawyer’s services had been used.

the SEC standards adopted in January 2003 generally are consistent with these state ethical standards.<sup>27</sup> They only will have an impact in states, such as California,<sup>28</sup> which prohibit counsel's disclosure of client confidences and secrets in situations involving financial harm.<sup>29</sup>

Moreover, as set forth in the January 2003 rule adoption, the SEC's position is similar to that of the American Bar Association (ABA) with respect to the noisy withdrawal issue. The key difference is that the ABA permits a noisy withdrawal to be made only if the client's fraud is ongoing.<sup>30</sup> According to the ABA, "[w]hen a lawyer's services have been used in the past by a client to perpetrate a fraud, but the fraud has ceased . . . a 'noisy' withdrawal is not permitted."<sup>31</sup> Irrespective of the ABA's position, the SEC

*Id.*

27. See Section 205.3(d)(2) of the SEC's Standards:

An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:

(i) To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;

(ii) To prevent the issuer, in a Commission investigation or administrative proceeding from committing perjury, proscribed in 18 U.S.C. 1621; suborning perjury, proscribed in 18 U.S.C. 1622; or committing any act proscribed in 18 U.S.C. 1001 that is likely to perpetrate a fraud upon the Commission; or

(iii) To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney's services were used.

Exchange Act Release No. 47,272, Fed. Sec. L. Rep. (CCH) ¶ 86,823 at 87,090 (January 29, 2003) (to be codified at 17 C.F.R. § 205.3(d)(2)). See generally Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on the Legal and Ethical Issues*, 58 BUS. LAW. 143 (2002).

28. See CAL. BUS. AND PROF. CODE § 6068(e), which states: "It is the duty of an attorney . . . to maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client"; see also California State Bar Standing Comm. on Prof'l Responsibility and Conduct, Formal Op. 1996-146 (1996).

29. See MODEL RULES OF PROF'L CONDUCT R. 1.6(a) (2002); C. WOLFRAM, MODERN LEGAL ETHICS § 6.7 (1986); M. STEINBERG, LAWYERING AND ETHICS FOR THE BUSINESS ATTORNEY 15-29 (2002).

30. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 92-366 (1992) (setting forth the limited instances in which an attorney may "disaffirm documents prepared in the course of the representation that are being, or will be, used in furtherance of [a] fraud, even though such a 'noisy' withdrawal may have the collateral effect of inferentially revealing client confidences").

31. *Id.* See N.Y. CODE OF PROF'L RESPONSIBILITY DR 4-101(c)(5) (2003) (setting forth that a "lawyer may reveal . . . [c]onfidences or secrets to the extent implicit in withdrawing a written or oral opinion or representation previously given by the lawyer and believed by the

and several states authorize the attorney to make a noisy withdrawal if the client employed such attorney's services to perpetrate a now-completed crime or fraud.<sup>32</sup>

Importantly, even under the ABA standards, an attorney commits an ethical violation by counseling or assisting a client in conduct that the attorney knows is fraudulent.<sup>33</sup> Moreover, depending on the circumstances, an attorney who discovers that a disclosure document that she drafted is materially false and is being relied upon by investors to their financial detriment may not simply withdraw from the representation. That alone may not be sufficient. In such situations, counsel may have to disaffirm her work product, hence making a noisy withdrawal, in order to effectuate the withdrawal. As stated in an ABA Formal Opinion, "where the client avowedly intends to continue to use the lawyer's work product, this amounts to a *de facto* continuation of representation even if the lawyer has ceased to perform any additional work."<sup>34</sup> Hence, "[t]he representation is not completed, any more than the fraud itself is completed."<sup>35</sup>

---

lawyer still to be relied upon by a third person where the lawyer has discovered that the opinion or representation was based on materially inaccurate information or is being used to further a crime or fraud").

