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Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation

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LAWYER DISCLOSURE OF CORPORATE FRAUD: ESTABLISHING A FIRM FOUNDATION

*Richard W. Painter**
*Jennifer E. Duggan***

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** Associate, Porter, Scott, Weiberg and Delehant, Sacramento, California; J.D., University of Oregon 1996; B.A., University of California at Davis 1992; Editor-in-Chief, *Journal of Environmental Law and Litigation*, 1995-96. Portions of this Article are based on a presentation made at a symposium sponsored by the University of Oregon Law and Entrepreneurship Center on April 12, 1996 in Beaverton, Oregon.

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I. INTRODUCTION

Practicing securities law is becoming a risky, and for many lawyers, even a dangerous, profession.¹ Securities lawyers usually represent honest clients and are well paid for their work. However, the occasional dishonest client can wreak havoc on a lawyer's career, particularly when it is not clear what the lawyer must do to detect and disclose fraud. This uncertainty is all the more frightening given the willingness of private plaintiffs and the Securities and Exchange Commission ("SEC") to take action against a lawyer when a client's fraud is discovered.

One of the most intimidating threats is the specter of civil liability. Although not nearly as ominous for lawyers as for accountants,² civil lia-

1. "Lawyers practicing in high-risk fields such as banking, securities, and other heavily regulated areas are finding malpractice insurance unavailable or increasingly expensive." Jennifer J. Johnson, *Limited Liability for Lawyers: General Partners Need Not Apply*, 51 Bus. Law. 85, 88 (Nov. 1995).

2. See text accompanying notes 56-59 & 75-85 *infra*; see generally JAY M. FEINMAN, *ECONOMIC NEGLIGENCE: LIABILITY OF PROFESSIONALS AND BUSINESSES TO THIRD PARTIES FOR ECONOMIC LOSS* (1995) (analysis of civil liability for professionals).

bility under the securities laws remains a serious threat to lawyers. Even a lawsuit that never results in a judgment can have a potentially ruinous effect on a lawyer's reputation and career. This threat is compounded by the fact that a lawyer is uncertain of exactly what a judge or jury, with the luxury of hindsight, will decide should have been done about client fraud. Case law is surprisingly vague about what lawyers must do to detect and disclose fraud,³ even though a clearer articulation of lawyers' responsibilities would go a long way toward preventing professional lapses that give rise to litigation in the first place.

A second threat facing securities lawyers is the SEC's various mechanisms for sanctioning lawyers. First, Rule 2(e) disciplinary proceedings allow the SEC to suspend or disbar a lawyer from practice before the SEC for, among other things, conduct that shows the lawyer to be "lacking in character or integrity or to have engaged in unethical or improper professional conduct."⁴ Second, the SEC can enter cease and desist orders under the 1990 Remedies Act.⁵ Although such orders can only be issued against persons found to have committed or to have been the "cause" of a violation of the securities laws, the statutory language would potentially be open ended if the SEC and the courts began to embrace an expanded view of what type of conduct "causes" a violation to occur. Finally, the SEC has long believed itself to have, and has exercised, the power to prosecute aiders and abettors of securities laws violations, a power recently affirmed in the newly enacted Private Securities Litigation Reform Act of 1995 (the "1995 Reform Act").⁶

These SEC disciplinary and enforcement proceedings can be unpredictable and protracted,⁷ and are particularly threatening to lawyers because they almost always arise out of situations where a client's conduct, not the lawyer's, initiated the underlying violation. This additional layer of potential sanctions against lawyers beyond state bar disciplinary proceedings is also administered by an agency whose primary objective is protection of investors, not professional ethics. Indeed, the effect of enforcement proceedings against lawyers may be secondary in the minds of agency officials bent on doing anything necessary to combat fraud. Although the SEC's expertise in securities law makes it an appropriate

3. See text accompanying notes 106-12 *infra*; Susan P. Koniak, *When Courts Refuse to Frame the Law and Others Frame It to Their Will*, 66 S. CAL. L. REV. 1075, 1081 (1993) (courts fail to effectively resolve differences between regulators and bar associations about disclosure of client misconduct).

4. SEC Procedural Rules § 2(e)(1)(ii), 17 C.F.R. § 201.102(e)(1)(ii)(1996).

5. 15 U.S.C. § 77h-1 (1996) [hereinafter the Remedies Act]; 15 U.S.C. § 78u-3 (1996). The Securities Act of 1933, May 27, 1933, ch. 38, title 1, 48 Stat. 74, is codified at 15 U.S.C. § 77 [hereinafter the 1933 Act]. The Securities & Exchange Act of 1934, June 6, 1934, ch. 404, 48 Stat. 881, is codified in scattered sections of 15 U.S.C. § 78 [hereinafter the 1934 Act].

6. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 104, 109 Stat. 737 (to be codified in scattered sections of 15 U.S.C. § 78) [hereinafter 1995 Reform Act] (amending § 20 of the 1934 Act).

7. For example, the SEC's proceeding against George Kern, see text accompanying notes 127-33 *infra*, lasted for over two years.

figure to establish and enforce professional conduct norms, the wielding of such power should be coupled with a clear articulation of the expected standards for lawyer conduct. Because the SEC and the courts have been ambiguous on what a lawyer is required to disclose about a client's conduct and to whom, this Article suggests that recent changes in the securities laws should have included a clear set of rules delineating exactly what lawyers should do about client fraud.

By examining the 1995 Reform Act, Title III, Section 301, which requires accountants to follow specified procedures when confronted with corporate fraud,⁸ this Article discusses whether the 1995 Reform Act should have imposed similar disclosure obligations on lawyers. This Article concludes that the 1995 Reform Act should have clearly articulated *ex ante* what lawyers' responsibilities are, rather than leave those responsibilities up to determination by courts and the Commission *ex post*. Finally, this Article proposes statutory language which would establish some immutable rules of professional conduct and some default rules. The default rules would apply unless a registrant clearly instructs its attorneys differently in language appearing in its articles of incorporation.

Part II of this Article describes some of the most important private rights of action that have been used against accountants and lawyers, as well as the SEC's enforcement arsenal against professionals. Parts III and IV examine inconsistencies in the standards that have been applied to accountants and lawyers respectively and the need for clarification of those standards. Part V describes how unclear standards have caused unpredictable accountant and lawyer discipline at the hands of the SEC. Part VI looks at how the 1995 Reform Act, with the approval of the accounting profession, clarified what exactly an auditor must do in the face of client fraud, and explains how the difference between functions performed by accountants and lawyers is reflected in the inclusion of accountants, but not lawyers, in the 1995 Reform Act's procedures for detection and disclosure of corporate fraud.

Part VII presents a proposal to clarify the obligations of lawyers who confront client fraud. Although the responsibilities of lawyers should have been addressed in the 1995 Reform Act, lawyer disclosure of client fraud should be approached differently than the manner in which the 1995 Reform Act approaches accountant disclosure of client fraud. Whereas immutable disclosure rules are imposed on accountants in the 1995 Reform Act, this Article suggests that lawyers should be governed by *some* immutable rules, such as those requiring lawyers to resign if a client refuses to rectify a material illegal act, and *some* default rules that clients could change by amending their articles of incorporation to give more protection to client confidences.⁹ Lawyers who comply with the rules should come within a statutory safe harbor immunizing them from civil suits and SEC disciplinary actions grounded in a theory that they

8. 15 U.S.C. § 78j-1 (1996).

9. See text accompanying notes 216-48 *infra*.

failed to perform a duty to disclose. Part VIII briefly summarizes some of the advantages and disadvantages of our proposal.

II. PROFESSIONAL ACCOUNTABILITY UNDER THE SECURITIES LAWS

A. CIVIL LIABILITY

The civil liability of accountants, lawyers, and other professionals is becoming an increasingly ominous specter in securities law. Professionals and their insurers are often believed to be "deep pockets" in situations where the issuer of securities, its promoters, and its principals are long gone, whether having flown the jurisdiction literally or figuratively by way of insolvency. The number of settlements of cases involving professionals grew at an annual rate of about 18.4% from 1989 to 1994.¹⁰ Indeed, a 1993 study of securities class actions found that including lawyers, accountants, or underwriters as codefendants added over 50% to a case's expected settlement value.¹¹ Although this Article will not explore all the possible variants of professional liability under the securities laws, two of the most important causes of action, those under Section 11 of the 1933 Securities Act (the "1933 Act") and Section 10(b) of the 1934 Securities Exchange Act (the "1934 Act") are worth mentioning.

Section 11 of the 1933 Act imposes liability on certain persons for a material misrepresentation or omission in a registration statement.¹² A purchaser of registered shares can sue under this section if, when a registration statement has become effective, the registration statement "contained an untrue statement of a material fact or omitted a material fact" necessary to make the statements made not misleading.¹³ The purchaser can sue the issuer, all persons who sign the registration statement, directors and partners of the issuer, and persons about to become directors or partners of the issuer.¹⁴

Section 11 also allows a purchaser to sue certain experts, including accountants who certify financial statements.¹⁵ This includes:

[E]very accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration state-

10. Steven P. Marino & Renée D. Marino, *An Empirical Study of Recent Securities Class Action Settlements Involving Accountants, Attorneys, or Underwriters*, 22 SEC. REG. L. J. 115, 131 (1994).

11. *Id.* at 117.

12. 1933 Act, *supra* note 5, § 11(1) (codified at 15 U.S.C. § 77k).

13. 1933 Act, *supra* note 5, § 11 (1).

14. 1933 Act, *supra* note 5, § 11(1)-(5).

15. 1933 Act, *supra* note 5, § 11(1)-(5). Financial statements include three principal statements of a company's financial condition: (1) the balance sheet; (2) income statement; and (3) statement of change in working capital. See Edward J. Yodowitz et al., *An Overview of Financial Statement Litigation*, in EMPLOYMENT LITIGATION 1985, at 115, 121 (PLI Litig. & Admin. Practice Course Handbook Series No. 492, 1985).

ment, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him.¹⁶

Noticeably absent from the enumerated list of professional defendants in Section 11 are the class of professionals who had a prominent role in drafting the 1933 Act but who, apart from narrowly crafted opinion letters, carefully avoid being named as experts in connection with a registration statement—lawyers.

Professionals may also be liable for securities fraud under Section 10-b of the 1934 Act and Rule 10-b-5 thereunder.¹⁷ Unlike Section 11, which predicates liability on a professional defendant allowing herself to be named in a registration statement, Section 10-b potentially reaches professionals, including lawyers, in a broad range of circumstances where they participate in a client's fraud. Two questions that have arisen under Section 10-b are: (1) whether a defendant can be liable for merely negligent, but not knowing or reckless, conduct, and (2) whether a defendant can be liable for aiding and abetting a fraud perpetrated by another person. The Supreme Court has answered both questions in the negative.

In *Ernst & Ernst v. Hochfelder*, respondents, customers of a brokerage firm audited by the Ernst & Ernst accounting firm, invested in a fraudulent securities scheme.¹⁸ When the fraud came to light, the respondents sued under Section 10-b. The Supreme Court held that a Section 10-b action required an allegation of intent to deceive, manipulate, or defraud.¹⁹ The Court relied on the "operative language of the statute" as well as the legislative history:

It is difficult to believe that any lawyer, legislative draftsman, or legislator would use these words if the intent was to create liability for merely negligent acts or omissions. Neither the legislative history nor the briefs supporting respondents identify any usage or authority for construing 'manipulative (or cunning) devices' to include negligence.²⁰

The Court thus dismissed the respondents' claim which had been brought under a negligence theory, but left for another day the decision of whether recklessness would meet the scienter requirement.²¹

In 1994, the Supreme Court addressed aiding and abetting liability under Section 10-b in *Central Bank v. First Interstate Bank*.²² Prior decisions had left open the question of whether private civil liability under

16. 1933 Act, *supra* note 5, § 11(4).

17. See *Fine v. American Solar King Corp.*, 919 F.2d 290, 297 (5th Cir. 1990) (triable issue of fact raised as to whether accounting firm had knowledge or was severely reckless in issuing false and misleading audit report); *Akin v. Q-L Inv., Inc.*, 959 F.2d 521, 526 (5th Cir. 1992) (triable issue of fact raised as to whether accountants intentionally or recklessly deceived investors when they failed to disclose certain items in audit report).

18. 425 U.S. 185 (1976).

19. *Id.* at 193.

20. *Id.* at 199, 203.

21. *Id.* at 194, n.12.

22. 511 U.S. 164 (1994).

Section 10-b could be extended to persons who, while not primary violators, aided and abetted another person's violation of Section 10-b.²³ The Court again applied a narrow reading of the statute and held that its prohibition of "manipulative and deceptive" conduct "does not include giving aid to a person who commits a manipulative or deceptive act."²⁴ The Court observed: "We cannot amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute."²⁵ Thus, after *Central Bank*, private plaintiffs will have to demonstrate that accountants or lawyers themselves committed fraud when suing them under Section 10-b of the 1934 Act.²⁶

B. THE SEC ENFORCEMENT ARSENAL AGAINST PROFESSIONALS

With the Supreme Court's limitation of Section 10-b civil liability to knowing or reckless conduct that amounts to a primary violation, the SEC's enforcement arsenal against professionals becomes all the more important as a deterrent to professional malfeasance or omission. Indeed, the narrower scope of civil liability may encourage the SEC to fill the perceived void with stepped up enforcement actions.

In addition to prosecuting primary violations of the securities laws,²⁷ the SEC may sanction professionals in a variety of ways, including Rule 2(e) disciplinary proceedings, cease and desist orders, or using its authority to prosecute aiders and abettors under the 1995 Reform Act.²⁸ Proceedings brought under each of these provisions are discussed more completely in Part V below.

1. Rule 2(e) Disciplinary Proceedings

SEC Rule 2(e) proceedings are more common than proceedings against professionals by other administrative agencies, although infre-

23. "In view of our holding that an intent to deceive, manipulate, or defraud is required for civil liability under § 10(b) and Rule 10b-5, we need not consider whether civil liability for aiding and abetting is appropriate under the section and the Rule, nor the elements necessary to establish such a cause of action." *Ernst & Ernst*, 425 U.S. at 191-92 n.7. "While several courts of appeals have permitted aider-and-abettor liability, see *IIT, An International Investment Trust v. Cornfeld*, 619 F.2d 909, 922 (CA2 1980) (collecting cases), we specifically reserved this issue in *Ernst & Ernst v. Hochfelder*." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 379 n.5 (1983).

24. *Central Bank*, 511 U.S. at 177.

25. *Id.*

26. Other Supreme Court cases that have restricted private rights of action under the 1934 Act, § 10-b, include *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (plaintiff has no standing to sue unless an actual purchaser or seller of securities) and *Santa Fe Indus. v. Green*, 430 U.S. 462 (1977) (no cause of action under § 10-b for breach of fiduciary duty by corporate officials standing alone, absent deceptive practice on investors).

27. See, e.g., 1933 Act, *supra* note 5, § 20 (codified at 15 U.S.C. § 17t); 1934 Act, *supra* note 5, § 21 (codified at 15 U.S.C. § 78u).

28. The discussion of SEC enforcement procedures herein, text accompanying notes 27-39 *infra*, is drawn in part from the discussion of SEC sanctions against attorneys in Richard W. Painter, *Game Theoretic and Contractarian Paradigms in the Uneasy Relationship Between Regulators and Regulatory Lawyers*, 65 *FORDHAM L. REV.* 149, 193-95 (1996).

quent relative to the number of lawyers and accountants working on securities offerings.²⁹ Rule 2(e)(1) provides:

[T]he [SEC] may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the [SEC] after notice of an 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.³⁰

Although the SEC used Rule 2(e) to define professional standards for attorneys through the early 1980s, it has since retreated from this position and has only started Rule 2(e) disciplinary proceedings against attorneys who have *already* been found by a court or the SEC to have violated the securities laws.³¹

2. Cease and Desist Orders Under the Remedies Act

The SEC also may sanction attorneys and accountants pursuant to the Remedies Act under which the Commission may:

[E]nter an order requiring [a person who has or is about to violate the securities laws], and any other person that is, was or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation of the same provision, rule, or regulation.³²

Although the Commission has occasionally used the Remedies Act against professionals,³³ the statutory language states that there must be, or about to be, a violation of the securities laws before the Commission

29. There had been a total of roughly 139 reported Rule 2(e) cases as of 1991. These cases involved 147 individual lawyers and four law firms. Robert W. Emerson, *Rule 2(e) Revisited: SEC Disciplining of Attorneys Since In re Carter*, 29 AM. BUS. L.J. 155, 175 (1991). During the "peak years" 1975-1977, 53 individual attorneys (36% of the total) and three law firms (75% of the total) were subject to such proceedings. *Id.* at 176. By contrast, only 26 lawyers went through Rule 2(e) proceedings during the 1980s. *Id.* at 176-77, 211-12.

30. SEC Procedural Rules § 2(e)(1), 17 C.F.R. § 201.102(e)(1)(1996).

31. See text accompanying notes 125-26 *infra*. See also James R. Doty, *Regulatory Expectations Regarding the Conduct of Attorneys in the Enforcement of the Federal Securities Laws: Recent Development and Lessons for the Future*, 48 BUS. LAW. 1543, 1544-48 (1993); Daniel L. Goelzer & Susan F. Wyderko, *Rule 2(e): Securities and Exchange Commission Discipline of Professionals*, 85 NW. U. L. REV. 652 (1991); Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look at the Next Decade*, 7 YALE J. ON REG. 149, 176-77 (1990).

32. 1933 Act, *supra* note 5, § 8A (codified at 15 U.S.C. § 77h-1); 1934 Act, *supra* note 5, § 21C (codified at 15 U.S.C. § 78u-3).

