ENRON, TYCO, WORLDCOM, ADELPHIA . . . . ETHICAL AND LEGAL RESPONSIBILITIES FOR ATTORNEYS REPRESENTING CORPORATIONS[1]

INTRODUCTION

In the wake of corporate misconduct scandals involving Enron, Tyco, Worldcom, Adelphia and others, Congress passed and President Bush signed into law in July, 2002 the Sarbanes-Oxley Act. While the heart of the Act places new responsibilities and penalties on business executives and accountants, provisions in that Act add substantial responsibilities to attorneys, both general counsel and outside attorneys who represent publicly traded companies. The panel discussion will analyze Sarbanes-Oxley, its impact on both general counsel and private attorneys, review the response by the American Bar Association (ABA), the proposed rules by the SEC and offer observations of where this is headed.

I. Ethical Responsibilities of Lawyers Representing Corporations.

The ethical responsibilities for Iowa attorneys are governed by the Iowa Code of Professional Responsibility. The Iowa Supreme Court is in the process of reviewing recommendations to change to a system which more closely follows the ABA's Model Rules of Professional Conduct. Therefore, reference will be made to both where pertinent.

A. Scope of Representation.

- Model Rule 1.2 states that "A lawyer shall abide by a client's decision concerning the objectives of representation and, as required by Rule 1.4, shall consult with the client as to the means by which they are to be pursued."

- 1.2(d) states that a "Lawyer shall not counsel the client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope and meaning or application of the law."

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Certain parts of this outline are adapted from a corporate advice memorandum of Dorsey & Whitney LLP which can be viewed at www.dorseylaw.com/firm_news.asp.

B. Confidentiality of Information.

- Model Rule 1.6 states that "A lawyer shall not reveal information relating to the representation of a client" unless "The lawyer reasonably believes necessary to prevent reasonably certain death or substantial bodily harm".

- Disciplinary Rule 4-101(c) allows an attorney to reveal the confidence of a client where it involves "the intention of the client to commit a crime and the information is necessary to prevent the crime".

- Note that under DR4-101 there is no obligation on the attorney to reveal confidential information. The Rule states that the attorney "may" reveal the information.

- Disciplinary Rule 7-102(b) states that "A lawyer who receives information clearly establishing that a client has, in the course of the representation, perpetrated a fraud upon a person or tribunal shall promptly call upon the client to rectify the same, and if the client refuses or is unable to do so, the lawyer shall reveal the fraud to the effected person or tribunal in all circumstances except where barred from doing so by Iowa Code §622.10. (Statute on preservation of confidential communication.) If barred from doing so by Iowa Code §622.10, the lawyer shall immediately withdraw from representation of the client unless the client fully discloses the fraud to the person or tribunal.

- Confidentiality is at the heart of the attorney client relationship. Exceptions are few and narrow. May do so to prevent a crime, otherwise withdraw.

C. Representing Corporations.

- Ethical Consideration 5-18 states that "A lawyer employed or retained by a corporation or similar entity owes allegiance to the entity and not to a stockholder, director, officer, employee, representative, or other person connected with the entity. In advising the entity, a lawyer should keep paramount its interest and a lawyers professional judgment should not be influenced by the personal desires of any person or organization."

- Model Rule 1.13 states that "The lawyer for the corporation represents the entity, not the individual directors, officers or employees with whom the lawyer may deal in representing the corporation."

- 1.13(b) requires that where an attorney knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a manner related to the representation that is in violation of a legal obligation of the organization or a violation of the law which may reasonably be imputed to the organization and is likely to result in substantial injury to the organization, the lawyer shall proceed as is reasonably necessary in the best interest of the organization.

- No specific action is required by the attorney but the lawyer is cautioned to take such measures as will "minimize disruption of the organization" and may include such things as asking for reconsideration of the matter, obtaining a separate legal opinion or referring the matter to higher authority in the organization. If the highest authority that can act insists upon action or a refusal to act that is clearly a violation of law and is likely to result in substantial injury to the organization, the lawyer may resign.

D. Truthfulness in Statements to Others.

- Both under Model Rule 4.1 and Disciplinary Rule 7-102, a lawyer cannot knowingly make a false statement of material fact or law to a third person. The Model Rule also prohibits an attorney from failing to disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client.

II. Post Enron Focus on Ethical Responsibilities of Lawyers Representing Corporations.

A. SEC Initial Response.

- On March 7, 2002, 40 law professors, led by Professor Richard Painter of the University of Illinois Law School, submitted a letter to SEC Chairman Harvey Pitt requesting that the SEC adopt a rule of practice applicable to lawyers appearing or practicing before the SEC.

- The gist of the professors' recommendation was that there should be a clear rule regarding an attorney's obligation to report corporate misconduct to the Board of Directors, particularly the independent directors. The professors noted: "We believe that, as a matter of public policy and corporate governance, a lawyer should inform a corporate client's directors, including its independent directors of prospective or on-going illegal conduct that senior management refuses to rectify."

- The SEC General Counsel David Becker responded to the professor's letter indicating that issues of professional responsibility of lawyers have been in the province of state bar rules overseen by state courts.