32. See *supra* notes 26-27 and accompanying text. See also, RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 67 (2000), which states:

(1) A lawyer may use or disclose confidential client information when the lawyer reasonably believes that its use or disclosure is necessary to prevent a crime or fraud, and:

(a) the crime or fraud threatens substantial financial loss;

(b) the loss has not yet occurred;

(c) the lawyer's client intends to commit the crime or fraud either personally or through a third person; and

(d) the client has employed or is employing the lawyer's services in the matter in which the crime or fraud is committed.

(2) If a crime or fraud described in Subsection (1) has already occurred, a lawyer may use or disclose confidential client information when the lawyer reasonably believes its use or disclosure is necessary to prevent, rectify, or mitigate the loss.

33. Model Rules of Prof'l Conduct R. 1.2(d) (2003). *Accord*, WYOMING RULES OF PROF'L CONDUCT R. 1.2(d) (2003).

34. ABA Formal Opinion 92-366, *supra* note 30 (emphasis added).

35. *Id.* See also, WYOMING RULES OF PROF'L CONDUCT R. 1.2 cmt. (2003):

A lawyer is required to give an honest opinion about the actual consequences that appear likely to result from a client's conduct. The fact that a client uses advice in a course of action that is criminal or fraudulent does not, of itself, make a lawyer a party to the course of action. However, a lawyer may not knowingly assist a client in criminal or fraudulent conduct. There is a critical distinction between presenting an analysis of



### III. FEDERAL SECURITIES LAW STANDARDS

Although aiding and abetting liability may not be incurred in private actions under the federal securities laws,<sup>36</sup> attorneys who knowingly<sup>37</sup> make material misstatements in opinion letters, disclosure documents, and similar materials are at risk.<sup>38</sup> With respect to attorney opinion letters, federal courts uniformly hold that primary liability is appropriate (provided that the elements of the subject claim are proven).<sup>39</sup> Regarding counsel's role in knowingly drafting materially false corporate client disclosures, such as in an offering document<sup>40</sup> or in a periodic report filed with the SEC,<sup>41</sup> an increasing number of federal district and appellate courts have ruled that counsel is subject to primary liability exposure.<sup>42</sup> Moreover, in SEC enforcement ac-

---

legal aspects of questionable conduct and recommending the means by which a crime or fraud might be committed with impunity. When the client's course of action has already begun and is continuing, the lawyer's responsibility is especially delicate. The lawyer is not permitted to reveal the client's wrongdoing, except where permitted by Rule 1.6. However, the lawyer is required to avoid furthering the purpose, for example, by suggesting how it might be concealed. A lawyer may not continue assisting a client in conduct that the lawyer originally supposes is legally proper but then discovers is criminal or fraudulent. Withdrawal from the representation, therefore, may be required.

*Id.*

36. See *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994). See also Marc I. Steinberg, *The Ramifications of Recent U.S. Supreme Court Decisions on Federal and State Securities Regulation*, 70 NOTRE DAME L. REV. 489 (1995).

37. The term "knowing" in this context generally encompasses intentional and reckless misconduct. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990) (en banc).

38. See MARC I. STEINBERG, *CORPORATE AND SECURITIES MALPRACTICE* 45-188 (1992).

39. See e.g., *Kline v. First Western Government Securities, Inc.*, 24 F.3d 480 (3rd Cir. 1994); *Ackerman v. Schwartz*, 947 F.2d 841 (7th Cir. 1991).

40. Offering documents include, for example, a private placement memorandum (PPM) and a Securities Act registration statement (including the prospectus, which forms a part of the registration statement).

41. Generally, the annual report is a Form 10-K, quarterly reports are filed on a Form 10-Q, and current reports are filed on a Form 8-K. See generally MARC I. STEINBERG, *UNDERSTANDING SECURITIES LAW* (3d ed. 2001).