33. See *In re Feldman*, Securities Act Release No. 33-7014, 55 SEC Docket (CCH) 9, 12 (Sept. 20, 1993) (lawyer for three Pakistani banks "aided and abetted and caused" violations of § 5(a) and (c) of the 1933 Act by incorrectly advising his client that the offering of rupee-denominated foreign exchange bearer certificates did not involve securities required to be registered prior to sale in U.S.).

may enter an order to cease and desist.³⁴ Accordingly, this limits the Commission's options since professional misconduct can only be sanctioned *after* a finding that a violation has occurred or is about to occur *and* the lawyer or accountant is found to be the violator or the "cause" of the violation. Nonetheless, the statutory language potentially authorizes the sanctioning of professionals for a wide range of conduct, depending on what the SEC and the courts view as conduct that "causes" a violation to occur.³⁵

3. *Prosecution of Aiders and Abettors*

The 1995 Reform Act, Section 104, amends Section 20 of the 1934 Act to expressly grant the Commission authority to prosecute persons who aid and abet violations of the securities laws:

[F]or purposes of any action brought by the Commission under paragraph (1) or (3) of Section 21(d), any person that knowingly provides substantial assistance to another person in violation of a provision of this title, or of any rule or regulation issued under this title, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.³⁶

Although the Supreme Court ruled in *Central Bank* that private litigants may not assert aiding and abetting claims under the 1934 Act,³⁷ the SEC has long believed itself to have the authority to prosecute aiders and abettors as well as primary violators. This provision of the 1995 Reform Act reaffirms that view. Nonetheless, the most prominent SEC proceeding against lawyers as aiders and abettors, *SEC v. National Student Marketing*,³⁸ was decided almost twenty years ago, and federal courts have traditionally resisted claims against professionals for aiding and abetting violations of the securities laws.³⁹

34. 1933 Act, *supra* note 5, § 8A(a); 1934 Act, *supra* note 5, § 21C(a).

35. Although the SEC's 1987 proceedings against George Kern were brought prior to the Remedies Act, and were ultimately dismissed on jurisdictional grounds, the underlying premise of those proceedings was that Kern had "caused" his client to violate the Williams Act. *See* text accompanying note 127 *infra*.

36. 1995 Reform Act, *supra* note 6, § 104 (codified at 15 U.S.C. § 78t).

37. *Central Bank*, 511 U.S. at 191 (no private cause of action for aiding and abetting under § 10(b) of the 1934 Act).

38. *SEC v. National Student Mktg. Corp.*, 457 F. Supp. 682 (D.D.C. 1978); *see* text accompanying note 107-11 *infra*.

39. Much of the case law in this area was decided prior to *Central Bank* and assumed a private right of action for aiding and abetting a violation of the 1934 Act. *See* *Barker v. Henderson*, 797 F.2d 490, 495 (7th Cir. 1986) (law firm not liable to purchasers of bonds for fraud under § 10(b) because lawyer had no duty to disclose client issuer's fraud to bond purchasers); *see also* *Renovitch v. Kaufman*, 905 F.2d 1040, 1045 (7th Cir. 1990) (attorney not liable under § 10(b) to investors in client's fraudulent cattle leasing program because no duty to disclose); *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1125-26 (5th Cir. 1988) (bond underwriter's counsel had no duty to plaintiff purchasers of bonds that could form the basis for liability under § 10(b)). *See* Richard W. Painter, *Toward a Market for Lawyer Disclosure of Services: In Search of Optimal Whistleblowing Rules*, 63 GEO. WASH. L. REV. 221, 236-37 (1995).

III. ACCOUNTANTS AND CORPORATE FRAUD

A. ACCOUNTANT PROFESSIONAL CONDUCT

The SEC first suggested in 1940⁴⁰ that publicly traded entities use audit committees, and then formally endorsed the practice in 1972.⁴¹ In 1987, the National Commission on Fraudulent Reporting recommended that "all public companies should be required by SEC rules to establish audit committees composed solely of independent directors."⁴² Accountants supervised by independent directors thus have an increasingly important role in monitoring registrants' adherence to the disclosure requirements of the securities laws.⁴³

The accounting profession, like the legal profession, is governed by internal standards of professional conduct.⁴⁴ Rule 202 of the American Institute of Certified Public Accountants Code of Professional Conduct ("AICPA Code") requires an AICPA member to comply with auditing and other standards "promulgated by bodies designated by [the AICPA council]."⁴⁵ Rule 203 states that a member shall not express an opinion or state affirmatively that financial statements are presented in conformity with GAAP or claim that she "is not aware of any material modifications that should be made," if such financial statements materially depart from promulgated standards.⁴⁶ Meanwhile, Rule 301 prohibits a member from "disclos[ing] any confidential client information without the specific consent of the client."⁴⁷ However, Rule 301 is not intended to relieve a member of professional obligations under rules 202 or 203, or to limit the member's duty "to comply with a validly issued and enforceable subpoena or summons."⁴⁸ Nor should Rule 301 be interpreted to prevent an

40. *In re McKesson & Robbins, Inc.*, Accounting Series Release No. 19, Exchange Act Release No. 34-2707, slip opinion (Dec. 5, 1940).

41. STANDING AUDIT COMMITTEES COMPOSED OF OUTSIDE DIRECTORS, Accounting Series Release No. 123 (Mar. 23, 1972); see G.H. Lander et al., *Reduced Liability for the Management Accountant*, 68 U. DET. L. REV. 1, 7 (1990).

42. ERNST & WHINNEY, REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING 8 (Oct. 1987). The Treadway Commission also recommended that "the board of directors of every public company should develop and approve a written charter delineating the audit committee's duties and responsibilities" and that "the SEC should require that the annual report to stockholders include a letter from the audit committee chairman describing the committee's responsibilities and activities during the year." *Id.* at 8-9. The responsibilities of auditors are now also broadly defined by statute. See discussion of the 1995 Reform Act, in text accompanying notes 177-85 *infra*.

43. Audit committees should "review the independence of the independent public accountant"; "monitor compliance with company codes of conduct as part of their ongoing oversight of the effectiveness of internal controls"; "oversee the quarterly reporting process"; and "monitor instances where managements seek second opinions on significant accounting issues." ERNST & WHINNEY, *supra* note 42, at 8-9.

44. See AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA), CODE OF PROFESSIONAL CONDUCT (1995) (for accountants) [hereinafter AICPA CODE]; MODEL RULES OF PROFESSIONAL RESPONSIBILITY (1995) (for lawyers).

45. AICPA CODE, *supra* note 44, Rule 202.

46. AICPA CODE, *supra* note 44, Rule 203.

47. AICPA CODE, *supra* note 44, Rule 301.

48. AICPA CODE, *supra* note 44, Rule 301; see James R. Doty, *Professional Liability Issues for Accountants and Lawyers*, in REFORMING LEGAL ETHICS IN A REGULATED EN-

AICPA member from exchanging information with a recognized "investigative or disciplinary body."⁴⁹ Although the AICPA Code does not ordinarily require the auditor to disclose its findings to persons other than the client itself, such a duty might arise under some circumstances.⁵⁰ For example, disclosure to the SEC becomes mandatory "when the entity reports changes in auditors to the SEC on the form 8-K."⁵¹ Disclosure of confidential client information is also mandatory in response to a successor auditor who makes an inquiry in accordance with applicable rules.⁵²

Furthermore, confidential information learned by an accountant from a client does not fall within any recognized and protected evidentiary privilege.⁵³ In *Couch v. United States*, the Supreme Court noted "that no confidential accountant-client privilege exists under federal law, and no state-created privilege has been recognized in federal cases."⁵⁴ Again, in *United States v. Arthur Young & Co.*, the Court elaborated its rationale for rejecting both an accountant-client work product doctrine as well as a privilege for communications with accountants:

Nor do we find persuasive the argument that a work-product immunity for accountants' tax accrual workpapers is a fitting analogue to the attorney work-product doctrine established in *Hickman v. Taylor*. The *Hickman* work-product doctrine was founded upon the private attorney's role as the client's confidential adviser and advocate, a loyal representative whose duty it is to present the client's case in the most favorable possible light. An independent certified public accountant performs a different role. By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all

VIRONMENT: THE REPORT ON THE CONFERENCE ON LAWYER AND ACCOUNTANT LIABILITY AND RESPONSIBILITY 71 (American Law Institute, 1994). The Interpretation to Rule 301 states that:

The prohibition against disclosure of confidential information obtained in the course of a professional engagement does not apply to disclosure of such information when required to properly discharge the member's responsibility according to the profession's standards. The prohibition would not apply, for example, to disclosure, as required by Section 561 of the Statement on Auditing Standards No. 1 [AU section 561], of subsequent discovery of facts existing at the date of the auditor's report which would have affected the auditor's report had he been aware of such facts.

AICPA CODE, *supra* note 44, Rule 301 (Interpretation).

49. AICPA CODE, *supra* note 44, Rule 301.

50. Doty, *supra* note 48, at 9.

51. Doty, *supra* note 48, at 9.

52. Doty, *supra* note 48, at 8-9.

53. Doty, *supra* note 48, at 8.

54. *Couch v. United States*, 409 U.S. 322, 335 (1973) (citing *Falsone v. United States*, 205 F.2d 734 (5th Cir.), *cert. denied*, 346 U.S. 864 (1953); *Garipey v. United States*, 189 F.2d 459, 463-64 (6th Cir. 1951); *Himmelfarb v. United States*, 175 F.2d 924, 939 (9th Cir.), *cert. denied*, 338 U.S. 860 (1949); *Olender v. United States*, 210 F.2d 795, 806 (9th Cir. 1954)).

times and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations.⁵⁵

This difference between functions performed by accountants and lawyers is reflected not only in the Court's different treatment of confidential client communications, but, as discussed in Part VI *infra*, also in the inclusion of accountants, but not lawyers, in the 1995 Reform Act's procedures for detection and disclosure of corporate fraud.

B. CIVIL LIABILITY OF ACCOUNTANTS FOR CLIENT FRAUD

Accountants have been named as defendants in securities lawsuits more often than lawyers and have settled these suits for much more money than lawyers have. Indeed, between 1989 and 1994, the Big Six accounting firms settled 35 securities class actions (70% of the total of 50 class actions against all accounting firms) for \$395.82 million (82% of the total of \$482 million paid by all firms).⁵⁶ Over that period the Big Six firms have each settled from 3 class actions (Price Waterhouse) up to 10 (KPMG Peat Marwick).⁵⁷ All of the Big Six firms are defending one or more lawsuits virtually all of the time⁵⁸ and "claim to be experiencing a tidal wave of liability lawsuits that threaten their existence."⁵⁹ With class actions so frequent and the stakes so large, the view of the courts, regardless of internal professional standards, is critical to these Big Six firms and to accounting firms in general. What exactly do courts expect auditors to do about client fraud? What and when are auditors required to disclose? Unfortunately, case law on this subject has not been entirely consistent, and has provided less guidance to accountants than it should, particularly given the amount of potential damages involved in securities fraud litigation.

Two appellate cases, *Windon Third Oil & Gas Drilling Partnership v. FDIC*⁶⁰ and *Rudolph v. Arthur Anderson & Co.*⁶¹, are representative of courts' differing approaches to accountants' duty to disclose client fraud under Section 10-b of the 1934 Act. In *Windon*, several limited partnerships were formed, including Windon Third Oil and Gas Drilling Partnership ("Windon"), in order to acquire "fractional interests in oil and gas

55. *United States v. Arthur Young & Co.*, 465 U.S. 805, 817 (1984) (citations omitted).

56. *Marino & Marino*, *supra* note 10, at 148 (table 8).

57. *Marino & Marino*, *supra* note 10, at 148. Five of KPMG Peat Marwick's class action suits were settled in one year, 1993. *Marino & Marino*, *supra* note 10, at 148.

58. *Marino & Marino*, *supra* note 10, at 148 (each one of the Big Six firms settled at least one securities class action in 1992 and 1993).

59. *Marino & Marino*, *supra* note 10, at 149.

60. *Windon Third Oil & Gas Drilling Partnership v. FDIC*, 805 F.2d 342 (10th Cir. 1986), *cert. denied*, 480 U.S. 947 (1987).

61. *Rudolph v. Arthur Anderson & Co.*, 800 F.2d 1040 (11th Cir. 1986), *cert. denied*, 480 U.S. 946 (1987).

leases for wells in Oklahoma, Kansas, and Texas.”⁶² Windon “retained Clifford Resources, Inc. (CRI), whose President, Hal Clifford had previously supervised the exploration, development, and operation of Windon partnership wells.”⁶³ The accounting firm of Peat, Marwick Mitchell & Co. audited CRI’s books and records, as well as those of Penn Square Bank, which had loaned capital to each of the Windon limited partners.⁶⁴ Windon later sued the accounting firm for allegedly making misrepresentations and failing to disclose material facts about the financial stability of CRI in a telephone conversation with Windon’s general partner prior to formation of the Windon partnership.⁶⁵ The Tenth Circuit held that the accountants had no duty to disclose the information to Windon because neither a trust nor a confidential relationship had been formed. The court explained:

The failure to disclose material information is actionable only when [one] is under a duty to do so. And the duty to disclose arises when one party has information that the other party is entitled to know because of a fiduciary or other similar relation of trust and confidence between them. A duty arises from the relationship between the parties not merely because one party has an ability to acquire information Without a duty to disclose, silence cannot be made fraudulent.⁶⁶

The court thus limited an accountant’s duty to disclose to those situations where a certain trust relationship had been formed between the parties.

In *Rudolph v. Arthur Anderson & Co.*, the Eleventh Circuit espoused a much more expansive view of the duties of accountants to disclose.⁶⁷ The *Rudolph* case stemmed from the failed limited partnership formed by auto magnate John DeLorean for the purpose of producing sports cars.⁶⁸ The investors sued Arthur Anderson & Co., the partnership’s auditor, claiming both that DeLorean “had intentionally defrauded the investors and that Anderson [was] liable for the loss because it either knew or should have known of the fraud.”⁶⁹ The court acknowledged that an omission is proscribed only when a duty to disclose has arisen.⁷⁰ The court then used several factors to determine whether the defendant in *Rudolph* had a duty to disclose the fraud. The court explained that whether a duty to disclose arose depended on the circumstances of the case, and that factors to consider in such an evaluation were: “the relationship between the plaintiff and defendant, the parties’ relative access to the information to be disclosed, the benefit derived by the defendant

62. *Windon*, 805 F.2d at 343.

63. *Id.*

64. *Id.* at 343-44.

65. *Id.* at 344, 346.

66. *Id.* at 347 (quoting *Chiarella v. United States*, 445 U.S. 222, 228 (1980)) (citations omitted).

67. *Rudolph*, 800 F.2d at 1040.

68. *Id.* at 1041.

69. *Id.*

70. *Id.* at 1043.

from the purchase or sale, defendant's awareness of plaintiff's reliance on defendant in making its investment decision, and defendant's role in initiating the purchase or sale."⁷¹ While the court found the above stated factors important in making a determination of whether a duty to disclose had arisen, the court did not find these factors to be exclusive. A duty to disclose may also arise from the defendant's previous voluntary disclosure, if non-disclosure would result in making the defendant's own statement misleading or deceptive, if the defendant had knowledge of the fraud, or if the misstatement or omission is particularly significant.⁷² Whereas the Tenth Circuit in *Windon* looked specifically for "a fiduciary or other similar relation of trust and confidence"⁷³ between the plaintiff and the defendant accountant, the Eleventh Circuit was prepared to decide the "duty to disclose"⁷⁴ issue on a broad range of particularized facts in each case.

IV. LAWYERS AND CORPORATE FRAUD

Attorneys have not been harmed as much as accountants by joint and several liability in securities class actions.⁷⁵ A statistical study of class action settlements shows that between 1989 and 1993 attorneys were named as parties in 61 class actions that were all or partially settled, and that 34 of these settlements were disclosed, totalling \$134.91 million.⁷⁶ A few very large attorney settlements affected this total (for example \$48 million in connection with the American Continental/Lincoln Savings and Loan litigation),⁷⁷ and the vast majority of attorney settlements were much smaller than the settlements for accountants (2 attorney settlements were for \$10 million or more, 16 for from \$1 million to under \$10 million, and 16 for less than \$1 million).⁷⁸ Fifty-nine law firms were sued in class actions, but, in sharp contrast to the accounting profession where the largest firms appear to be at the heart of the liability wave, only 9 of these law firms were among the largest 100 firms in the country.⁷⁹ The overwhelming majority (69%) of attorney settlements involved two types of transactions, bond offerings and investments in limited partnerships.⁸⁰

71. *Id.* (quoting *First Va. Bankshares v. Benson*, 559 F.2d 1307, 1314 (5th Cir. 1977), *cert. denied*, 435 U.S. 952 (1978)).

72. *Id.* Such a context-specific approach is in keeping with that urged by Professor Feinman in his 1995 treatise on the liability of professionals and businesses. Feinman "advocates attention to the nature of the relationships involved in a particular case and to the details of context as the best way to choose which doctrine to use and how to apply it." Jean Braucher, *Economic Negligence: Liability of Professionals and Businesses to Third Parties for Economic Loss*, 51 *BUS. LAW.* 795, 797 (1996) (book review) (citing FEINMAN, *supra* note 2, §§ 1.4, 7.4.1).

73. *Windon*, 805 F.2d at 347.

74. *Rudolph*, 800 F.2d at 1043.

75. Marino & Marino, *supra* note 10, at 159; *see also* text accompanying notes 56-59 *supra*.

76. Marino & Marino, *supra* note 10, at 162 (table 13).

77. Marino & Marino, *supra* note 10, at 163.

78. Marino & Marino, *supra* note 10, at 162.

79. Marino & Marino, *supra* note 10, at 162.

80. Marino & Marino, *supra* note 10, at 160.

Perhaps most important, only 2 law firms were named as defendants twice in class actions; all others were named only once.⁸¹ For attorneys, being named a defendant in a securities class action is not a repeat period game⁸² as it is for Big Six accounting firms; the specter of civil liability is real, but nowhere near the magnitude of that confronting accountants.