42. See, e.g., *Rubin v. Shottenstein, Zox, & Dunn*, 143 F.3d 263, 268 (6th Cir. 1998) (stating "while an attorney representing the seller in a securities transaction may not always be under an independent duty to volunteer information about a 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"); *Klein v. Boyd*, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,136, at 90,318 (Feb. 12, 1998), *rehearing en banc granted, judgment vacated*, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,165 (Mar. 9, 1998) (holding "that a lawyer who can fairly be characterized as an author or a co-author of a client's fraudulent document may be held primarily liable to a third-party investor under the federal securities laws for the material misstatements or omissions, contained in the document, even when the lawyer did not sign or endorse the document and the investor is therefore unaware of the lawyer's role in the fraud"); *Trust Co. of Louisiana v. N.N.P. Inc.*, 104 F.3d 1478 (5th Cir. 1997) (holding lawyer and his firm primarily liable for claiming his law firm was in possession of certain certificates, when in fact the lawyer knew that this was false); *In re Enron*

tions, counsel engaging in such misconduct may incur liability as either a primary or secondary violator,<sup>43</sup> with the levying of such sanctions as a bar from practicing before the Commission, money penalty, injunction, and cease-and-desist order.<sup>44</sup> Criminal prosecution by the U.S. Attorney also may be pursued.<sup>45</sup>

An attorney, who knowingly drafts materially misleading disclosure to investors, such disclosure being “alive” in the marketplace,<sup>46</sup> does not reduce liability exposure by simply resigning from the representation. Indeed, in such circumstances, even a noisy withdrawal would not eliminate liability if such disclosure had reached investors. In such circumstances, by making a noisy withdrawal prior to “public” dissemination of the knowingly false material disclosures, the subject attorney would be in a better situation to minimize or avoid liability.<sup>47</sup>

#### IV. STATE SECURITIES AND COMMON LAW

Under state securities and common law, attorneys who advise clients that engage in fraud or other illegal conduct may incur liability.<sup>48</sup> For exam-

---

Corp. Securities, Derivative & ERISA Litigation, 235 F. Supp. 2d 549, 692 (S.D. Tex. 2002) (holding that “when a person, acting alone or with others, creates a misrepresentation . . . the person can be liable as a primary violator”). *But see* Ziemba v. Cascade International, Inc., 256 F.3d 1194 (11th Cir. 2001) (holding that a lawyer’s, or a law firm’s, misstatement or omission must have been both relied upon by the plaintiff and publicly attributable to the defendant at the time the plaintiff made its investment decision). *See generally* Mark Klock, *Two Possible Answers to the Enron Experience: Will It Be Regulation of Fortune Tellers or Rebirth of Secondary Liability?*, 28 J. CORP. L. 69 (2002); Marc I. Steinberg & Noah K. Hansford, *The Plight of “Secondary Actors” Under Section 10(b): Distinguishing Primary from Secondary Liability*, 28 SEC. REG. L. J. 36 (2000).

43. The SEC has both aiding and abetting and cease and desist authority in its arsenal. *See, e.g.*, In the Matter of Jean Costanza, Securities Act Release No. 7621, (January 6, 1999) (negligent violations of § 17(a)(2) and § 17(a)(3) of 1933 Act by bond counsel due to attorney’s negligent role in drafting offering documents and negligent rendering of legal opinion).

44. *See generally* MARC I. STEINBERG & R. FERRARA, *SECURITIES PRACTICE: FEDERAL AND STATE ENFORCEMENT* (2d ed. Supp. 2001 & 2002).

45. *See, e.g.*, Section 32(a) of the Securities Exchange Act, codified at 15 U.S.C. § 78ff (2000).

46. *Backman v. Polaroid Corp.*, 910 F.2d 10, 17 (1st Cir. 1990) (en banc).

47. *See supra* notes 30-35 and accompanying text. *See generally* Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry Into Lawyers’ Responsibility for Clients’ Fraud*, 46 VAND. L. REV. 75 (1993); Richard W. Painter & Jennifer E. Duggan, *Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation*, 50 SMU L. REV. 225 (1996); Richard M. Phillips, *Client Fraud and the Securities Lawyer’s Duty of Confidentiality*, 49 WASH. & LEE L. REV. 823 (1992); Larry P. Scriggins, *Legal Ethics, Confidentiality, and the Organizational Client*, 58 BUS. LAW. 123 (2002); William H. Simon, *Whom (or What) Does the Organization’s Lawyer Represent?: An Anatomy of Intraclient Conflict*, 91 CAL. L. REV. 57 (2003); Marc I. Steinberg, *Attorney Liability for Client Fraud*, 1991 COLUM. BUS. L. REV. 1 (1991).

48. *See generally*, Joseph C. LONG, *BLUE SKY LAW* (2002); MARC I. STEINBERG, *SECURITIES REGULATION: LIABILITIES AND REMEDIES* § 9.06 (2002); Douglas M. Branson, *Collateral Participant Liability Under State Securities Laws*, 19 PEPP. L. REV. 1027 (1992);

ple, a number of states hold that an attorney who drafts a materially misleading offering document is a "seller" under the applicable state securities statute,<sup>49</sup> signifying that he must establish the exercise of reasonable care in order to avoid liability.<sup>50</sup> Additionally, counsel who recklessly advises a client with respect to a securities transaction, through drafting or other similar means, may be held liable in private actions as an aider under state securities statutes.<sup>51</sup> Hence, unlike federal law, many state securities statutes explicitly impose liability upon secondary violators.<sup>52</sup> State securities regulators also may initiate actions against attorneys in this context.<sup>53</sup>

Attorney liability under state common law also exists in this context. For example, under Delaware law, a corporate fiduciary has a duty of candor to the corporation's shareholders.<sup>54</sup> This fiduciary obligation applies in contexts where shareholder action is called for<sup>55</sup> and when no such action is requested.<sup>56</sup> An attorney who knowingly counsels a client to engage in a disclosure violation thus may be held liable as aiding and abetting the fiduciary's breach.<sup>57</sup>

Similarly, an attorney who drafts materially misleading disclosures may be subject to liability for negligent misrepresentation<sup>58</sup> and for fraud,<sup>59</sup> provided that the requisite elements of the applicable claim can be shown.<sup>60</sup> Hence, under state law, an attorney who is involved in a representation where deficient disclosure is transmitted to investors is at risk. Merely withdrawing from the representation after the materially false representations

Joseph C. Long, *Developments and Issues in Civil Liability Under Blue Sky Law*, 62 U. Cin. L. Rev. 439 (1993); Keith A. Rowley, *The Sky Is Still Blue in Texas: State Law Alternatives to Federal Securities Remedies*, 50 BAYLOR L. REV. 99 (1998); Symposium, *The Lawyer's Duties and Liabilities to Third Parties*, 37 S. TEX. L. REV. No. 4 (1996).

49. See, e.g., *Prince v. Brydon*, 764 P.2d 1370 (Or. 1988).

50. See Uniform Securities Act (USA) § 410(a)(2) (1956); § 605(b)(2) (1985).

51. See, e.g., ARIZ. REV. STAT. ANN. § 44-2003 (West 2003); OHIO REV. CODE ANN. § 1707.43 (West 2002).

52. See, e.g., Texas Securities Act, TEX. REV. CIV. STAT. ANN. art. 581, § 33F(2) (Vernon 2001).

53. See LONG, BLUE SKY LAW, *supra* note 48, at § 7.07[2][b][ii].

54. See Lawrence A. Hamermesh, *Calling Off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087 (1996); Mark Klock, *Litigating Securities Fraud as a Breach of Fiduciary Duty in Delaware*, 28 SEC. REG. L. J. 296 (2000); Marc I. Steinberg, *Short-Form Mergers in Delaware*, 27 DEL. J. CORP. L. 489 (2002).

55. *Lynch v. Vickers Energy Corp.*, 383 A.2d 278, 279 (Del. 1978).