However, lawyers find civil suits, as well as the SEC disciplinary proceedings discussed in Part V below, to be difficult and costly, primarily because attorneys' lower exposure to monetary damages is counterbalanced by their very high exposure to loss of reputational capital.⁸³ Reputational capital is important to accountants as well as to lawyers, but there is a difference. The accounting profession is dominated by the Big Six accounting firms, all of which have been sued for substantial sums in connection with securities fraud claims, making differentiation by reputation difficult. The difference between Coopers and Lybrand, which disclosed \$145 million in settlements in 1992, and KPMG Peat Marwick, which disclosed \$4.5 million in the same year, is discernable but also debatable, particularly in view of the fact that, in the following year (1993) Coopers and Lybrand disclosed \$25.90 million in settlements whereas KPMG Peat Marwick disclosed \$55.32 million.⁸⁴ By contrast, there are hundreds of law firms practicing in the securities area. Only a small, although growing, portion of these firms have been named as defendants in high profile securities fraud litigation. 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 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. A securities practice that took years to build can dissolve almost overnight as clients, with plenty of lawyers and law firms to choose from, depart for one of many competitors who have managed to avoid disciplinary actions or civil suits, regardless of how those proceedings are ultimately resolved. For accountants, although reputation is important, it may be the money paid out in judgments and settlements that matters the most; for lawyers, the effect of a proceeding on reputation is perhaps most

81. Marino & Marino, *supra* note 10, at 163.

82. Although this Article will not apply the insights of game theory to class action settlement negotiations, it is worth noting that repeat period games are played differently than games in which one or more of the players are not likely to play for a second time. This is also true of "games" between lawyers and regulators. See Painter, *supra* note 28, at 157-58; Ian Ayres, *Response to Painter*, 65 *FORDHAM L. REV.* 201 (1996).

83. For a discussion of the importance of reputational capital to securities lawyers, see Karl S. Okamoto, *Reputation and the Value of Lawyers*, 74 *OR. L. REV.* 15 (1995). As Okamoto observes, "[t]he reputational capital paradigm is an economic model that was first developed in an article by Professors Klein and Leffler." *Id.* at 22 n.18 (citing Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 *J. POL. ECON.* 615 (1981)).

84. See Marino & Marino, *supra* note 10, at 148 (table 8).

critical.⁸⁵

Attorneys, perhaps even more than accountants, would thus benefit from clear and predictable rules that help them avoid even being named as defendants in a lawsuit or as respondents in disciplinary proceedings. Entrepreneurial and other high-risk issuers could also benefit if a clearer definition of lawyers' responsibilities encouraged securities lawyers to take more risks and seek a wider range of clients, instead of concentrating their practice on established issuers, as many now do.⁸⁶ The problem is that there is significant disparity between the views of the bar, the courts, and the SEC over what the rules are. The cost of this confusion and lack of clarity is substantial, and perhaps exceeds the costs that would be imposed on the legal profession by any one rule, whatever that rule might be.

The bar has traditionally endorsed rules that restrict disclosure of client confidences.⁸⁷ For example, Model Rule 1.6 of the ABA Model Rules of Professional Conduct (the "Model Rules") allows disclosure of client confidences, but only if the client intends to commit a crime that the lawyer reasonably believes is likely to result in imminent death or substantial bodily harm.⁸⁸ Yet, even under these limited circumstances, disclosure is not required,⁸⁹ and if the client intends to commit fraud or crimes causing only financial injury (unless that injury is to the lawyer),⁹⁰ disclosure is not permitted.⁹¹ In some situations, a lawyer may be required to withdraw from representing a client because Model Rule 1.2(d) prohibits a

85. Reputation for integrity and good judgment is essential to much of the work that lawyers do. "From a profession charged with such responsibilities there must be exacted those qualities of truth-speaking, of a high sense of honor, of granite discretion, of the strictest observance of fiduciary responsibility, that have, throughout the centuries, been compendiously described as 'moral character.'" *Schwartz v. Board of Bar Examiners*, 353 U.S. 232, 247 (1957) (Frankfurter, J., concurring).

86. Karl Okamoto's statistical study of registration statements on Form S-1 (often filed by new issuers) and on Form S-3 (available only to established issuers) shows that prestigious firms with high reputational capital to protect are choosier about stock offerings than they are about less risky debt offerings, have a larger share of the market in less risky S-3 offerings than they do in the more risky S-1 offerings, and shun IPOs by unestablished companies. Okamoto, *supra* note 83, at 35-37. "Clearly the top-fifty firms were . . . leaving the smaller companies to the lower prestige law firms." Okamoto, *supra* note 83, at 37. "The principal finding from the data is the existence of segmentation in the market for legal services based on the value of reputation. . . . [H]igh-reputation law firms shun high-risk work." Okamoto, *supra* note 83, at 38.

87. See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 (1995).

88. *Id.* "[A] lawyer *may* reveal [confidential client] information to the extent the lawyer reasonably believes necessary: (1) to prevent the client from committing a criminal act that the lawyer believes is likely to result in imminent death or substantial bodily harm." *Id.* Rule 1.6(b)(1) (emphasis added).

89. *Id.* Model Rule 1.6(b) defines an attorney's obligations in terms of "may," not "shall." *Id.*

90. Model Rule 1.6 permits a lawyer to disclose client confidences in order to establish her own claim or defense once the lawyer has been sued, criminally charged, or charged in a disciplinary proceeding in connection with conduct in which the client was involved. *Id.* Rule 1.6(b)(2).

91. *Id.* Rule 1.6(a). Financial injury to the lawyer is the one exception. Model Rule 1.6 allows the disclosure necessary to collect unpaid fees. See *id.* Rule 1.6 cmt. 19.

lawyer from assisting in criminal or fraudulent conduct,⁹² and a lawyer may, but is not required to, make a “noisy withdrawal”⁹³ in which she renounces her prior opinions or work product. It is also worth noting that most states have not adopted these very narrow exceptions to confidentiality in Model Rule 1.6.⁹⁴

The ABA Code of Professional Responsibility (“Code”) is somewhat less restrictive than the Model Rules in allowing disclosure when a client intends to commit a crime.⁹⁵ The Code, like Rule 1.6, is permissive; the lawyer does not have to disclose. Also, the Code, like Rule 1.6, does not allow disclosure in order to rectify a past crime. For example, a lawyer, under the Code, may not alert investors to her client’s prior fraudulent sale of stock unless the client is continuing to violate the law.⁹⁶ Although Disciplinary Rule 7-102(A)(7) prohibits a lawyer from counseling or assisting a client in illegal or fraudulent conduct,⁹⁷ the Code does not require a lawyer who has discovered that her services have been used for such ends to reveal the crime or fraud.⁹⁸

92. “A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent” MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2(d) (1995). Model Rule 1.2(d), however, might be ignored where private litigants’ remedies for lawyer assisted fraud are sharply limited. See *Central Bank v. First Interstate Bank*, 511 U.S. 164 (1994) (no private right of action for aiding and abetting a violation of § 10-b prohibition on fraud in connection with purchase or sale of a security).

93. See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 cmt. 16 (1995).

94. Many state supreme courts have rewritten Rule 1.6 to allow or even require disclosure in a broader range of circumstances. See Koniak, *supra* note 3, at 1100. For a discussion of Model Rule 1.6 see Painter, *supra* note 39, at 231-32.

95. “A lawyer *may* reveal . . . the intention of his client to commit a crime and the information necessary to prevent the crime.” MODEL CODE OF PROFESSIONAL RESPONSIBILITY, DR 4-101(C)(3) (1995) (emphasis added). Ironically, the *Model Code of Professional Responsibility* requires a lawyer to disclose when the misconduct is that of another lawyer instead of her own client. See *id.* DR 1-103(A) (requiring lawyer possessing unprivileged knowledge of disciplinary rules violation to report such knowledge to tribunal or authority empowered to investigate); *In re Himmel*, 533 N.E.2d 790 (Ill. 1989) (suspending lawyer from practice for one year for violating DR 1-103(A)).

96. See MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 4-101 (1995).

97. “In his representation of a client, a lawyer shall not . . . Counsel or assist his client in conduct that the lawyer knows to be illegal or fraudulent.” *Id.* DR 7-102(A)(7).

98. See generally Painter, *supra* note 39, at 231-32. The American Law Institute (“ALI”) addresses disclosure of client confidences in its drafts of the *Restatement of the Law Governing Lawyers*. RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 117A (Proposed Final Draft No. 1, 1996) [hereinafter ALI Restatement]. Section 117A(1)(a) of the draft Restatement permits disclosure to prevent death or serious bodily injury. However, the extent of disagreement within the ALI, as within other bar associations, on lawyer “whistleblowing” is best revealed by the two versions of § 117A(1)(b) that permit disclosure if a client has committed or intends to commit a crime or fraud that threatens to cause substantial financial loss. The Reporters’ proposed version permits disclosure necessary to prevent the loss following a good faith attempt to dissuade the client from committing the crime or fraud. The alternative version, preferred by the ALI Director upon consultation with a four-person ad hoc subcommittee of the ALI Council, only permits disclosure of a crime or fraud “in the commission of which the lawyer’s services were or are being employed.” *Id.* § 117A(1)(b). As the Reporters point out, the section “does not apply to a past act of a client, no matter how clearly illegal and serious, if all of the harmful consequences of the act have already occurred.” *Id.* cmt. a. Nowhere does § 117A require disclosure by the lawyer to prevent death, serious bodily injury, or financial loss. *Id.*

These disclosure rules for lawyers are significantly different than the rules that permit and sometimes require disclosure of client confidences by accountants. Furthermore, confidential communications by clients to lawyers, unlike those to accountants, are subject to an evidentiary privilege and to protection under the work product doctrine.⁹⁹

The securities laws also contemplate a somewhat different role for lawyers than for accountants. As pointed out above, lawyers are not among the professionals enumerated in Section 11 as being potentially liable for certifying a materially misleading portion of a registration statement.¹⁰⁰ Although Section 11 would still allow a lawyer to be sued in connection with a portion of a registration statement that with his consent named him as having prepared or certified that portion, rarely will a lawyer agree to do so. Model Rule 2.3 allows a lawyer to "undertake an evaluation of a matter affecting a client for the use of someone other than the client."¹⁰¹ Such an evaluation could presumably include certification of a portion of a registration statement. However, legal opinions included or referenced in a registration statement are usually targeted at such issues as due incorporation, corporate authority, and tax treatment of an investment.¹⁰² Opinions giving "negative assurances" concerning a client's dis-

99. See *Hickman v. Taylor*, 329 U.S. 495 (1947) (developing modern work product doctrine). *Hickman* created two categories of work product: (1) factual material (such as notes on an interview with a witness), which is protected from discovery unless the demanding party shows that production of these facts is essential to preparation of his case; and (2) the attorney's mental impressions (such as often found in private notes or in a legal memorandum), which are covered by an absolute privilege that continues regardless of the other party's need for the information. *Id.* at 511-12. Under the Federal Rules of Civil Procedure, material prepared in anticipation of litigation is discoverable only upon a showing that the party seeking discovery has a "substantial need for the materials in the preparation of the party's case and that the party is unable without undue hardship to obtain the substantial equivalent of the materials by other means." FED. R. CIV. P. 26(b)(3).

100. See note 16 *supra* and accompanying text. "[C]ertain individuals who play a part in preparing the registration statement generally cannot be reached by a §11 action. These include . . . lawyers not acting as experts." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 387 n.22 (1983); see also *Kitchens v. United States Shelter*, [1988-89 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,920 (D.S.C. 1988).

101. MODEL RULES OF PROFESSIONAL CONDUCT Rule 2.3 (1995). The comments to Rule 2.3 point out that the evaluation, while performed at the client's direction, may be for the "primary purpose of establishing information for the benefit of third parties." *Id.* Rule 2.3 cmt. 1. The comments point out that, in such circumstances, "a legal duty to that [third] person may or may not arise." *Id.* cmt. 4.

102. Even apart from § 11 liability, when third parties rely on lawyers' representations, courts may hold the lawyers liable if the representations turn out to be inaccurate. See generally *Greycas, Inc. v. Proud*, 826 F.2d 1560 (7th Cir. 1987) (borrower's lawyer who certified to lender that borrower's farm machinery was free of encumbrances when in fact it was not, liable to borrower for negligent misrepresentation), *cert. denied*, 484 U.S. 1043 (1988); *Capital Bank & Trust v. Core*, 343 So. 2d 284 (La. Ct. App. 1977) (lawyer for corporate borrower could be liable for fraud on lender when opinion letter addressed to lender stated that lawyer had examined certain records of his client when he had not); *Prudential Ins. Co. v. Dewey*, 605 N.E.2d 318 (N.Y. 1992) (borrower's lawyer owes lender duty of care with respect to opinion addressed to lender). See Morgan Shipman, *The Liabilities of Lawyers in Corporate and Securities Work*, 62 U. CIN. L. REV. 513, 523-25 (1993) (discussing lawyer's duties to opinion letter addressees who are not clients); JONATHAN R. MACEY, *THIRD PARTY LEGAL OPINIONS* (1993); ABA Committee on Legal Opinions, *Third Party Legal Opinion Report, Including the Legal Opinion Accord of the Section of*

closure of material facts are used in securities offerings, but are narrowly crafted to refer to specific disclosure documents and do not cover future illegal acts.¹⁰³

For these reasons, most actions brought against lawyers under the securities laws allege that the lawyers went beyond mere failure to disclose illegal acts. In rare circumstances, a lawyer who departs from her usual professional functions to actively engage in solicitation of prospective buyers for securities can become a "seller" of the securities, and therefore liable in a suit for misrepresentation under Section 12(2) of the 1933 Act.¹⁰⁴ Occasionally, a lawyer may be deemed the equivalent of a "seller" under state law even if she only performs her normal professional functions in the offering.¹⁰⁵

An attorney who knowingly allows a client to use his assistance to consummate a fraudulent sale of securities can furthermore be sued either as a primary violator or, in a SEC enforcement action, as an aider and abetter under Section 10-b of the 1934 Act.¹⁰⁶ In *SEC v. National Student Marketing Corp.*,¹⁰⁷ attorneys representing National Student Marketing ("National") discovered that National's earnings had been overstated in financial statements, yet allowed a merger of National into another company to go forward without resoliciting approval from both companies' shareholders.¹⁰⁸ The court held that the attorneys aided and abetted their client in violation of Section 10-b of the 1934 Act because the attorneys neglected their duty to protest National's decision to go ahead with

Business Law, American Bar Association, 47 *BUS. LAW.* 167 (1991) [hereinafter ABA Opinion Accord].

103. In securities offerings, issuers often hire outside law firms to give opinions to underwriters and other persons who might be liable for misstatements or omissions in offering materials under § 11 of the 1933 Act. These opinions recite "negative assurances" that material misstatements or omissions have not come to the attention of the opinion giver. Typical language reads "based upon [our participation in drafting the Transaction Documents, involvement in transaction negotiations, etc.] nothing has come to our attention that causes us to believe . . . [that there] is any misstatement or omission of material facts (excluding financial and accounting data)." *Id.* at 228.

104. See *Wilson v. Saintine Exploration & Drilling Corp.*, 872 F.2d 1124, 1126 (2d Cir. 1989) (lawyers for issuer of securities are not "sellers" under § 12(2) if they perform "only their usual professional functions in preparing documents for an offering"). Since the Supreme Court's holding in *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061 (1995), § 12(2) liability only attaches to the sale of securities pursuant to a public offering.

105. See *Prince v. Brydon*, 764 P.2d 1370 (Or. 1988) (lawyer for issuer of unregistered securities liable under state law because lawyer substantially assisted in sale by drafting tax opinion and other documentation for transaction).

106. See *SEC v. Frank*, 388 F.2d 486, 489 (2d Cir. 1968) (reversing for procedural defects injunction against future violations by attorney of § 10(b) after misrepresentations discovered in offering circular drafted in part by attorney); see also *In re American Continental Corp.*, 794 F. Supp. 1424, 1452 (D. Ariz. 1992).

An attorney may not continue to provide services to corporate clients when the attorney knows the client is engaged in a course of conduct designed to deceive others, and where it is obvious that the attorney's compliant legal service may be a substantial factor in permitting the deceit to continue.

Id.

107. *SEC v. National Student Mktg. Corp.*, 457 F. Supp. 682 (D.D.C. 1978).

108. *Id.* at 694.

the merger.¹⁰⁹ "Their silence was not only a breach of this duty to speak, but in addition lent the appearance of legitimacy to the closing."¹¹⁰ In a pattern that recurs throughout the cases and SEC disciplinary proceedings discussed in this Article, however, the court was less clear on exactly what the lawyers should have done. "[I]t is unnecessary to determine the precise extent of their obligations here, since . . . they took no steps whatsoever to delay the closing. . . ."¹¹¹ As Susan Koniak correctly points out in her insightful discussion of case law in this area, the *National Student Marketing* court and others like it have been ineffective in resolving differences between competing visions of lawyers' responsibilities when confronted with client fraud.¹¹² This confusion over standards of professional conduct is substantial enough that the SEC or Congress should step in and say something about what lawyers are and are not required to do.

V. THE SHIFTING SANDS OF SEC DISCIPLINE FOR LAWYERS AND ACCOUNTANTS

Although private claims against lawyers in connection with securities offerings are more difficult after the Supreme Court's curtailment of private actions for aiding and abetting in *Central Bank*,¹¹³ the SEC may respond with stepped up enforcement efforts of its own. As discussed further in this section, the SEC has already sometimes taken a position at odds with the organized bar and demanded that lawyers do more to prevent and disclose client fraud. Administrative proceedings in the last fifteen years demonstrate the SEC's willingness to discipline professionals who do not live up to its expectations. However, a closer look at these proceedings reveals that the SEC's standards for professional discipline of accountants and lawyers are no clearer than the standards courts use for imposing civil liability.

A. *IN RE CARTER & JOHNSON*

In re Carter & Johnson is a good example of a case where the SEC was perceived by lawyers to have overreached and then pulled back in its final disposition of the case.¹¹⁴ Carter and Johnson represented National Telephone for over a year and a half during which National Telephone ignored legal advice from both Carter and Johnson and repeatedly failed to make required disclosures in a 1933 Act registration statement, 1934

109. *Id.* at 715.

110. *Id.* at 713.

111. *Id.*

112. See Koniak, *supra* note 3, at 1081.

113. *Central Bank v. First Interstate Bank*, 511 U.S. 164 (1994).

114. The reaction of the securities bar to the *Carter & Johnson* proceedings is discussed in Werner Kronstein, *SEC Practice: The Carter-Johnson Case: A Higher Threshold for SEC Action Against Lawyers*, 9 SEC. REG. L. J. 293 (1981).

Act periodic filings, and letters to shareholders.¹¹⁵ The SEC found that Carter and Johnson each had an affirmative obligation to correct National Telephone's disclosure violations, including either to approach the rest of National Telephone's board of directors or to resign.¹¹⁶

Initially, the SEC's administrative law judge sanctioned Carter and Johnson under Rule 2(e) for aiding and abetting National Telephone's violations of Section 10(b) of the 1934 Act and for engaging in "unethical [and] improper professional conduct."¹¹⁷ The administrative law judge embraced a "red flags theory" that had been the basis of prior SEC actions against attorneys, saying that incidents involving National Telephone "should have, at least, served as red flags to alert respondents to some course of action which would have prevented the violations found herein."¹¹⁸ This theory by its very nature sought to incorporate a negligence standard into Rule 2(e) proceedings against attorneys.

In its final decision, however, the full Commission reversed the administrative law judge and dismissed the charges against Carter and Johnson. The Commission explicitly stated that the two attorneys "could not be sanctioned under Rule 2(e)(1)(iii) for willfully aiding and abetting [a client's securities law] violations unless they 'were aware or knew that their role was part of an activity that was improper or illegal.'"¹¹⁹ The Commission went on to read a scienter standard into Rule 2(e) by saying that "wrongful intent provides the basis for distinguishing between those professionals who may be appropriately considered as subjects of professional discipline and those who, acting in good faith, have merely made errors of judgment or have been careless."¹²⁰ The SEC's reversal of its position on intent led one commentator to observe that "[i]ndeed, if the Commission in authorizing the initiation of the *Carter-Johnson* case had applied the same standards that it pronounced at its conclusion, it is most doubtful whether it would ever have authorized the institution of this action in the first place."¹²¹ This was not the first time, nor the last, that the SEC would be accused of switching standards midstream in proceedings against professionals.

The SEC did not sanction Carter and Johnson under Rule 2(e) because it believed standards for professional conduct in securities practice had

115. *In re Carter & Johnson*, Exchange Act Release No. 34-17597, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,145 (Feb. 28, 1981) [hereinafter *Carter & Johnson*].

116. *Id.*

117. *Id.* at 84,173; see also SEC Procedural Rules § 2(e)(1)(ii), 17 C.F.R. § 201.102(e)(1)(ii) (1996).

118. *In re Carter*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,175, at 82,179 (Mar. 7, 1979); see also Kronstein, *supra* note 114, at 295.

119. *Checkosky v. SEC*, 23 F.3d 452, 484 (D.C. Cir. 1994) (quoting *Carter & Johnson*, *supra* note 115, at 84,167).

120. *Checkosky*, 23 F.3d at 484. If a securities lawyer is to exercise his "best independent judgment . . . he must have the freedom to make innocent—or even, in certain cases, careless—mistakes without fear of [losing] the ability to practice before the Commission." *Id.*

121. Kronstein, *supra* note 114, at 295.

not yet been satisfactorily developed.¹²² It is surprising that the SEC would acknowledge at this juncture, *almost fifty years after enactment of the 1933 Act*, that it did not feel justified in sanctioning lawyers because it had yet to satisfactorily develop clear standards for what lawyers must do when confronted with client noncompliance with the securities laws. Instead, the SEC articulated standards that lawyers presumably must adhere to in the future:

[W]hen a lawyer with significant responsibilities in the effectuation of a company's compliance with the disclosure requirements of the federal securities laws becomes aware that his client is engaged in a substantial and continuing failure to satisfy those disclosure requirements, his continued participation violates professional standards unless he takes prompt steps to end the client's noncompliance.¹²³

Despite its retreat on the issue of intent, the SEC apparently sought to place an affirmative duty on a lawyer to halt a client's continued noncompliance with the securities laws. Securities lawyers thus must abide not only by rules of professional responsibility, such as Model Rule 1.2(d), which prohibits a lawyer from assisting a client in a crime or fraud,¹²⁴ but also by the arguably higher standard imposed by the SEC in *Carter & Johnson*.

Unfortunately, it is not entirely clear from the *Carter & Johnson* release exactly what these higher standards are. The SEC did say that a lawyer in such a situation must take "prompt steps to end the client's noncompliance," and suggested two steps that Carter and Johnson could have taken: (1) approaching other members of National Telephone's board of directors; and (2) resigning. However, it is questionable whether it would have been sufficient for the lawyers only to approach some of the other directors; arguably, Carter and Johnson would have been required to go to the full board. If the full board failed to rectify the situation, were the lawyers required to resign? If the lawyers did resign, were they required to do anything to disavow the work product they had done for National Telephone? All of these questions went unanswered, presumably to be determined the next time the SEC sought to sanction an attorney under Rule 2(e).

However, after *Carter & Johnson* the SEC avoided answering these questions by retreating further from the forefront of defining lawyers' professional obligations through Rule 2(e) proceedings. In fact, the *Carter & Johnson* proceeding was the last time the SEC used administrative proceedings to determine *de novo* a securities lawyer's professional obligations.¹²⁵ Since *Carter & Johnson*, the SEC has only begun Rule

122. *Carter & Johnson*, *supra* note 115, at 84,173.

123. *Carter & Johnson*, *supra* note 115, at 84,172.

124. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2(d) (1995).

125. Emerson, *supra* note 29, at 213. "With respect to attorneys, the Commission generally has not sought to develop or apply independent standards of professional conduct . . . the Commission, as a matter of policy, generally refrains from using its administrative forum to conduct *de novo* determinations of the professional obligations of attorneys."

2(e) proceedings against attorneys who have *already* been found to have violated the securities laws in some way.¹²⁶

B. *IN RE KERN*

In *In re Kern*, the SEC claimed that George Kern “caused” his client Allied Signal to violate Section 14 of the 1934 Act.¹²⁷ Kern served as an attorney and board member for Allied Corporation when the company, while the subject of a tender offer, began negotiations with a “white knight.” Under the Williams Act, this event had to be disclosed to the SEC.¹²⁸ Allied failed to disclose the negotiations with the new suitor.¹²⁹ An administrative law judge found that Kern had assumed responsibility for determining when an amendment to Allied’s Schedule 14D-9 would be filed: “When Kern accepted discretionary authority to make [decisions regarding whether amendments to Allied’s Schedule 14D-9 were required] he also accepted the responsibility the Allied officers [otherwise would have had] for compliance with Rule 14D-9.”¹³⁰ Arguably, Kern’s own choice to accept the responsibility for disclosure triggered the requirement that he disclose to the SEC all material facts, including the merger negotiations.¹³¹ However, the question arises of whether the SEC would have sought to sanction Kern if he had not been a director of Allied as well as its lawyer. Also, Kern’s potentially career damaging mistake was to make an arguably wrong decision about the timing of disclosure in a fast-paced hostile takeover situation. Securities lawyers have reason to be concerned that the SEC may pursue further actions against lawyers whose mistake is not a wrong decision of *whether* to disclose, but a wrong decision on the more difficult question of *when* to disclose.¹³² Even more troubling is the vague question of when a lawyer is a “cause” of a client’s violation of the securities laws, language that subsequently became even more important with its inclusion in the Remedies Act.¹³³

SEC Final Rule on Rule 2(e) Proceedings, Exchange Act Release No. 25,893, [1987-88 Transfer Binder] Fed. Rec. L. Rep. (CCH) ¶ 84,248, at 84,244 (July 7, 1988).

126. Emerson, *supra* note 29, at 213 n.292. At a meeting on July 7, 1988, SEC General Counsel David Golzar explained that “it has been commission policy for the last seven years to only bring 2(e) proceedings against an attorney if he or she previously has been involved in another enforcement action.” *Id.*

127. *In re Kern*, Administrative Proceeding File No. 3-6869, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342, at 89,580 (Nov. 14, 1988), *aff’d in part, vacated in part*, 50 S.E.C. 596 (1991) [hereinafter *Kern*].

128. *Id.* at 89,584.

129. *Id.* at 89,580-82.

130. *Id.* at 89,592.

131. This case was later dismissed on jurisdictional grounds, thus the holding was never expressly ratified by the SEC. *Id.* at 89,595-96. Under the 1990 Remedies Act, which was enacted after *Kern*, the SEC would now have jurisdiction.

132. The Remedies Act, *supra* note 5, authorizes actions against persons who are a “cause” of a violation and thus removes the jurisdictional impediment that eventually terminated the proceedings against Kern.

133. See *supra* text accompanying note 32.

C. THE SALOMON BROTHERS CASE

In *In re Gutfreund*, Salomon Brothers' chief legal officer (in-house counsel) Donald M. Feuerstein repeatedly advised CEO John H. Gutfreund to report to the government falsified bids for United States treasury securities by trader Paul Mozer.¹³⁴ Gutfreund did not report the falsified bids to the SEC.¹³⁵ The SEC determined that Feuerstein, because his role as chief legal officer of Salmon Brothers caused him to become a "supervisor" of Mozer for purposes of Sections 15(b)(4)(E) and 15(b)(6) of the 1934 Act, was obligated under the 1934 Act's provisions regulating broker dealers to take appropriate steps to deal with Mozer's misconduct.¹³⁶ The SEC suggested that such appropriate steps would include approaching senior management, and if that failed, approaching the board of directors, resigning, or disclosing the misconduct to regulators.¹³⁷

The SEC did note, however, that where the supervisor was an attorney, the "applicable Code of Professional Responsibility and Cannons of Ethics may bear upon what course of conduct that individual may properly pursue."¹³⁸ Thus, confidentiality rules might limit disclosure by an attorney, particularly in jurisdictions that adhere to Model Rule 1.6.¹³⁹ This raises the question of whether the SEC expects an attorney to disclose illegal acts everywhere except jurisdictions that prohibit disclosure, a particularly troublesome prospect when many corporate clients have offices in several states and it is not always entirely clear which jurisdiction's rules of professional conduct apply. *In re Gutfreund* also raises the question of whether the SEC would impute the same responsibilities to a general counsel at any publicly held corporation that it did in this case to the general counsel at a broker dealer.

In *In re Gutfreund*, the SEC once again set forth its view of what an attorney's obligations were without imposing a sanction. One wonders why the SEC is so hesitant to impose sanctions. Is the SEC merely waiting for the right combination of circumstances to appear before imposing serious sanctions on an attorney who has failed to live up to the espoused standards? Alternatively, does the SEC itself recognize that the standards it is espousing are not precise enough to warrant sanction for departure therefrom? If so, the SEC needs to articulate its standards more clearly, and also should recognize that, to an attorney charged with improper conduct, the potential sanction is not the only harm. Injury to an attorney's reputation caused by the attorney being subjected to a protracted enforcement proceeding, as was George Kern, or having his con-

134. *In re Gutfreund*, Exchange Act Release No. 31,554, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,067, at 83,599 (Dec. 3, 1992).

135. *Id.*

136. *Id.* at 83,609.

137. *Id.*

138. *Id.* n.26; see, e.g., MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 (1995) (prohibiting disclosure of client confidences).

139. See *supra* text accompanying notes 88-94.

duct criticized in a SEC release, as was that of Donald Feuerstein, can cause almost as much harm as a formal sanction.¹⁴⁰

D. *CHECKOSKY*

In *Checkosky v. SEC*,¹⁴¹ the United States Court of Appeals for the District of Columbia discussed the difference between lawyers and accountants, and criticized the SEC's unclear articulation of the standards it would apply to each. In this case, the Commission had suspended two partners of Coopers and Lybrand, David Checkosky and Norman Aldrich, for two years under Rule 2(e) for "improper professional conduct" in auditing financial statements that Savin Corporation, a marketer of photocopiers, had submitted to the Commission.¹⁴² "The Commission alleged that Checkosky and Aldrich had misrepresented that the financial statements were in conformity with GAAP [Generally Accepted Accounting Principles] when they certified that Savin ha[d] properly deferred its costs associated with the copier project" and "violated GAAS [Generally Accepted Auditing Standards] by failing to exercise professional due care in planning and performing the audits and in preparing the audit reports."¹⁴³ The Commission then affirmed an administrative law judge's "conclusion that the auditors had violated GAAP and GAAS and that scienter is not required to state a violation of Rule 2(e)(1)(ii)—and noted that the auditor's conduct did in fact rise to the level of recklessness."¹⁴⁴

Checkosky and Aldrich argued that the Commission did not have the authority to administer a Rule 2(e) proceeding, but this argument had been rejected before by the courts.¹⁴⁵ Alternatively, they argued that "even if the Commission may police practitioners before it, its authority does not extend to disciplining professionals for negligence."¹⁴⁶ This issue had not been addressed by appellate courts, and was not to be ad-

140. See *supra* text accompanying notes 83-85.

141. 23 F.3d 452 (D.C. Cir. 1994).

142. *Id.* at 454-55.

143. *Id.* at 455.

144. *Id.*

145. See, e.g., *Touche Ross & Co. v. SEC*, 609 F.2d 570, 582 (2d Cir. 1979) ("Rule 2(e), promulgated according to its statutory rulemaking authority, represents an attempt by the Commission to protect its own processes."). As Judge Silberman observed in *Checkosky*:

[T]he Court in *Touche* clearly distinguished the Commission's authority to discipline professionals from its substantive enforcement functions . . . since under the 1934 Act's jurisdictional provisions, 15 U.S.C. Section 78aa (1988), district courts have exclusive jurisdiction over violations of the securities laws. The Commission had promulgated Rule 2(e) not to augment its enforcement arsenal but to protect its administrative processes, and the Court correctly recognized that the Commission may not "usurp the jurisdiction of the federal courts to deal with 'violations' of the securities laws."

Checkosky, 23 F.3d at 456 (citations omitted).

146. *Checkosky*, 23 F.3d at 456. As Judge Silberman points out, "[T]his argument has not been squarely addressed by the courts of appeals." *Id.* (citing *Davy v. SEC*, 792 F.2d 1418, 1422 (9th Cir. 1986) (reserving judgment on what level of culpability is required)). However, "[o]ne district court has addressed the issue and held that *Davy* necessarily determined that the Commission's authority under Rule 2(e) extends to all mental states of

dressed here because the Commission did not clearly state that it was disciplining Checkosky and Aldrich for negligence. The Commission found that Checkosky and Aldrich had "violated GASS and misrepresented that Savin's statements complied with GAAP"¹⁴⁷ and stated that "[w]e affirm the [administrative] law judge's holding (and reaffirm prior Commission precedent) that proof of bad faith or wilful misconduct is not a prerequisite for the imposition of sanctions pursuant to Rule 2(e)(1)(ii)."¹⁴⁸ Nonetheless, as Judge Silberman points out, "the Commission's opinion is ambiguous. The Commission declared that bad faith is not a prerequisite for a violation, but does not specify the state of mind both necessary and sufficient to constitute a violation in light of its past precedents."¹⁴⁹ It was "unclear whether the Commission actually applied a simple negligence standard in this case—or, for that matter, what standard the Commission actually did apply."¹⁵⁰

The court, in a two sentence per curium opinion, ordered that the case be "remanded to the Commission for a more adequate explanation of its interpretation of Rule 2(e)(1)(ii) and its application in this case."¹⁵¹ Judge Silberman, in a separate opinion, elaborated on the difficulty of reviewing a Commission disciplinary order where the Commission did not make clear the applicable standard of culpability:

The Commission has variously indicated that different levels of mental culpability are needed to make out a 2(e)(1)(ii) violation by professionals (lawyers or auditors): simple negligence as the Commission privately held in *Schulzetenberg*; gross negligence implied by the "so deficient" language of *Haskins & Sells*; recklessness hinted by the Commission in its opinion below; or willfulness or bad faith suggested by *Logan and Carter [& Johnson]*. I think the Commission must choose its standard and forthrightly apply it to this case. Given the enormous impact on accountants—and lawyers—that the Rule has, and in fairness to petitioners, the Commission must be precise in declaring the standard against which petitioners' conduct is measured and exactly why that conduct violated the standard.¹⁵²

Absent a clearer articulation of what standard the Commission actually was seeking to apply, it would be premature for a reviewing court to decide whether the Commission has authority to sanction merely negligent conduct.¹⁵³

culpability." *Id.* n.4 (citing *Danna & Dentinger v. SEC*, No. C-93-4158, 1994 U.S. Dist. Lexis 7256 (N.D. Cal., Feb. 8, 1994)).

147. *Id.* at 458.

148. *Id.*

149. *Id.*

150. *Id.* at 456.

151. *Id.* at 454.

152. *Id.* at 462.

153.

If the Commission were to determine that an accountant's negligence is a per se violation of Rule 2(e), it would have to consider not only the administrative burden such a position would entail but also whether it would constitute a de facto substantive regulation of the profession and thus raise questions of the legitimacy of Rule 2(e)(1)(ii)—or at least its scope.