56. *Malone v. Brincat*, 722 A.2d 5, 14 (Del. 1998).

57. See *Bernstein v. Portland Sav. and Loan Ass'n*, 850 S.W.2d 694 (Tex. App. 1993).

58. See *McCamish, Martin, Brown & Loeffler v. F.E. Applying Interests*, 991 S.W.2d 787 (Tex. 1999); *H. Rosenblum, Inc. v. Adler*, 461 A.2d 138 (N.J. 1983); *Zendell v. Newport Oil Corp.*, 544 A.2d 878 (N.J. Super. Ct. App. Div. 1988); RESTATEMENT (SECOND) OF TORTS § 552 (1977).

59. See *Fassihi v. Sommers, Schwartz, Silver, Schwartz & Tyler, P.C.*, 309 N.W.2d 645 (Mich. Ct. App. 1981).

60. *Id.* at 649; see also cases cited *supra* note 58.

reach investors and are “alive” in the marketplace may not be sufficient to avoid liability.<sup>61</sup>

The impact of state law liability exposure in private actions is lessened by Congress’ enactment of the Securities Litigation Uniform Standards Act of 1998.<sup>62</sup> This statute, with certain exceptions, preempts state law with respect to class actions<sup>63</sup> involving nationally traded securities.<sup>64</sup> Nonetheless, significant risk remains for attorneys under state law. For example, irrespective of the 1998 Act, attorneys are subject to suit in private actions in state court: (1) in individual actions; (2) where the subject security is not nationally traded; (3) where the alleged misconduct did not involve the subject plaintiff’s purchase or sale of a security, such as circumstances where no shareholder action is requested as in the filing of a Form 10-K with the SEC; (4) in shareholder derivative actions; and (5) in the merger and acquisi-

61. See *supra* notes 30-35 and accompanying text.

62. Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified at 15 U.S.C. § 78a). For literature on the Act, see Lisa L. Casey, *Shutting the Doors to State Court: The Securities Litigation Uniform Standards Act of 1998*, 27 SEC. REG. L. J. 141 (1999); David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California’s Blue Sky Laws*, 54 BUS. LAW. 1 (1998); Richard W. Painter, *Responding to a False Alarm: Federal Preemption of State Securities Fraud Causes of Action*, 84 CORNELL L. REV. 1 (1998).

63. Pursuant to the Act, a “covered class action” is :

(i) any single lawsuit in which –

(I) damages are sought on behalf of more than 50 persons or prospective class members, and questions of law or fact common to those persons or members of the prospective class, without reference to issues of individualized reliance on an alleged misstatement or omission, predominant over any questions affecting only individual persons or members; or

(II) one or more named parties seek to recover damages on a representative basis on behalf of themselves and other unnamed parties similarly situated, and questions of law or fact common to those persons or members of the prospective class predominate over any questions affecting only individual persons or members; or

(ii) any group of lawsuits filed in or pending in the same court and involving common questions of law or fact, in which –

(I) damages are sought on behalf of more than 50 persons; and

(II) the lawsuits are joined, consolidated, or otherwise proceed as a single action for any purpose.

Securities Litigation Uniform Standards Act, 15 U.S.C. § 16(f)(2)(A) (2000); and The Securities Exchange Act, 15 U.S.C. § 78bb(f)(5)(B) (2000).