This is doubtless an important case regarding the SEC's authority to regulate the conduct of professionals practicing before the Commission. . . . I think the Commission should state clearly and without equivocation its decisional standard with respect to "improper professional conduct" under Rule 2(e) and how petitioner's conduct violated that standard.¹⁵⁴

Judge Randolph's opinion in *Checkosky* underscored another problem with the Commission's approach to Rule 2(e) proceedings, the Commission's failure to clearly articulate whether it was applying a different state of mind criteria to accountants than to lawyers, and if so, why. Thirteen years earlier, the Commission had issued its release in *Carter & Johnson*, stating that attorneys "could not be sanctioned under Rule 2(e)(1)(iii) for willfully aiding and abetting [a client's securities law] violations unless they 'were aware or knew that their role was part of an activity that was improper or illegal,'"¹⁵⁵ and that "wrongful intent" was a "basis for distinguishing between those professionals who may be appropriately considered as subjects of professional discipline and those who, acting in good faith, have merely made errors of judgment or have been careless."¹⁵⁶ In *Checkosky*, however, the Commission applied a different standard to the two accountants, stating that "scienter is not required to state a violation of Rule 2(e)(1)(ii)."¹⁵⁷ As Judge Randolph observes, why the principles set forth in *Carter & Johnson* "would not apply equally to auditors prosecuted under Rule 2(e)(1)(ii) for 'improper professional conduct' is far from evident. The Commission's opinion in this case does nothing to answer the question."¹⁵⁸ Although there are some very good reasons for applying a scienter rather than a negligence standard to lawyers in SEC disciplinary proceedings, many of the same reasons apply to accountants as well. As Judge Randolph observes:

[*Carter & Johnson*] said that without a scienter requirement, lawyers would slant their advice out of fear of incurring liability, and management therefore would not consult them on difficult questions. I cannot see why this sort of reasoning would not apply as well to audi-

Id. at 459.

154. *Id.* at 465-66.

155. *Id.* at 484 (quoting *Carter & Johnson*, *supra* note 115, at 84,167).

156. *Id.* at 484. "The Commission reasoned that if a securities lawyer is to exercise his 'best independent judgment . . . he must have the freedom to make innocent—or even, in certain cases, careless—mistakes without fear of [losing] the ability to practice before the Commission.'" *Id.*

157. *Id.* at 455.

158. *Id.* at 484. As Judge Randolph points out, the SEC in the proceedings below had observed that the *Carter* release addressed "the standard for willful aiding and abetting liability under Rule 2(e)(1)(iii), a provision not at issue in [*Checkosky*]." *Id.*

[However,] earlier in its *Carter* opinion, the Commission stated that subsections (i), (ii) and (iii) of Rule 2(e)(1) were of a piece. Each subsection shared the 'same focus'; each 'reflect[ed] the same concerns'; and each was directed at the same goal of protecting the 'integrity of the Commission's processes.' Since 'wrongful intent' distinguishes those 'professionals' worthy of suspension from those who should not be sanctioned, as *Carter* indicated, one is left to wonder why it matters which of Rule 2(e)(1)'s subsections is involved.

Id. (citations omitted).

tors. . . . Encouraging management to be completely candid with its auditor about difficult accounting issues may be just as desirable as encouraging management to consult candidly with outside lawyers, and for similar reasons. If imposing discipline on lawyers for negligence would be counterproductive, as [*Carter & Johnson*] determined, it is not immediately apparent why the same would not be true with respect to accountants.¹⁵⁹

On appeal, the Commission argued that "lawyers owe a duty to their client whereas accountants owe a duty directly to the investing public."¹⁶⁰ However, Judge Randolph found that "the point is elusive,"¹⁶¹ and that "the federal securities laws do not make culpability turn on the nature of the professional."¹⁶² Indeed, before the Commission decided the *Checkosky* case, it was "said with confidence that '[n]either Rule 2(e), nor the courts' recognition of it, ha[s] ever drawn a distinction between accountants and attorneys."¹⁶³ Most important, "if the Commission intends to draw that distinction now, for the first time in its history, it must articulate a rationale for doing so and it must explain why the varying roles of accountants and lawyers translate into varying standards under a rule that makes the same language applicable to both."¹⁶⁴ Judge Randolph concluded with the frustrated observation that *Carter & Johnson* "points in one direction, this case in another" and concurred in the court's decision to remand the case so that the Commission could justify its decision.¹⁶⁵

E. *DANNA & DENTINGER*

In *In re Angelo P. Danna & Mark P. Dentinger*,¹⁶⁶ the SEC sought to impose sanctions under Rule 2(e) on two accountants at Arthur Young & Company in connection with the audit for fiscal 1986 for ILC Technology ("ILC"):

The report, issued December 10, 1986, stated that the examination had been conducted in accordance with generally accepted auditing standards (GAAS) and that the financial statements presented ILC's financial position in accordance with generally accepted accounting principles (GAAP). On January 13, 1987, ILC included this clean or unqualified report in its annual report on Form 10-K with the Com-

159. *Id.*; but see *U.S. v. Arthur Young & Co.*, 465 U.S. 805, 817 (1984) (rejecting analogy between attorney-client and accountant-client communications).

160. *Checkosky*, 23 F.3d at 486 (citing Securities and Exchange Commission brief).

161. *Id.*

162. *Id.* "Accountants, for example, cannot be held liable under section 10(b) of the 1934 Act for negligent conduct any more than lawyers can." *Id.*

163. *Id.* (quoting *In re Keating*, 17 SEC Docket 1149, 1165-66 n.10 (July 2, 1979) (concurring opinion of Chairman Williams)).

164. *Id.* at 486-87.

165. *Id.* at 487. Judge Randolph found that the Commission "not only neglected to spell out what standard it had applied, but also neglected to reconcile this case with its past decisions." *Id.* at 490-91. Believing the Commission acted arbitrarily and capriciously, Judge Randolph urged that the Commission's order be vacated, a step with which the rest of the court did not concur. *Id.*

166. *In re Danna & Dentinger*, Exchange Act Release No. 62, 59 SEC Docket 208 (Apr. 11, 1995) [hereinafter *Danna & Dentinger*].

mission. . . . Less than six weeks later, on February 26, 1987, Raymond Montoya, ILC's Vice President Finance, was arrested and charged with grand theft and embezzlement. As a result of Mr. Montoya's embezzlement, ILC reported an aggregate \$4.366 million as the net before-tax decrease in income resulting 'from restatement for the correction of fictitious inventory and fixed assets and accounting irregularities' in its report for the quarter ended March 31, 1987 on Form 10-Q filed on or about July 6, 1987.¹⁶⁷

The SEC's Office of the Chief Accountant ("OCA") alleged "that the Respondents violated GAAS with respect to the annual audit of ILC's consolidated financial statements for fiscal 1986 because they failed to (1) adequately plan and supervise the audit, (2) obtain sufficient competent evidence, (3) detect errors and irregularities, and (4) exercise due professional care."¹⁶⁸

Danna and Dentinger sought to enjoin the SEC from commencing Rule 2(e) proceedings against them without alleging bad faith on their part. The Federal District Court for the Northern District of California denied their motion, stating that the SEC's "authority under Rule 2(e) . . . is not limited to instances in which improper professional conduct is alleged to have been committed in bad faith, but extends to all situations in which improper professional conduct is alleged which may impair the integrity of the Commission's processes."¹⁶⁹ The district court noted that "[t]he Commission reasonably distinguished between the duties of attorneys in representing clients and the duties of accountants in certifying SEC filings in *Checkosky*."¹⁷⁰

SEC Chief Administrative Law Judge Brenda Murray's subsequent findings of law and fact in *Danna & Dentinger*, however, were made

167. *Id.* at 209-10.

168. *Id.* at 212-13.

Specifically the OCA alleges that Respondents did not conduct an audit in accordance with GAAS because:

1. [T]hey failed to adequately plan the audit with respect to the cash and fixed assets accounts; they failed to adequately plan or perform audit procedures to search for errors or irregularities with respect to the cash account; they failed to properly investigate potential errors or irregularities in the fixed assets account; and they failed to adequately plan the audit of the inventory account to search for errors or irregularities (First Standard of Field Work, SAS 1, SAS 16, SAS 22);

2. [T]hey failed to supervise the audit of the cash and fixed assets accounts, and Mr. Danna failed to supervise Mr. Dentinger with respect to the inventory account (SAS 1, SAS 22);

3. [T]hey failed to acquire sufficient competent audit evidence concerning cash disbursements, fixed assets, and inventory (First Standard of Field Work, SAS 1, SAS 31), and

4. [T]hey failed to exercise due professional care. (Third General Standard, SAS 1) (OCA's Post-trial Brief).

Id.

169. *Danna & Dentinger v. SEC*, No. C-93-4158, 1994 U.S. Dist. Lexis 7256, *3 (N.D. Cal. Feb. 8, 1994).

170. *Id.* at *10. The district court in *Danna & Dentinger* issued its ruling prior to the District of Columbia's remand of *Checkosky* for a more definitive articulation of the culpability standard. See *Checkosky*, 23 F.3d at 454.

against the backdrop of the District of Columbia Circuit's 1994 opinion remanding *Checkosky* to the SEC for more adequate explanation. Judge Murray stated:

I have applied a negligence standard, i.e., the failure to use such care as a reasonably prudent and careful person would use under similar circumstances; the doing of some act which a person of ordinary prudence would not have done under similar circumstances or failure to do what a person of ordinary prudence would have done under similar circumstances.¹⁷¹

Judge Murray went on to state that:

Auditors are persons who based on education, experience, and professional licenses hold themselves out as capable of performing a specialized service at a level which meets GAAS and GAAP. . . .

When auditors fail to meet these minimum standards established by their peers they are negligent. Thousands of publicly held companies are required to file financial statements with the Commission under a regulatory process that has proven to be effective. For the process to work, the filings must conform to a clearly defined and generally accepted level of competence. That standard is the level of accepted professionalism which the accounting and auditing professions have set for themselves in the GAAS and GAAP. To do less is negligent because it does not fulfill the performance level required of a reasonably prudent and careful auditor.¹⁷²

Finding "that Respondents have committed unprofessional conduct," Judge Murray suspended Danna from appearing or practicing before the SEC for one year and Dentinger for six months.¹⁷³

In applying the negligence standard, Judge Murray responds to Judge Silberman's request in *Checkosky* for a more definite standard by defining and applying a negligence standard for Rule 2(e) proceedings against accountants. However, she does not clearly articulate why a negligence standard is appropriate in a Rule 2(e) proceeding other than to state that, "[f]or the [disclosure] process to work, the filings must conform to a clearly defined and generally accepted level of competence."¹⁷⁴ In addition, Judge Murray does not directly address Judge Randolph's observations in *Checkosky* that the SEC had applied a scienter standard to lawyers in *Carter & Johnson* and that "[t]he federal securities laws do not make culpability turn on the nature of the professional."¹⁷⁵ The *Danna & Dentinger* opinion thus does not address the applicable standard for lawyers and why the standard for accountants should be different. It is true that "[a]uditors are persons who based on education, experience, and professional licenses hold themselves out as capable of performing a

171. *Danna & Dentinger*, *supra* note 166, at 213 (citing BLACK'S LAW DICTIONARY 249 (6th ed. 1990)).

172. *Danna & Dentinger*, *supra* note 166, at 213.

173. *Danna & Dentinger*, *supra* note 166, at 244.

174. *Danna & Dentinger*, *supra* note 166, at 213.

175. *Checkosky*, 23 F.3d at 486.

specialized service,"¹⁷⁶ but the same is true of lawyers. One is left wondering whether, if Judge Murray were to decide the *Carter & Johnson* case, she would apply a negligence standard there as well.

VI. LEGISLATIVE CLARIFICATION OF THE STANDARD FOR ACCOUNTANTS

Title III, Section 301 of the 1995 Reform Act¹⁷⁷ amends the 1934 Act¹⁷⁸ by inserting a Section 10A specifying procedures for accountant detection and disclosure of corporate fraud. Section 10A provides that each audit performed pursuant to the 1934 Act must include procedures designed to discover illegal acts having a material effect on financial statements and to identify related party transactions.¹⁷⁹ In relevant part the new section provides that:

Each audit required pursuant to this title of the financial statements of an issuer . . . shall include . . . procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts . . . [and] procedures designed to identify related party transactions that are material to the financial statements . . .¹⁸⁰

Thus, under the new act, accountants must implement procedures to discover illegal acts of their clients. The procedures must be aimed at finding illegal acts that would be material to the financial statements, presumably under the materiality standard applied elsewhere in the 1934 Act.¹⁸¹

In addition, the 1995 Reform Act requires accountants who discover information indicating that an illegal act may have occurred to determine the likelihood that the illegal act has in fact occurred, determine the possible effect of the illegal act on the financial statements of the corporation, and report the illegal act to the appropriate level of management unless such act is clearly inconsequential.¹⁸² If the accountant does report to management under this new section, and remains unsatisfied that management has remedied the problem, then the accountant must go to the full board of directors.¹⁸³ The statute then requires the board to disclose the illegal act to the SEC within one day of the accountant's report.¹⁸⁴ If the board does not disclose the illegal act to the SEC, the statute requires disclosure by the accountant to the SEC.¹⁸⁵ Thus, the

176. *Danna & Dentinger, supra* note 166.

177. H.R. 1058, 104th Cong., 1st Sess. (1995).

178. 15 U.S.C. § 78a (1996).

179. See 1995 Reform Act, *supra* note 6, § 301.

180. 1995 Reform Act, *supra* note 6, § 301.

181. See *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) ("An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.").

182. See 1995 Reform Act, *supra* note 6, § 301(b)(1).

183. See 1995 Reform Act, *supra* note 6, § 301(b)(2).

184. See 1995 Reform Act, *supra* note 6, § 301(b)(3).

185. See 1995 Reform Act, *supra* note 6, § 301(b)(3)(B).

mandatory disclosure requirement leaves virtually no opportunity for the board to rectify the illegal act once notified. In fact, it hardly gives the board an opportunity to verify the report prior to informing the SEC unless the board has prior knowledge of the problem. Although such a procedure may be appropriate for accountants charged with a "watchdog" function, it would not be appropriate for lawyers, whose fiduciary duty to their clients presumably requires them to allow a board of directors time to rectify and/or disclose an illegal act prior to disclosure by the lawyers to the SEC.

The Joint Explanatory Statement of the Committee of Conference explains the effect of the 1995 Reform Act's fraud detection and disclosure provisions on accountants:

The Conference Report requires independent public accountants to adopt certain procedures in connection with their audits and to inform the SEC of illegal acts. These requirements would be carried out in accordance with generally accepted auditing standards for audits of SEC registrants—as modified from time to time by the Commission—on the detection of illegal acts, related party transactions and relationships, and evaluation of an issuer's ability to continue as a going concern.¹⁸⁶

Section 10A(d) provides that the SEC may, in the event of a violation of these provisions, enter a cease and desist order under Section 21C of the 1934 Act or "impose a civil penalty against the independent public accountant and any other person that the Commission finds was a cause of such violation" under the standards in Section 21B.¹⁸⁷ Furthermore, the conference committee never intended to affect the SEC's authority in areas not specifically addressed by the legislation.¹⁸⁸ Therefore, Rule 2(e) proceedings against accountants should not be directly affected, although substantial departure from the 1995 Reform Act's procedures for detection and disclosure of client fraud presumably would be "improper professional conduct" within the meaning of Rule 2(e)(1)(ii). Although the statute does not specifically address standards of culpability, there is no indication that mere negligence excuses departure from the procedures mandated therein. Insofar as failure to carry out the procedures required by Section 10A is concerned, the standard for accountant culpability that is at issue in *Checkosky* and *Danna & Dentinger* appears resolved in favor of negligence.

Although one might expect auditors to oppose these provisions, objections from the accounting profession focused principally on earlier proposals that the audit procedures specified in Section 10A be set "in

186. See 1995 Reform Act, *supra* note 6, Joint Explanatory Statement of the Committee of Conference, Auditor Disclosure of Corporate Fraud, at 43 [hereinafter Joint Statement].

187. 1995 Reform Act, *supra* note 6, § 301(d).

188. Joint Statement, *supra* note 186, at 43.

accordance with methods prescribed by the Commission.”¹⁸⁹ Once this language was amended to refer to “generally accepted auditing standards, as may be modified or supplemented by the Commission,” the AICPA supported the legislation.¹⁹⁰ In addition to the limitations on accountant liability discussed more fully below, one reason for the profession’s support may have been the legislation’s clarification of standards that would be applied in cases of accountant liability¹⁹¹ and discipline.

In particular, the new provision specified exactly what auditors must do to confront client fraud. As pointed out above, while accountants are governed by their profession’s confidentiality rules, they may be required to disclose confidential information in compliance with other laws.¹⁹² The new language of Section 10A requires auditors to implement procedures under GAAS and to forego keeping a client confidence when a client’s management fails to rectify material illegal acts.¹⁹³ The Tenth Circuit in *Winton* conditioned a duty to disclose on a “fiduciary or other similar relation of trust and confidence” between the plaintiff and defendant¹⁹⁴ and the Eleventh Circuit said in *Rudolph* that such a duty could arise out of the “circumstances” of each case.¹⁹⁵ Section 10A instead specifically defines when an auditor has a duty to disclose and to whom. The chosen rules are substantially similar to, and do not conflict with, the rules that the profession has already made for itself.¹⁹⁶ Perhaps most im-

189. H.R. 574, 103d Cong., 1st Sess. (1993), *quoted in* Quinton F. Seamons, Address Before the Business Law Section, Law and Accounting Committee (Mar. 30, 1996) (manuscript on file with the *SMU Law Review*) [hereinafter Seamons].

190. The AICPA said that the measure “should bolster public confidence in the nation’s financial reporting system by requiring auditors to provide earlier public notification of possible misconduct.” *Amended Fraud Detection Bill Approved by House Subcommittee*, 25 Sec. Reg. L. Rep. (BNA) 400 (Mar. 19, 1993). Representative Edward Markey (D-Mass) commented that the bill also enjoyed the support of the Big Six accounting firms. *Kerry Introduces Financial Fraud Bill with Safe Harbor for Whistleblowers*, 25 Sec. Reg. L. Rep. (BNA) 500 (Apr. 2, 1993).

191. Section 203 of the 1995 Reform Act specifically states that “[n]othing in this Act . . . shall be deemed to create or ratify any private right of action,” and an accountant thus presumably could not be sued by a private plaintiff for a violation of § 10A alone. However, the mandate in § 10A could be very relevant to existing causes of action discussed in the text accompanying notes 56-74 *supra*. In particular, courts are unlikely to find that accountants who establish that they complied with § 10A when confronted with client fraud did not perform any duty they might have had to disclose.

192. See discussion *supra* part III.A.

193. See 1995 Reform Act, *supra* note 6, § 301.

194. See *supra* text accompanying notes 62-66.

195. See *supra* text accompanying notes 67-74.

196. There are 171 procedures for detecting and disclosing client fraud. See AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS STATEMENT ON AUDITING STANDARDS 53 (1988). Section 10A(b) of the 1934 Act, added by the 1995 Reform Act, requires auditors to implement procedures for notifying a registrant’s board of directors that are essentially similar to the procedures in SAS 54 (illegal act by clients). SAS 54 also notes that “[d]isclosure to the Securities Exchange Commission may be necessary if, among other matters, the auditor withdraws because the board of directors has not taken appropriate remedial action. Such failure may be a reportable disagreement on Form 8-K.” *Id.* at 54 n.3; see also *id.* at 59 (auditor’s consideration of entity’s ability to continue as going concern). “The Reform Act did not identify any new substantive areas that had not already been considered by the accounting profession. What is new is that the SEC now has express authority to modify or supplement audit standards in these three areas [illegal acts,

portant, at least everyone knows what the rules are.

Congressman, now Senator, Ron Wyden,¹⁹⁷ the sponsor of the Financial Fraud Detection and Disclosure Act, observed in March of 1995:

When this bill becomes law, auditors and executives will be put on notice that while companies may pay for auditors, they do not own them. Investors and taxpayers will sleep better knowing that financial statements describing a company's financial condition reflect reality, not funhouse mirrors.

Accountants sometimes don't find irregularities because current auditing standards do not require them to look sufficiently hard for fraud. The fraud detection system provisions in the Financial Fraud and Disclosure Act will toughen auditing standards by requiring accountants to look harder for material fraud and related party transactions. Auditors will also be expected to evaluate whether there is substantial doubt about a company's ability to continue as a viable concern.

This legislation will not impose new regulatory burdens on public companies, but it will significantly help protect investors and taxpayers, which is why the SEC and state securities regulators have historically supported this legislation. To its substantial credit, the American Institute of Certified Public Accountants has also come out in support of this bill.¹⁹⁸

A critical objective of the Act was not only to require auditors to do a better job, but also to use auditors to change the ethical standards among registrants:

The Financial Fraud Detection and Disclosure Act will change the psychology in the corporate suites of would-be dishonest companies. It will put managers on notice that if they commit fraud, it is more likely to be discovered by auditors, and if the auditors do detect fraud, they cannot be coerced into silence.

Restoring the historical independence of the accounting profession and toughening up its procedures will put well-armed auditors back where they belong—on the front lines protecting the public against financial fraud.¹⁹⁹

Indeed, the new mandate of Section 10A might make auditors' services more valuable by strengthening their position as reputational intermediaries for their clients.²⁰⁰

related party transactions, and going concern evaluations], if not generally." Seamon, *supra* note 189, at 1. Perhaps even more important, "generally accepted auditing standards, as may be modified or supplemented by the Commission" are now specifically incorporated into the 1934 Act and can be enforced by the SEC as such. 1995 Reform Act, *supra* note 6, § 301(a)(1).

197. Senator Wyden is a democrat from Oregon.

198. Ron Wyden, *Requiring Auditors Who Really Audit*, ROLL CALL ASSOCIATES (Mar. 27, 1995).

199. *Id.*

200. Investors rely on "reputational intermediaries," such as bond rating agencies, investment advisors, and investment banks to cost effectively tap into the information market on their behalf. Underwriter liability under § 11 of the 1933 Act, by bonding due diligence work of investment bankers, actually increases the value of investment bankers'

The 1995 Reform Act's quid pro quo for accountants is in Title II, Section 201. This provision eliminates joint and several liability in securities fraud litigation except for defendants who engage in knowing fraud.²⁰¹ A system of proportionate liability is introduced whereby a "covered person against whom a final judgement is entered in a private action shall be liable solely for the portion of the judgement that corresponds to the percentage of responsibility of that covered person."²⁰² This portion is determined by a judge or jury after specific findings as to "the percentage of responsibility of such person, measured as a percentage of the total fault of all persons who caused or contributed to the loss incurred by the plaintiff."²⁰³ Although the definition of "covered person" is broadly defined to include "a defendant in any private action arising under this title [the 1934 Act]," accountants will benefit immensely from thus escaping joint and several liability for frauds that are mostly the work of their clients.²⁰⁴

VII. PROPOSED LEGISLATIVE CLARIFICATION OF THE DISCLOSURE STANDARD FOR LAWYERS

Lawyers have not been affected as much as accountants by joint and several liability in securities class actions,²⁰⁵ but lawyers will also benefit from proportionate liability. Because lawyers do not have fraud detection and disclosure responsibilities imposed on them in the 1995 Reform Act, it might appear that lawyers are getting a "free ride" into proportionate liability. However, precisely the opposite is true. As discussed in Parts IV and V of this Article, confusion over the responsibilities of lawyers faced with client fraud makes a securities lawyer's ride through a civil suit, much less SEC disciplinary proceedings, anything but free. Specification of the lawyer's responsibilities would provide the lawyer with valuable defenses in both civil suits and disciplinary proceedings. Furthermore, while lawyers have statistically lower exposure to monetary damages than accountants, their exposure to losses of reputational capital is significantly greater.²⁰⁶ Thus, while proportionate liability reduces po-

reputations, and this "reputational intermediary" function justifies a significant part of the underwriting fees paid to investment bankers. Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 620 (1984). Accountants and lawyers bound by appropriate rules for detection and disclosure of client fraud could also be valuable reputational intermediaries.

201. "Any covered person against whom a final judgment is entered in a private action shall be liable for damages jointly and severally only if the trier of fact specifically determines that such covered person knowingly committed a violation of the securities laws." 1995 Reform Act, *supra* note 6, § 201 2(A) (1995).

202. 1995 Reform Act, *supra* note 6, § 201(2)(B)(i).

203. 1995 Reform Act, *supra* note 6, § 201(3)(A)(ii).

204. The 1995 Reform Act extends this system of proportionate liability to outside directors of issuers sued under § 11 of the 1933 Act by including in the definition of covered person a defendant in "any private action arising under section 11 of the Securities Act of 1933, who is an outside director of the issuer of the securities that are the subject of the action." 1995 Reform Act, *supra* note 6, § 201(10)(C)(ii).

205. See Marino & Marino, *supra* note 10, at 163; see *supra* text accompanying notes 75-82.

206. See *supra* text accompanying notes 83-85.

tential judgments against lawyers, it does not salvage the reputation of a lawyer subject to a civil suit or SEC disciplinary proceeding. In addition, proportionate liability does not give practicing lawyers what they need most, a clear articulation of what responsibilities they have upon discovering that a client is violating the securities laws. The proposal described below seeks to provide some of the needed clarity by amending the securities laws to include rules for lawyer disclosure of client fraud.

A. DETECTION OF CLIENT FRAUD

From the outset, it is important to recognize that lawyers have a different role in securities transactions than accountants. Thus, procedures for detection and disclosure of client fraud should be different for the two professions. For example, under the 1995 Reform Act, "[e]ach audit required pursuant to this title of the financial statements of an issuer . . . shall include . . . procedures designed to provide reasonable assurance of detecting illegal acts" and "procedures designed to identify related party transactions."²⁰⁷ Lawyers, however, probably should not also be required to exercise due diligence to detect client fraud.²⁰⁸

Indeed, imposing a due diligence requirement on securities lawyers could harm both lawyers and clients. First, a due diligence requirement could change the fundamental nature of a contract for legal services. A lawyer is an advocate and a counselor, not an auditor doing the work of a "public watchdog."²⁰⁹ The accounting and legal professions thus perform separate functions, and a mandatory due diligence requirement imposed on lawyers conflates the two. Second, if high reputation lawyers were to respond to a due diligence requirement by only representing high reputation clients, the requirement could reinforce stratification of the market for the services of securities lawyers.²¹⁰ For some very risky businesses, legal representation for securities offerings might not even be available.

207. 1995 Reform Act, *supra* note 6, § 301(a)(1), (2).

208. Lawyers of course have an obligation to their clients to do their job competently. Lawyers representing an organizational client are potentially liable for negligent failure to detect fraud on the part of an officer or employee of the organization. Nonetheless, there is a substantial difference between malpractice liability running to a client and due diligence obligations running to the SEC or to third parties.

209. *See* United States v. Arthur Young & Co., 465 U.S. 805, 818 (1984) (the "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.").

210. For example, consider underwriters, who are bound by liability under § 11 of the 1933 Act coupled with a due diligence defense. Underwriters are just as choosy about their clients as the lawyers described in Karl Okamoto's study. *See* Okamoto, *supra* note 83. Established underwriters on Wall Street often will not accept business from entrepreneurial and other high-risk issuers, leaving this business for regional firms. However, this pattern is beginning to change, perhaps because courts and the Commission have in the 60 years since passage of the 1933 Act clarified exactly what is "due diligence" for purposes of § 11, and perhaps because of increased competitiveness in the underwriting industry. *See* Frederick D. Lipman, *The Best Way to Launch an Initial Public Offering*, NAT'L L.J., Apr. 17, 1995, at C25. "Even large, prestigious national underwriters occasionally will underwrite a company that has minimal or no earnings or large losses, but has great growth potential." *Id.*

Thus, while issuers and their lawyers should be free to contract for lawyer due diligence running to third parties, for example through opinion letters,²¹¹ the securities laws should not contain a provision for lawyers similar to the 1995 Reform Act provision requiring accountants to implement "procedures designed to provide reasonable assurance of detecting illegal acts."²¹² A lawyer should not turn a blind eye to illegal acts, but it is enough to require a lawyer to take appropriate steps once the lawyer becomes "aware of information that an illegal act has occurred."²¹³ The securities laws thus can put deliberate ignorance outside the parameters of appropriate responses to client fraud without imposing a due diligence obligation. The tension between the negligence standard espoused for accountants in *Danna & Dentinger*²¹⁴ and the statement in *Carter & Johnson* that "wrongful intent" is the basis for professional discipline²¹⁵ should be resolved for attorneys in favor of the scienter standard in *Carter & Johnson*.

B. DISCLOSURE TO THE BOARD OF DIRECTORS

One possible approach would be to require lawyers to report illegal acts, including failure to make required disclosures under the securities laws, first to the appropriate officer or committee within a corporate client. Using language similar to the 1995 Reform Act provisions for accountants, the 1934 Act could require:

(1) INVESTIGATION AND REPORT TO MANAGEMENT.—

If, in the course of carrying out significant responsibilities in the effectuation of a registrant's compliance with disclosure requirements under this Act, a lawyer detects or otherwise becomes aware of information indicating that an illegal act has occurred, the lawyer shall:

(A)(i) determine whether it is likely that an illegal act has occurred; and

(ii) if so, determine and consider the possible effect of the illegal act on the disclosures made by the issuer; and

(B) as soon as practicable, inform the appropriate level of the management of the issuer, unless the illegal act is clearly inconsequential.²¹⁶

Although more precisely articulated, this proposed statutory language imposes on securities lawyers an obligation essentially similar to obligations lawyers already have under applicable rules of professional conduct. Model Rule 1.13, for example, states that if a lawyer representing an organization knows that a constituent of the organization is acting in violation of the law in a manner that could be harmful to the organization,

211. See Painter, *supra* note 39, at 259 (discussing mandatory lawyer whistleblowing coupled with due diligence requirement as opt-in or default rule).

212. 1995 Reform Act, *supra* note 6, § 301(a)(1).

213. See *infra* text accompanying note 216.

214. *Danna & Dentinger*, *supra* note 166.

215. *Carter & Johnson*, *supra* note 115.

216. See 1995 Reform Act, *supra* note 6, § 301(b)(1).

"the lawyer shall proceed as is reasonably necessary in the best interest of the organization."²¹⁷ Under this Rule, measures the lawyer may employ include "referring the matter to higher authority in the organization."²¹⁸ Although this Rule does not require the lawyer to make such a report, doing so may become necessary in certain circumstances, and the comment to the Rule states that if asking the constituent to reconsider the matter fails, "it may be *reasonably necessary* for the lawyer to take steps to have the matter reviewed by a higher authority in the organization."²¹⁹

The proposed statutory language also requires a report only when a lawyer "detects or otherwise becomes aware of information indicating that an illegal act has occurred," departing from the language in the 1995 Reform Act which requires an accountant to make a report of information indicating that an illegal act "has or *may have* occurred."²²⁰ A lawyer need not be absolutely certain of an illegal act in order to be aware of information *indicating* that such an act has occurred. The proposed language, however, is intended to emphasize that lawyers, unlike accountants, should not have an affirmative duty to seek out client fraud.

If a report to management does not remedy the situation, should a lawyer then be required to report to the full board of directors?²²¹ Although there is some debate over whether this additional step is already required under applicable rules of professional conduct,²²² reporting illegal acts to the full board would clearly be the safer course of action for an attorney seeking to avoid liability or discipline in connection with client conduct later deemed to be fraudulent. If incorporated into the 1934 Act, such a reporting requirement would closely mirror the accountant's reporting requirement in the 1995 Reform Act, excluding for now the additional requirement of reporting to the SEC:

217. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13(b)(1995).

218. *Id.*

219. *Id.* Rule 1.13 cmt. 4 (emphasis added). "The stated policy of the organization may define circumstances and prescribe channels for such review, and a lawyer should encourage the formulation of such a policy." *Id.* Rule 1.13 cmt. 3. Essentially, the statutory language proposed in this Article would impose on a registrant a policy requiring a lawyer to report illegal conduct to an appropriate level of management within the organization.

220. 1995 Reform Act, *supra* note 6, § 301(b)(1) (emphasis added).

221. See Del. Gen. Corp. § 141(a). The board of directors runs a corporation and is thus the logical recipient of information concerning a violation of the securities laws and other alleged misconduct.

222. Neither the Model Rules nor the Model Code specifically require that lawyers report illegal acts to a client's full board of directors, and bar associations have resisted attempts by regulators to impose such a requirement. See American Bar Association, *Working Group on Lawyers' Representation of Regulated Clients Report to the House of Delegates* (1993), reprinted in INVITATIONAL CONFERENCE MATERIALS ON LAWYER AND ACCOUNTANT LIABILITY AND RESPONSIBILITY 575 (1993) [hereinafter ABA Working Group]. The Working Group complains that the Office of Thrift Supervision, in prosecuting actions against the attorneys for failed savings and loans, developed "novel theories of professional responsibility" including the notion that lawyers have an obligation to report misconduct to superiors, going "all the way to the client's board of directors." *Id.* at 583. In stark contrast to the obligations that accountants are routinely assumed to have to third parties, the Working Group believed that regulators were also wrong to "seek to impose a duty of due diligence on lawyers with respect to the accuracy of any statements made to federal banking agencies by *the lawyers*." *Id.* (emphasis added).

(2) **RESPONSE TO FAILURE TO TAKE REMEDIAL ACTION**—If, after determining that the person or persons to whom a report was made under paragraph 1 above, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of the lawyer in the course of the representation of the registrant, the lawyer concludes that—

(a) the illegal act has a material effect on the disclosure by the registrant;

(b) the senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the illegal act;

the lawyer shall, as soon as practicable, directly report the lawyer's conclusions to the board of directors.²²³

The principal effect of this statutory language would be to crystalize the amorphous remedial measures suggested in Model Rule 1.13 into a mandatory reporting obligation running ultimately to the board of directors.²²⁴

C. RESIGNATION AND WAVING THE RED FLAG

1. *Resignation*

Still another option would be a rule which requires a lawyer to resign if his client refuses to correct disclosure violations or other illegal acts. Once again, it is not entirely clear that resignation is required in such circumstances under the Model Rules or Model Code,²²⁵ although the SEC's position in *Carter & Johnson* seems to be that a lawyer in such circumstances should not continue to have "significant responsibilities in the effectuation of a company's compliance with the disclosure requirements of the federal securities laws."²²⁶

2. *Waving the Red Flag*

In addition to mandatory resignation, the rule could also require a lawyer whose client refuses to refrain from an illegal act to withdraw any opinion letters and renounce any work product done for the client, effecting a so called "noisy withdrawal."²²⁷ A requirement of withdrawal cou-

223. See 1995 Reform Act, *supra* note 6, § 301(b)(2).

224. However, we also note that registrants should perhaps be allowed to opt out of such a policy by delegating the board's authority over such matters to a committee or to the general counsel of the registrant. See *infra* text accompanying note 242.

225. "[T]he regulators have sometimes taken the view that the lawyer must resign if his or her efforts to prevent the wrongdoing prove unsuccessful. The Working Group again believes this to be an incorrect reading of Rule 1.13 and Rule 1.16." ABA Working Group, *supra* note 222, at 583. It is interesting to note that the ABA Working Group takes this position, despite the fact that the ABA's own ethics opinions require a lawyer to withdraw when her services will further a client's fraud. See ABA Comm. on Ethics and Professional Responsibility, Formal Op. No. 92-366 (1992) (recommends withdrawal when lawyer's services will be used to perpetrate fraud).

226. *Carter & Johnson*, *supra* note 115, at 82,847.