64. The term national traded security or “covered security” means a security that meets the standards set forth in Section 18(b) of the Securities Act. 15 U.S.C. § 77r(b) (2000). These securities include those that are listed for trading on the New York Stock Exchange, American Stock Exchange, and the NASDAQ National Market System (NMS). *Id.* Securities issued by registered investment companies also are defined as nationally traded securities. *Id.*

tion setting, such as in going-private transactions, mergers, and tender offers.<sup>65</sup> Hence, state law will continue to serve as an attractive venue for plaintiffs seeking to hold lawyers liable for their alleged misconduct.<sup>66</sup>

#### V. THE ROLE OF CIRCUMSTANTIAL EVIDENCE

A lawyer involved in counseling a client involved in fraud or other illegal conduct is, of course, in a difficult position. Counseling appropriate corrective action is essential.<sup>67</sup> If the client declines to adhere to the lawyer's advice, withdrawal from the representation becomes a necessity.<sup>68</sup>

65. See The Uniform Standards Act § 101, 15; *Malone v. Brincat*, 722 A.2d 5 (Del. 1998); sources cited *supra* note 62. Note that the Act does not preempt the authority of state securities regulators.

66. See sources cited *supra* note 48.

67. See *supra* notes 11-15 and accompanying text.

68. See, e.g., WYOMING RULES OF PROF'L CONDUCT R. 1.16(a) (2003). A comment to the rule states, "A lawyer ordinarily must decline or withdraw from representation if the client demands that the lawyer engage in conduct that is illegal or violates the Rules of Professional Conduct or other law." Rule 1.16, cmt. As the SEC stated two decades ago:

We do not imply that a lawyer is obliged . . . to seek to correct every isolated disclosure action or inaction which he believes to be at variance with applicable disclosure standards, although there may be isolated disclosure failures that are so serious that their correction becomes a matter of primary professional concern. It is also clear, however, that a lawyer is not privileged to unthinkingly permit himself to be co-opted into an ongoing fraud and cast as a dupe or a shield for a wrong-doing client.

Initially, counseling accurate disclosure is sufficient, even if his advice is not accepted. However, there comes a point at which a reasonable lawyer must conclude that his advice is not being followed, or even sought in good faith, and that his client is involved in a continuing course of violating the securities laws. At this critical juncture, the lawyer must take further, more affirmative steps in order to avoid the inference that he has been co-opted, willingly or unwillingly, into the scheme of non-disclosure.

The lawyer is in the best position to choose his next step. Resignation is one option, although we recognize that other considerations, including the protection of the client against foreseeable prejudice, must be taken into account in the case of withdrawal. A direct approach to the board of directors or one or more individual directors or officers may be appropriate; or he may choose to try to enlist the aid of other members of the firm's management. What is required, in short, is some prompt action that leads to the conclusion that the lawyer is engaged in efforts to correct the underlying problem, rather than having capitulated to the desires of a strong-willed, but misguided client.

Some have argued that resignation is the only permissible course when a client chooses not to comply with disclosure advice. We do not agree. Premature resignation serves neither the end of an effective lawyer-client relationship nor, in most cases, the effective administration of the securities laws. The lawyer's continued interaction with his client will ordinarily hold the greatest promise of corrective action. So long as a lawyer is

Nevertheless, if the attorney's work product is being used by the client to perpetrate an ongoing fraud, withdrawal alone under certain circumstances may not be sufficient. This is so even if the attorney was unaware of the fraud when rendering her assistance to the client.<sup>69</sup>

In assessing the practical realities, the role of circumstantial evidence is often key.<sup>70</sup> Frequently, to avoid liability the attorney must be viewed as credible by the fact finder. Plaintiffs will allege that, due to the massive fraud that was perpetrated, the attorney "must" have known of the pertinent circumstances at the time of the engagement. In certain situations, other alleged violators will claim that they relied upon the attorney for legal counsel and that the attorney was informed of all the material facts. The generous legal fees that lawyers receive may provide the plaintiffs with ammunition for asserting a motive underlying the alleged misconduct. When counsel has an equity stake in the client, this arrangement will be prominently displayed before the jury.<sup>71</sup> Not surprisingly, if the question of the

---

acting in good faith and exerting reasonable efforts to prevent violations of the law by his client, his professional obligations have been met. In general, the best result is that which promotes the continued, strong-minded and independent participation by the lawyer.