227. See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 cmt. 16 ("Neither this Rule nor Rule 1.8(b) nor Rule 1.16(d) prevents the lawyer from giving notice of the fact of

pled with a mandatory "red flag" would perhaps read as follows:

(3) RESPONSE TO FAILURE TO TAKE REMEDIAL ACTION—If, after determining that the board of directors is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of the lawyer in the course of the representation of the registrant, the lawyer concludes that—

(a) the illegal act has a material effect on the disclosure by the registrant;

(b) the senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the illegal act;

the lawyer shall, as soon as practicable (i) resign from the representation and (ii) withdraw or disaffirm any opinion, document, affirmation or similar work product for the registrant that the lawyer believes at the time of withdrawal to be materially misleading or likely to assist the registrant in committing a further illegal act, including a violation of this Act.²²⁸

The "red flag" under this proposed language must call attention to both work product that is misleading at the time of withdrawal (for example, a legal opinion that the lawyer later discovers to have been based on misrepresentations by her client)²²⁹ and work product the registrant could use to commit an illegal act (for example, a tax opinion which, while accurate in its description of the tax treatment of an investment, will be used to sell securities about which the registrant has made material misstatements).²³⁰ Thus, this proposed language would codify into the securities laws the "noisy withdrawal" permitted in the comments to Model Rule 1.6. Additionally, it would require withdrawal of any opinion that a client seeks to use for illegal purposes.

withdrawal, and the lawyer may also withdraw or disaffirm any opinion, document, affirmation or the like."); see also ABA Comm. on Ethics and Professional Responsibility, Formal Op. No. 375 (1993); Ronald D. Rotunda, *The Notice of Withdrawal and the New Model Rules of Professional Conduct: Blowing the Whistle and Waving the Red Flag*, 63 OR. L. REV. 455, 483-84 (1984) (notice of withdrawal essentially amounts to disclosure and thus accomplishes indirectly an objective that earlier drafts of Rule 1.6 by the Kutak Commission had sought to accomplish directly: allowing lawyers to disclose client confidences to prevent a crime or fraud).

228. The 1995 Reform Act does not contain a similar "noisy withdrawal provision." See 1995 Reform Act, *supra* note 6, § 301(b)(2).

229. Legal opinions and letters to auditors for the most part make representations about a client's affairs at a particular moment in time, such as the closing of a loan or the end of a fiscal year. Generally, the lawyer has no legal obligation to advise the opinion recipient or any third party of changes of law or fact that occur after the date of the opinion letter. ABA Opinion Accord, *supra* note 102, at 203-04. However, if a lawyer writes an opinion letter and later begins to doubt factual or legal representations contained therein, he may be liable for securities fraud for allowing a client to circulate the opinion letter to third parties. *Ackerman v. Schwartz*, 947 F.2d 841, 848-49 (7th Cir. 1991).

230. It is generally considered unethical for a lawyer to provide even a factually and legally correct opinion letter to a client engaged in a fraudulent transaction. "A lawyer should not give an opinion (including one based on hypothetical facts or one that is legally correct as to the limited matters to which it is addressed), if he knows or suspects that the opinion is being sought to further an illegal securities transaction." Association of the Bar of the City of New York, *Report by the Special Committee on Lawyers' Role in Securities Transactions*, 32 BUS. LAW. 1879, 1887 (1977).

D. DISCLOSURE TO THE SEC

The 1995 Reform Act requires an issuer whose board of directors receives a report from an auditor of an illegal act to inform the SEC within one business day, and if the issuer fails to make such a report, the auditor must itself inform the SEC.²³¹ Lawyers probably should not be bound by a similar rule because information concerning an illegal act by a client is almost certain to involve an attorney-client confidence. Because such information is privileged, at a minimum the lawyer should exhaust all appropriate remedies within the organizational client *before* going to the SEC. It clearly would not be in keeping with professional norms for a lawyer simultaneously to report her client's illegal acts to the board of directors and the SEC as the 1995 Reform Act almost requires an auditor to do.²³² A lawyer should give the full board, and particularly the independent directors,²³³ a chance to take remedial measures first. If a whistleblowing requirement were to be added to the statutory language, it should therefore read as follows:

(4) NOTICE TO THE COMMISSION.—If, after determining that the full board of directors of the registrant is adequately informed with respect to illegal acts that have been detected or have

231. 1995 Reform Act, *supra* note 6, § 301(b)(3).

232. The ALI Restatement, *supra* note 98, does contemplate attorney whistleblowing to persons outside an organizational client. Section 155(3) states that when "a constituent of the organization has engaged in action or intends to act in a way that violates a legal obligation to the organization and that will cause substantial injury to it," the lawyer may ask the constituent to reconsider the matter, recommend that a legal opinion be sought, and seek review by an appropriate supervisory authority within the organization (including referral to the highest authority that can act on behalf of the organization). ALI Restatement, *supra* note 98. Up to this point, the language in the ALI Restatement is remarkably similar to Model Rule 1.13. See *supra* text accompanying notes 217-19. However, the ALI Restatement also allows the lawyer to withdraw from the representation or:

[D]isclose the breach of legal duty to persons outside the organization when the lawyer reasonably believes that: (a) the harm to the organization of the threatened breach is likely to exceed substantially the costs and other disadvantages of such disclosure; (b) no other measure could reasonably be taken by the lawyer within the organization to protect its interests adequately; (c) disclosure is reasonably likely to prevent or limit the harm to the organization in a substantial way; and (d) following reasonable inquiry by the lawyer, no constituent of the organization who is authorized to act with respect to the question and is not complicit in the breach is available to make a decision about such disclosure.

In making disclosure, the lawyer must take reasonable measures to restrict disclosure outside the organization to the extent consistent with protecting the interest of the organization.

ALI Restatement, *supra* note 98, § 155(4).

233. Independent directors' concern about their own liability may cause them to demand corrective action upon learning of illegal acts. For this reason, management may keep independent directors in the dark when illegal acts occur. See *Carter & Johnson*, *supra* note 115, at 84,164. National Telephone's independent directors learned that National Telephone was not making the required disclosures for the first time on May 24, 1975, although Carter and Johnson had been recommending that the disclosures be made for over a year. *Carter and Johnson*, *supra* note 115, at 84,164. On May 27, National Telephone's officers resigned and a press release was issued making the required disclosures, causing National Telephone's stock to plummet. *Carter and Johnson*, *supra* note 115, at 84,164.

otherwise come to the attention of the lawyer in the course of representing the registrant, the lawyer concludes that—

(a) the illegal act has a material effect on the disclosure by the registrant;

(b) the board of directors has not taken timely and appropriate remedial actions with respect to the illegal act;

the lawyer shall, as soon as practicable, (i) resign from the representation, and (ii) inform the Commission in writing of the reasons for the lawyer's resignation.²³⁴

The last provision, in effect requiring the lawyer to “rat” on her client, is the most controversial of our proposed amendments to the securities laws. For this reason, the requirement that a lawyer disclose illegal client conduct to the SEC should be either an opt-out rule or an opt-in rule. Thus, the above statutory language should be prefaced with “[u]nless the registrant’s articles of incorporation require otherwise” (opt-out) or “[i]f the registrant’s articles of incorporation so require” (opt-in).²³⁵

E. DEFAULT RULES: OPT-IN AND OPT-OUT

As pointed out above, lawyer disclosure of client fraud to the SEC, like “whistleblowing” generally, is probably best governed by default rules rather than immutable rules. Immutable rules, such as a rule requiring all lawyers to disclose illegal acts by their clients to the SEC, are inefficient if imposed on some lawyers and clients and are likely to be ignored by lawyers who do not want to disclose.²³⁶ Some clients will benefit from the effect mandatory disclosure rules have on their relations with regulators, investors, or other third parties.²³⁷ For example, a rule requiring lawyer disclosure to the SEC of illegal acts (Rule 4 above), might be preferred by a registrant’s institutional investors (securities law violations indeed almost always involve failure to disclose to investors), or even by the management of a registrant seeking to regain credibility after a recent scandal. Other clients, however, will not benefit from mandatory disclosure and will purposely seek out lawyers who ignore such rules. Default rules instead allow lawyers or clients to opt out if they do not want the disclosure regime specified by the rules. A critical component of such an opt-in/opt-out lawyer disclosure regime is that the default rule and any rules chosen in its place should be disclosed *ex ante* (before illegal acts occur) to persons who might be affected by the client’s illegal acts.²³⁸

If default rules are used instead of immutable rules, the next question is who should choose the rules—lawyers or clients? Although in some situations the locus of rule choice should be the lawyer,²³⁹ here the locus of

234. See 1995 Reform Act, *supra* note 6, § 301(b)(3).

235. See discussion *infra* part VII.E.

236. See Painter, *supra* note 39, at 208-96.

237. Painter, *supra* note 39, at 224.

238. Painter, *supra* note 39, at 227.

239. Painter, *supra* note 39, at 257-58 (proposing that lawyers be allowed to choose between different whistleblowing rules and then be required to advertise their choice).

rule choice should be the client. Although lawyers could choose rules and disclose their choice to clients and third parties, the existing disclosure provisions of the securities laws provide an ideal mechanism for a registrant to choose whether to opt-out of the default rule and then to disclose its choice in publicly available filings with the SEC.

Regulatory defaults can be set as majoritarian rules (rules that are appropriate for a majority of registrants) or as penalty default rules (more stringent default rules designed to encourage registrants to choose and clearly articulate their own rules).²⁴⁰ However, in many circumstances, tailor-made rules might be too confusing or idiosyncratic. SEC regulations should thus provide different alternative rules for registrants to choose from by adopting standardized language into their articles of incorporation in place of the default rule specified in the statute.²⁴¹ So long as the chosen rule is clearly stated in the registrant's articles of incorporation, the SEC could take the rule into account in deciding how much to scrutinize the registrant's compliance with disclosure requirements. In addition, investors could take the rule into account when valuing the registrant's securities.

1. *Opt-Out Rules*

Some or all of the above provisions could be enacted as opt-out default rules. A good example is the rule described in section B above that a registrant's lawyer must inform the board of directors if management will not remedy an illegal act. The statutory language should perhaps allow the registrant to delegate the board's authority to deal with an illegal act to a particular committee of the board or even to a particular officer.²⁴² Thus, a registrant could be allowed to opt out of lawyer disclosure to the

240. Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *YALE L.J.* 87-130 (1989). A majoritarian rule might require that a lawyer resign in the face of client refusal to desist from egregious misconduct. A penalty default rule, on the other hand, might require that the lawyer disclose the misconduct to regulators.

241. Corporate law in the United States allows corporate management and shareholders to choose between a variety of forms of corporate governance by choosing where to incorporate. See Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, in *JOURNAL OF LAW, ECONOMICS AND ORGANIZATION* 225-83 (1985). Lawyers could be allowed to choose between a variety of rules of professional conduct concerning such controversial topics as whistleblowing by opting in to professional conduct rules used in another jurisdiction (for example, voluntarily agreeing to be bound by New Jersey's rule requiring lawyers to disclose client confidences if necessary to prevent a crime or fraud). See Painter, *supra* note 39, at 257-58.

242. The SEC has sought comment on a proposal to suggest or require that there be a "disclosure committee" of a registrant's board of directors. See Securities Act Concepts and Their Effects on Capital Formation IS-1022, Securities Act and Exchange Act Release Nos. 33-7314, 34-37480, 62 S.E.C. Doc. 1046 (July 25, 1996), at 30, 61 Fed. Reg. 54,518-01 (1996) (to be codified at 40 C.F.R. pts. 230, 240) (proposed Oct. 18, 1996). Presumably such a committee would "improve the accuracy of disclosure," but it might "result in a diminished oversight role for the rest of the board." *Id.* A registrant which establishes such a committee might choose to opt out of the default rule of disclosure of illegal acts to the full board and instruct its lawyers instead to inform the committee, which in turn would be responsible for rectifying the problem or notifying the board.

board by specifying certain alternative procedures in its articles of incorporation. For example, the articles could instead provide that the registrant's lawyers should report to the general counsel or to a compliance committee. The "noisy withdrawal" required in section C above is another good example. A registrant should probably be allowed to opt out of a mandatory noisy withdrawal by inserting a provision in its articles giving discretion on noisy withdrawal back to the lawyer. Such a provision would replace the proposed statutory default rule with the rule specified in Comment 16 to Model Rule 1.6. that a lawyer *may* "disaffirm any opinion, document, affirmation or the like".²⁴³

2. *Opt-In Rules*

In addition to using opt-out default rules, the securities laws could allow registrants to amend their articles to opt in to enhanced lawyer reporting requirements. A registrant could thus amend its articles to opt in to the last and most controversial rule discussed above: the requirement discussed under section D that the registrant's lawyers report illegal acts to the SEC if the board of directors does not take prompt remedial action. For example, a registrant with a large number of interested or "inside" directors might choose this option to reassure investors that violations of securities laws will not be tolerated. Other opt-in rules might include due diligence obligations analogous to those imposed by the 1995 Reform Act on accountants.²⁴⁴

3. *Opt-In vs. Opt-Out*

Coasian contractual theory suggests that it does not matter whether opt-in or opt-out rules are used. Whatever the original rule is, parties will opt in or opt out to get to the rule they prefer.²⁴⁵ However, game theory might suggest that initial rule choice does matter.²⁴⁶ The default rule may become a focal point that players are unwilling to depart from by opting out of the rule or opting in to another rule. If so, the statute could promote disclosure by requiring disclosure in the default rule and allowing registrants to opt out for nondisclosure.²⁴⁷

243. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 cmt. 15 (1996).

244. For example, a fraud detection rule could require that "unless [the registrant's] lawyer, after reasonable investigation, has reasonable ground to believe and does believe that [the registrant] has not committed and does not intend to commit a crime or fraud, [the] lawyer *shall* reveal the crime or fraud and information necessary to prevent it as well as information necessary to rectify injury to persons or property caused by [the registrant's] commission of a crime or fraud." Painter, *supra* note 39, at 245 (emphasis added). Section 11 of the 1933 Act imposes a similar due diligence obligation in connection with a registration statement on the directors of the issuer, persons signing or certifying the registration statement, and underwriters (but not lawyers). See 1933 Act, 15 U.S.C. § 77k(a) (1988).

245. The Coase theorem holds that, assuming all parties know what the default rule is and there are no transaction costs, it does not matter which default rule is chosen. Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

246. See Painter, *supra* note 28, at 174.

247. Painter, *supra* note 28, at 188.

4. *Opting In or Opting Out in the Bylaws*

Should a registrant's board of directors be allowed to amend its bylaws to opt in or opt out of a lawyer disclosure rule? Unless the board is opting in to more disclosure than provided by the default rule, probably not.

Opting out of a default rule in the articles of incorporation must be approved by the shareholders and directors, whereas a change in the bylaws can be approved by the directors alone.²⁴⁸ Not only are shareholders excluded from the rule choice process, but, until a new bylaw is disclosed in a press release or a securities filing, adequate information about bylaws is less likely to be disseminated to investors than if proxies are solicited to amend the articles. For this reason, registrants probably should not be allowed to opt out for less disclosure than that specified in the default rule merely by amending their bylaws (for example to require the registrant's lawyer to report illegal acts to an officer or committee instead of to the board). Opting in to more disclosure than required under the default rule, however, will in most circumstances give investors enhanced protection and should therefore be allowed by amendment to the bylaws as well as to the articles.

5. *Will Default Rules Help Investors?*

In some ways, a registrant's articles of incorporation embody a contract with its stockholders. Investors thus may pay more for the securities of issuers that use this contract to instruct their lawyers to report illegal conduct to an appropriate authority within the issuer and possibly to the SEC. Alternatively, investors might pay less for securities of an issuer that has chosen to instruct its lawyers to report illegal acts only to a particular officer within the issuer rather than to the full board of directors.

However, such a contractarian approach to legal ethics is open to the same criticism as a contractarian approach to corporate law: namely, opt-in and opt-out rules are inapposite when there is no real "contract" or when one "party," here registrants and their lawyers, chooses the rules, and the other "party," investors, is presented with the rules on a take-it-or-leave-it basis. This contractarian approach can indeed be problematic in the corporate law context where corporate directors and officers are entrusted with funds by large numbers of public investors. As Tamar Frankel observes: "We should reject the view that all rules applicable to public fiduciaries are default rules, no matter how tenuous the 'contract' bargain around [those] rules."²⁴⁹ These are valid criticisms of the contractarian approach to corporate law, particularly where fiduciary duties

248. See MODEL BUSINESS CORP. ACT § 10.02 (amendment of articles of incorporation by board of directors alone only in connection with certain specified corporate formalities), § 10.03 (amendment of articles of incorporation by board of directors and shareholders), § 10.20 (amendment of bylaws by board of directors or shareholders) (1991).

249. Tamar Frankel, *Fiduciary Duties as Default Rules*, 74 OR. L. REV. 1209, 1267 (1995).

established by statutory and common law are “voluntarily” waived.²⁵⁰ However, in the area of professional responsibility, the priorities are somewhat different. Clear standards for lawyer conduct are critical, yet lacking, in the current regime. The current regime mandates lawyer fiduciary duties to clients, but says little about lawyers’ duties to investors.²⁵¹ In circumstances where different rulemaking bodies such as courts, regulators and bar associations can hardly agree on what rules ought to apply,²⁵² an opt-in/opt-out regime using default rules instead of mandatory rules would at least help lawyers and regulators develop standards that are effective and predictable.²⁵³

6. *Is Clarity in Professional Discipline Necessarily Desirable?*

Some scholars have suggested that clear default rules are not necessarily more desirable than “fuzzy” standards. Both Ian Ayres and Michael Klausner have pointed out advantages of open-ended default standards in the corporate law context, including the fact that such standards encourage “building a thick common law precedent of interpretation.”²⁵⁴ In the professional ethics arena, Ian Ayres has suggested that “some substantial minority of contractors (attorneys/firms/agencies)” might:

[J]ointly prefer to have attorneys bound by some open-ended standards that attorneys must act ‘reasonably,’ ‘in good faith,’ or ‘not overreach.’ While each of these standards is imprecise, it may allow attorneys to assure their clients and the agencies that they will not in some sense ‘defect’ Even if only ten percent of the contracting parties jointly prefer to be bound by a standard, it might be best to choose the standard as a default, so that a thick interpretive precedent could most easily form, and allow the remaining ninety percent to explicitly contract for the clarity they prefer.²⁵⁵

Essentially, Ayres argues that lawyers might be better off with fuzzy standards as default rules because courts and agencies would build valuable precedent interpreting those standards and, furthermore, everyone would have an incentive to contract for clearer rules.

In the corporate law context, such a position is not only defensible, but probably correct—jurisdictions such as Delaware have already developed a rich body of case law interpreting standards such as “good faith,” “disinterested director,” and “business judgment,” and this case law has constructed valuable “network externalities” around standards that might

250. For a discussion of limitations on waivers of rights to fiduciary duties, see *id.* at 1242-51.

251. See *Barker v. Henderson*, Franklin, Starnes & Holt, 797 F.2d 490 (7th Cir. 1986); *Renovitch v. Kaufman*, 905 F.2d 1040 (7th Cir. 1990); *Abell v. Potomac Ins. Co.*, 858 F.2d 1104 (5th Cir. 1988). See also Painter, *supra* note 39, at 236-37.

252. See *supra* text accompanying notes 87-176.

253. See Painter, *supra* note 28, at 186-87.

254. Ayres, *supra* note 82, at 208 (commenting on Painter, *supra* note 28); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995).

255. Ayres, *supra* note 82, at 208.

otherwise be intolerably vague.²⁵⁶ In the professional responsibility context, however, such is not the case.

In particular, the "common law precedent of interpretation" developed by the SEC in cases like *Carter & Johnson*, *In re Kern*, and *In re Gutfreund*, is thin and unpredictable, and vague standards continue to predominate.²⁵⁷ The precedent developed by other agencies such as the Office of Thrift Supervision is even worse. Regulators' handling of the savings and loan debacle demonstrated laxity toward both regulated institutions and their lawyers followed by multi-million dollar asset attachments once conduct became egregious.²⁵⁸ Also, unlike disputes over corporate law, matters of professional discipline in regulatory law practice are decided by administrative agencies, not by the courts, except occasionally as a forum of last resort reached only after a lawyer's reputation and career have perhaps already been ruined by an agency.²⁵⁹ The District of Columbia Circuit's remand of Rule 2(e) proceedings in *Checkosky v. SEC*²⁶⁰ is but one example of how courts will wait for clear definitions by agencies of applicable standards before they will begin the process of judicial review. In light of the fact that agencies often settle actions against attorneys²⁶¹ and prefer to articulate professional conduct norms without actually sanctioning lawyers,²⁶² the courts undoubtedly will wait a long time before clearly articulating standards for lawyer disclosure of corporate fraud. Thus, given the extraordinary power that agencies have over lawyers, and the potential for abuse of that power, using a fuzzy standard as a "penalty default" is excessively harsh on the practicing bar. This is particularly true in circumstances where an agency can interpret the fuzzy standard any way it wants to *ex post*, with little chance of judicial review.

The ABA has already moved in precisely the opposite direction by adopting the more concrete Model Rules and abandoning the aspirational standards of the Canons and the Ethical Considerations in the Model Code. Even law students prefer to be governed by definitive stan-

256. See Klausner, *supra* note 254, at 773.

257. See *supra* text accompanying notes 114-40.

258. Painter, *supra* note 39, at 266. See Jonathan R. Macey & Geoffrey P. Miller, *Kaye, Scholer, FIRREA, and the Desirability of Early Closure: A View of the Kaye, Scholer Case from the Perspective of Bank Regulatory Policy*, 66 S. CAL. L. REV. 1115, 1132-39 (1993) (arguing that OTS charged Kaye, Scholer in part to cover up its own ineptitude). Federal deposit insurance and criteria used to evaluate banking agencies create "strong incentives for regulators to delay closing insolvent financial institutions. In fact, banking regulators have strong incentives to delay identifying problem banks, to deny the severity of the banking crisis generally, and to postpone meaningful action for as long as possible regardless of the cost." *Id.* at 1133.

259. The *Kern* case dragged on for nearly two years before the SEC dismissed the case on jurisdictional grounds. See *Kern*, *supra* note 127.

260. See *supra* text accompanying notes 141-65.

261. See *In re Fishbein*, OTS AP-92-19, 1992 WL 560939 (O.T.S.) (Mar. 1, 1992).

262. See *Carter & Johnson*, *supra* note 115; *Kern*, *supra* note 127; and *In re Gutfreund*, Exchange Act Release No. 34-31554, 52 S.E.C. Doc. 2849 (Dec. 3, 1992).

dards rather than "morally and politically loaded words."²⁶³ The proposal in this Article seeks to establish for securities lawyers some of the certainty in professional conduct norms that the bar has aspired to more generally. The proposal is also efficient in providing this certainty through default rules rather than forcing lawyers and clients to contract for the certainty they prefer.

VIII. ADVANTAGES AND DISADVANTAGES OF THE PROPOSAL

A. ADVANTAGES

1. For Lawyers

The *National Student Marketing* court deemed it "unnecessary to determine the precise extent of [the lawyers'] obligations"²⁶⁴ when clients mislead their shareholders. However, such a determination is necessary, and without it lawyers can be left without clear guidance when faced with conflicts between client loyalty²⁶⁵ and confidentiality²⁶⁶ on the one hand and responsibility to uphold the law on the other.²⁶⁷ A clear answer to the question of when and to whom a lawyer must disclose client fraud would restore some much needed certainty to the practice of securities law. Nevertheless, the courts and the SEC have so far failed to provide such an answer. Under the proposal in this Article, lawyers will have the benefit of clear rules that define their responsibilities when faced with corporate fraud. Indeed the proposal would be even more useful, and attractive to the practicing bar, if coupled with a statutory safe harbor protecting lawyers who comply from both civil suits and SEC disciplinary proceedings.

263. Frederick Schauer, *Formalism*, 97 *YALE L.J.* 509, 512 n.8. (1988). Thus, there has been

[T]ransformation of the 'honor codes' at various venerable universities. These codes were phrased in quite general terms at their inception in the 18th and 19th centuries because these schools contained homogeneous student bodies who shared a common conception of the type of conduct definitionally incorporated within the word 'honor.' If a person thought that purchasing a term paper from a professional term paper service was consistent with being honorable, then that person simply did not know what 'honor' meant. As values have changed and as student bodies have become less homogeneous, however, shared definitions of terms such as 'honor' have broken down. Some people now do think that buying a term paper can be honorable, and this breakdown in shared meaning has caused general references to 'honor' to be displaced in such codes by more detailed rules. There may now be little shared agreement about what the precept 'be honorable' requires, but there is considerable agreement about what the rule 'do not purchase a term paper' requires.

Id.

264. *SEC v. National Student Mktg. Corp.*, 457 F. Supp. 682, 713 (D.D.C. 1978).

265. See MODEL CODE OF PROFESSIONAL RESPONSIBILITY Canon 7 (1995) ("A lawyer should represent a client zealously within the bounds of the law.").

266. See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 (1996).

267. *Id.* pmb. ("[A] lawyer's conduct should conform to the requirements of the law . . ."); *id.* ("Lawyers play a vital role in the preservation of society.").

2. *For Registrants*

The proposal in this Article strengthens the working relationship between lawyers, officers, and boards of directors because everybody will know what lawyers must disclose and to whom. Corporate officers will know when a registrant's lawyers are required to turn to the full board of directors. Directors in turn will know that lawyers are required to tell them when management fails to remedy an illegal act. Unless the registrant opts out of disclosure to the board by amending its articles of incorporation, the problem that ruined National Telephone, the failure of Carter and Johnson to inform the outside directors of securities laws violations for over a year,²⁶⁸ is unlikely to occur. Finally, the board will know what lawyers are required to do if the board does not take action to remedy an illegal act.

Game theory postulates that cooperation among players is fostered by some degree of certainty about how each other will act.²⁶⁹ The same is true of lawyers and their clients. Officers and directors of organizational clients are more likely to listen to, and follow the advice of, lawyers whom they know must do something about client fraud. The opt-in and opt-out mechanisms of the proposal allow clients some flexibility to specify *ex ante* exactly what it is that the lawyers must do.

3. *For Investors*

The proposal in this Article provides additional protection to investors who rely on complete and accurate disclosure in buying securities. By looking at a registrant's articles of incorporation, investors will know how much lawyer "gatekeeping" they can expect. In addition, the proposal removes ambiguity about how lawyers should respond to corporate fraud and as a result may increase investors' confidence in the integrity of the legal profession.

B. DISADVANTAGES

1. *For Lawyers*

This proposal may increase malpractice insurance premiums if insurers anticipate lawsuits based on failure to carry out the new disclosure obligations. One way to reduce the cost of insurance would be for the disclosure provisions to specifically exclude a civil right of action for violation thereof.²⁷⁰ Furthermore, insurers should recognize ways in which a re-

268. See *Carter & Johnson*, *supra* note 115.

269. "[T]he conditions for Nash equilibrium are that players are relatively certain how their opponents will act." DAVID M. KREPS, *GAME THEORY AND ECONOMIC MODELING* 140 (1990); see *Painter*, *supra* note 39.

270. Section 203 of the 1995 Reform Act specifically states that "[n]othing in this Act . . . shall be deemed to create or ratify any implied private right of action," and an accountant thus presumably could not be sued for a violation of 1934 Act Section 10A alone. 1995 Reform Act, *supra* note 6, § 203 (codified at 15 U.S.C. § 78j-1). A statutory requirement that lawyers disclose client fraud should be subject to a similar limitation on private rights

quirement to disclose client fraud diminishes total malpractice liability exposure. If required disclosure cuts down on client fraud and makes lawyers less likely to be caught up in whatever fraud does occur, insurance premiums actually should go down.²⁷¹ A statutory safe harbor for lawyers who comply would also reduce the cost of insurance.

Another perhaps more serious problem with the proposal is that the rules may remain unclear. If lawyers and the SEC cannot reach a similar understanding as to when information indicates "that an illegal act has occurred," then lawyers may be no better off than they are under the current regime.²⁷² The proposed language does not impose on lawyers a due diligence duty to look for client fraud. However, some facts that a lawyer may learn about her client lie in the grey area between information clearly indicating that a fraud has occurred and information that only should put a reasonably diligent lawyer on notice that she should investigate further. Of course, the materiality standard that lies at the heart of the securities laws, including the new Section 10A, also contains grey areas, and these grey areas do not make that standard inoperable. It remains to be seen how well the SEC and the accounting profession handle grey areas in the accountant disclosure provisions of the 1995 Reform Act. Perhaps their success in implementing that statute will indicate how well similar language would work for lawyers.

2. For Registrants

One result of the proposal is that corporate officers may be inclined not to share vital information with their lawyers because they fear disclosure to the board of directors or to the SEC. If clients fear disclosure because of a lawyer disclosure requirement, this may impede other aspects of lawyers' work for their clients.²⁷³ The result would be a decrease in the overall quality of representation for clients as well as potential harm to investors resulting from lawyers' lack of information they need to rectify illegal conduct. For this reason, we propose that registrants be allowed to insert opt-out provisions in their articles to redirect disclosure from the full board of directors (the default rule) to a committee of the board, a compliance officer, or another appropriate person. This is also the principal justification for making disclosure to the SEC an opt-in rule that will be chosen only by those registrants who believe that they will benefit more than they will be harmed by instructing their lawyers *ex ante* to disclose.²⁷⁴

of action. Compliance with the statutory requirement, however, should be available as a defense to suits brought under existing private rights of action.

271. See Painter, *supra* note 39, at 291.

272. As Quinton Seamons asks about the accountant disclosure provisions in § 10A, "What is the standard of evidence for auditors in determining illegal acts—for example, preponderance of the evidence, clear and convincing evidence, beyond a reasonable doubt, reasonable evidence, etc." Seamons, *supra* note 189, at 8.

273. See generally Painter, *supra* note 39, at 286-91.

274. See Painter, *supra* note 39, at 275 (discussing the benefits to clients of *ex ante* commitments by lawyers to disclose illegal acts to regulators). See also U.S. SENTENCING COM-

3. Political Disadvantages

Attorneys, unlike accountants, are primarily subject to the supervision of state courts and bar disciplinary committees. The SEC has found that mandating disclosure, or any standard of professional conduct, by lawyers can be even more controversial from a political standpoint than similar regulation of accountants. Attempts by the SEC or by federal legislation—such as that proposed in this Article—to regulate attorney conduct raise federalism issues and issues surrounding the respective functions of the legislature and the judiciary; these issues do not arise in the case of accountants. Shouldn't individual states be allowed to determine appropriate standards for lawyer conduct without interference from the federal level? And shouldn't courts, rather than Congress and the SEC, be the ultimate regulators of the legal profession?²⁷⁵

These are legitimate questions, although it is also legitimate to ask why lawyers should not, like all other participants in securities transactions, be subject to federal as well as state regulation. On balance, it furthermore appears that the patchwork of state ethics rules and bar opinions that govern disclosure of client fraud is insufficient, unclear, and, worst of all for issuers selling securities in multiple jurisdictions, inconsistent. As Harris Weinstein, the former Chief Counsel of the Office of Thrift Supervision, has pointed out:

If you are in Wilmington, Delaware, confronted by a client's intended fraudulent conduct that will likely cause substantial financial harm, and you practice law also in Pennsylvania and New Jersey, you are subject to three different rules. New Jersey requires disclosure to the proper authorities. Delaware forbids disclosure. Pennsylvania permits but does not require disclosure.²⁷⁶

MISSION FEDERAL SENTENCING GUIDELINES MANUAL § 8C2.5(f),(g) (five-point reduction in culpability for self-reporting a particular offense).

275. In 1982, a federal policy making committee made up of both regulators and attorneys reviewed disciplinary proceedings against lawyers by federal agencies and found that "any current problems arising from the discipline of attorneys by federal agencies are not of such a magnitude or so widespread as to require legislative action or a Conference recommendation for the adoption of uniform federal standards." Lawrence G. Baxter, *Reforming Legal Ethics in a Regulated Environment: An Introductory Overview*, 8 GEO. J. LEGAL ETHICS 181, 200 (1995) (citing Report of the Committee on Governmental Processes of the Administrative Conference of the U.S., in II DISCIPLINE OF ATTORNEYS PRACTICING BEFORE GOVERNMENT AGENCIES 488 (1982)). Professor Baxter suggests that "it would be hard to imagine that regulators could muster sufficient political support for so great an invasion of what lawyers perceive as their most exclusive province," even though the "gains in certainty" from federal standards might be in the interest of lawyers practicing in regulated areas. *Id.* at 201-02. Of course, political support from bar associations is not a prerequisite for action by agencies or Congress, *id.* at 202 n.80, and the safe harbor provisions suggested in this Article might be a sufficient inducement for the securities bar to support uniform federal standards of the type suggested herein.

276. Harris Weinstein, *Attorney Liability in the Savings and Loan Crisis*, 1993 U. ILL. L. REV. 53, 64. See N.J. RULES OF PROFESSIONAL CONDUCT Rule 1.6(b)(1) (1996) (requiring a lawyer to disclose information necessary to prevent a client "from committing a criminal, illegal or fraudulent act that the lawyer reasonably believes is likely to result in death or substantial bodily harm or substantial injury to the financial interest or property of another."); DEL. RULES OF PROFESSIONAL CONDUCT Rule 1.6 (1996) (following Model Rule 1.6); PENN. RULES OF PROFESSIONAL CONDUCT Rule 1.6(c)(1) (1996). Although many

What does a lawyer do when assisting a client with selling securities, subject to the 1933 Act, the 1934 Act, and state blue sky laws, in New Jersey, Delaware, and Pennsylvania?

Furthermore, as discussed above, regulators' vision of lawyer professional obligations often conflicts with the bar's interpretation of ethics rules adopted in the various states.²⁷⁷ The judiciary in turn has done little to referee this dispute between regulators and bar associations or to articulate clear, workable, and enforceable standards for lawyer conduct.²⁷⁸

IX. CONCLUSION

Courts have yet to clarify the lawyer's responsibilities regarding client fraud. Also, the SEC's disciplinary and enforcement proceedings rely on vague and sometimes inconsistent standards. Because courts and the SEC have been ambiguous on what a lawyer is required to disclose about a client's conduct and to whom, Congress should clearly articulate *ex ante* what lawyers' responsibilities are rather than leave those responsibilities up to determination by courts and the SEC *ex post*.

This Article has proposed enacting into the securities laws a clear set of rules stating exactly what lawyers must do about client fraud. Although the 1995 Reform Act's immutable disclosure rules are appropriate for accountants, lawyers should not be required to disclose client confidences to regulators. Lawyers should instead be governed by some immutable rules, such as rules requiring a lawyer to resign if a client refuses to rectify a material illegal act, and some default rules, such as rules requiring disclosure of illegal acts to the full board of directors. Lawyers who comply with the rules should be immune from civil suits and SEC disciplinary actions grounded in a theory that they failed to perform a duty to disclose. The statutory language proposed in this Article thus should give lawyers clear guidance for their practice, the SEC clear standards for lawyer discipline, and clients some opportunity to choose the rules that are best for them.

states follow Pennsylvania in making disclosure optional, Florida follows New Jersey in requiring disclosure. See FLORIDA RULES OF PROFESSIONAL CONDUCT Rule 1.6(b)(1) (1996).

277. See, e.g., *supra* note 222; see generally Painter, *supra* note 39, at 230-37.

278. See *supra* text accompanying notes 106-12; Koniak, *supra* note 3, at 1079-91.