We recognize, however, that the "best result" is not always obtainable, and that there may occur situations where the lawyer must conclude that the misconduct is so extreme or irretrievable, or the involvement of his client's management and board of directors in the misconduct is so thorough-going and pervasive that any action short of resignation would be futile. We would anticipate that cases where a lawyer has no choice but to resign would be rare and of an egregious nature.

*In re Carter and Johnson*, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,172-73 (Feb. 26, 1981).

69. See *supra* notes 30-35 and accompanying text.

70. See *S.E.C. v. Sargent*, 229 F.3d 68, 75 (1st Cir. 2000) (stating, "Circumstantial evidence, if it meets all the other criteria of admissibility, is just as appropriate as direct evidence . . .").

71. See ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 00-418 (2000) (stating that attorneys who enter these fee arrangements "inform the client that events following the stock acquisition could create a conflict between the lawyer's exercise of her independent professional judgment as a lawyer on behalf of the corporation and her desire to protect the value of her stock," and that "[t]he best way to comply with the requirements of Rule 1.8(a) is to set forth the salient terms of the transaction in a document written in a language that the client can understand and, after the client has had an opportunity to consult with independent counsel, to have the document signed by both client and lawyer"). See also, Formal Opinion 2003-3 of the Association of the Bar of the City of New York, Committee on Professional and Judicial Ethics (2000). See generally Jason M. Klein, *No Fool for a Client: The Finance and Incentives Behind Stock-Based Compensation for Corporate Attorneys*, 1999 COLUM. BUS. L. REV. 329 (1999); Gwyneth E. McAlpine, *Getting a Piece of the Action: Should Lawyers Be Allowed to Invest in Their Clients' Stock?*, 47 UCLA L. REV. 549 (1999); Poonam Puri, *Taking Stock of Taking Stock*, 87 CORNELL L. REV. 99 (2001).

lawyer's knowledge is one for the jury, the subject lawyer should have great concern.<sup>72</sup>

## VI. RECOMMENDED COURSE OF ACTION

Regardless whether the SEC elects to adopt a noisy withdrawal or similar rule, counsel who withdraws from representing a client committing fraud or other illegal conduct would be prudent to do more than "quietly" resign. In such circumstances, it may be appropriate for the attorney to inform the SEC, the applicable state regulator, and/or investors of counsel's withdrawal. No more need be stated in the communication. No client confidence or secret must be revealed. The fact of the communication alone should serve as a "red flag" to government authorities and reasonable investors that illegal or unethical conduct may be present. As importantly, the threat by the attorney to the client that counsel will make this communication if the client fails to take corrective action acts as a powerful measure to induce client compliance. This leverage may well be necessary to avert fraud or illegality, investor financial loss, and the imposition of liability.<sup>73</sup>

Critics of this recommendation perceptively assert that the issues involved in disclosure determinations, such as materiality,<sup>74</sup> often are problematic. Rather than a clear duty to disclose, variations in the "gray" zone often arise. Without the benefit of hindsight, an attorney's good faith interpretation may prove erroneous. Indeed, public knowledge of an attorney's noisy withdrawal may cause the market price of the subject company's stock to plummet. If counsel is mistaken as to the commission of a material violation (when no such violation exists), claims for attorney malpractice, among others, may ensue. Hence, in practical effect, in order to comply with the applicable ethical norms and act in the corporate client's best interests, counsel must be certain that fraud or other major impropriety is afoot before making a noisy withdrawal. Unfortunately, as critics observe, certainty does not frequently prevail in the "real world."<sup>75</sup>

The solution to this dilemma is rather straightforward. In situations where an attorney counsels that the corporate client must undertake certain corrective action and that advice is resisted by the independent directors of

---

72. See, e.g., George D. Reycraft, *Conflicts of Interest and Effective Representation: The Dilemma of Corporate Counsel*, 39 HASTINGS L.J. 605 (1988).

73. See *supra* notes 18-21 and accompanying text. See also Charles P. Axelrod, *A View of the SEC's Proposed Attorney Responsibility Rules Under Sarbanes-Oxley*, 34 Sec. Reg. & L. Rep. (BNA) 2053, 2059 (2002).

74. Compare *Ganino v. Citizens Utilities Co.*, 228 F.3d 154 (2nd Cir. 2000), with *Parnes v. Gateway 2000, Inc.*, 122 F.3d 539 (8th Cir. 1997). See also SEC Staff Accounting Bulletin 99, 64 Fed. Reg. 45,150 (Aug. 19, 1999). See generally Hodges, *The Qualitative Considerations of Materiality: The Emerging Relationship Between Materiality and Scierter*, 30 SEC. REG. L. J. 4 (2002).

75. See Schwartz, *Lawyer Rules Go Too Far*, NAT. L. J., Dec. 16, 2002, at A13.

the board of directors, counsel should insist that the client procure an independent "second opinion" from an accomplished lawyer (or law firm).<sup>76</sup> Although such a second opinion may be costly, may bruise counsel's ego, and may pose a threat that the second opining law firm will "steal" the client, this solution has been recognized for decades and is now firmly entrenched in ethical norms.<sup>77</sup> Indeed, the SEC standards adopted allow for the procurement of a second opinion.<sup>78</sup> The employment of attorney second opinions thus is a sound practice to help persuade corporate insiders that appropriate corrective action is required and serves as a meaningful protective mechanism to minimize attorney liability. Hence, use of the "second opinion" in this context normally will enhance the accuracy of the legal advice rendered, thereby serving the best interests of both client and counsel.<sup>79</sup>

---

76. See *ABA Panelists Assess How Sarbanes-Oxley SEC Rules Will Change Practice and Ethics*, 35 *Sec. Reg. & L. Rep.* (BNA) 312, 312 (2003) (quoting SEC Chief Litigation Counsel David Kornblau that "obtain[ing] an opinion from outside counsel" would be advisable in certain circumstances). Such a second opinion should focus on whether the reporting lawyer's belief regarding evidence of a material violation is reasonably likely to be valid.

77. See, e.g., WYOMING RULES OF PROF'L CONDUCT R. 1.13(b)(2) (2003); MODEL RULES OF PROF'L CONDUCT R. 1.13(b)(2) (2003).

78. See *Implementation of Standards of Professional Conduct for Attorneys*, Exchange Act Release No. 47,276, Fed. Sec. L. Rep. (CCH) ¶ 86,823, at 87,105-106, 87,108 (January 29, 2003) (to be codified at 17 C.F.R. §§ 205.2(b), 205.3(b)(6)(ii)). SEC Standards §§ 205.2(b), 205.3(b)(6)(ii); Securities Exchange Act Release No. 47276 (2003). At this time, the SEC employs the term "colorable defense" in this context. Such a vague and weak standard would seem to be counterproductive. See Comment Letter from Professors Susan P. Koniak, Roger C. Cramton and George H Cohen, File No. S7-45-02 (April 2003).

79. As this author opined twenty years ago:

[T]he second opinion is not recommended as a "sure-proof" mechanism. Its greatest attribute, however, is its precautionary deliberative nature. For clients who desire to procure such an opinion, it may well work to their ultimate benefit. For lawyers, the second opinion may lower the risks of successful malpractice claims and may even lower the costs of malpractice insurance premiums.

Sporkin & Steinberg, *Second Opinion for Lawyers – The 'Consultative Attorney,'* N.Y.L.J., Jan. 3, 1983, at 1, 3. See Editorial, *A Second Opinion*, NAT. L. J., Jan. 10, 1983, at 12 ("We agree with Mr. Sporkin and Mr. Steinberg that the concept is a good one, and that attorneys should be open to its use in the future."). See also, Marc I. Steinberg, *Attorney Conflicts of Interest in Corporate Acquisitions*, 39 HASTINGS L.J. 579, 586-88 (1988).