B. Sarbanes-Oxley Section 307.

- Senator John Edwards of North Carolina, a former successful plaintiff's attorney, submitted an amendment to the accounting and corporate governance reform legislation requiring the SEC to adopt minimum standards of professional conduct applicable to lawyers practicing before the SEC. Section 307 provides:

> Not later than 180 days after the date of enactment of this Act, the Commission shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers,
>
> Including a rule –
>
> (1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and
>
> (2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

C. ABA Task Force on Corporate Responsibility.

- On March 27, 2002 ABA President Robert Hirshon appointed a task force on corporate responsibility. The ABA task force produced a preliminary report dated July 16, 2002. Apart from a variety of recommendations relating to internal corporate governance, the preliminary report includes proposals to consider amendments to the Model Rules of Professional Conduct. The task force provided the following summary of its recommendations relating to lawyer responsibility and conduct which include their proposals to amend the model rules of professional responsibility:

1. Amend Rule 1.13 to require the lawyer to pursue remedial measures for misconduct whether the problem is related to the representation or learned through the representation and to communicate with higher corporate authority where other efforts fail to prevent or rectify the problem, to make clear that disclosure of confidential client information to higher authority within the corporation does not violate Rule 1.6, and to revise language that discourages lawyers from communicating with higher corporate authorities.

2. Extend permissible disclosure under Rule 1.6 to reach conduct that has resulted or is reasonably certain to result in substantial injury to the financial interests or property of another, and require disclosure under Rule 1.6 to prevent felonies or other serious crimes, including violations of the federal securities laws; where such misconduct is known to the lawyer.

3. Expand Rules 1.2(d), 1.13 and 4.1 to reach beyond actual knowledge to circumstances in which the lawyer reasonably should know of the crime or fraud.

4. Improve the linkage among the Model Rules relating to the obligations of a lawyer faced with illegal conduct or breach of fiduciary duty in representing a corporate client.

The task force also made proposals for establishing lines of communication by general counsel and outside counsel.

1. Corporations should adopt a practice whereby general counsel meets routinely and periodically, privately, with one or more independent directors, to facilitate Board attention to potential violations of law by and breaches of duty to the corporation.

2. All engagements of outside counsel should establish at the outset a direct line of communication with general counsel through which outside counsel should inform the general counsel of violations/potential violations of law and duty to the corporation.

III. SEC Proposed Rules.

- The SEC has proposed rules to implement the "up the ladder" reporting requirements of Section 307. See SEC Release No. 33-8150 (www.sec.gov/rules/proposed/33-8150.htm).

- The rules require in-house and outside attorneys for SEC reporting companies to report "up the ladder" if they become aware of "evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer."

A. Scope.

- Applies to in-house and outside counsel who are "appearing and practicing before the SEC in the representation of an issuer".

- Appearing and practicing before the SEC has broad range including transacting business with the SEC, representing any party or witnesses in SEC proceeding, participating in the preparation of any statement, opinion or other writing and preparing or editing discreet sections of SEC filings or other submissions to the SEC.

B. Triggering the Obligation to Report "Up the Ladder".

- "Up the ladder" report is required "if, in appearing and practicing before the SEC in the representation of an issuer, an attorney becomes aware of evidence of a material violation by the issuer whereby any officer, director, employee, or agent of the issuer.

- A material violation includes a "material violation of the securities law, a material breach of fiduciary duty, or similar violation." A breach of fiduciary duty includes any breach recognized at common law, including misfeasance, nonfeasance, abdication of duty, abuse of trust or approval of unlawful transactions.

- Material means conduct or information about which "a reasonable investor would want to be informed before making investment decisions."

- Evidence of a material violation means "information that would leave an attorney reasonably to believe that a material violation has occurred, is occurring, or is about to occur.

- The SEC states that the proposed rules are not intended to impose upon an attorney in a duty to investigate evidence of a material violation or to determine whether in fact there is a material violation.

C. Operation of the "Up the Ladder" Reporting Obligation.

- Initial report. The attorney is required to report the evidence of a material violation to the issuer's chief legal officer (CLO) or the CLO and CEO. While the report can be oral, the reporting attorney must take steps reasonable under the circumstances to document the report and response and must retain this documentation for a reasonable time.

- The CLO must cause such inquiry into the evidence to be made as he or she reasonably believes is necessary to determine whether a material violation has occurred, is occurring or is about to occur. If the CLO reasonably believes there is no material violation, the CLO must so advise the reporting attorney.

- If the CLO reasonably believes that a material violation has occurred, is occurring or is about to occur, the CLO is required to take any reasonable steps necessary to insure that the issuer adopts appropriate remedial measures.

- The rules require the reporting attorney to report further "up the ladder" if he or she reasonably believes that the CLO has not provided an "appropriate response" to the attorney's initial report or has not responded to the initial report within a "reasonable time".

- If an appropriate response is not received, the reporting attorney must report the evidence of a material violation to the issuer's audit committee, to another committee of the issuer's board consisting solely of directors who are not employed directly or indirectly by the issue.

- Failure on the part of the audit committee to make an appropriate response within a reasonable time requires reporting attorneys to take further action:

    - Outside counsel must:

        1. Withdraw indicating that it is based on "professional considerations."

        2. Notify the SEC in writing of the withdrawal within one business day (noisy withdrawal).

        3. Promptly disaffirm to the SEC any opinion, document, affirmation, representation, characterization or the like in a document filed with or submitted to the SEC that the attorney has prepared or assisted in preparing that the attorney reasonably believes is or may be materially false or misleading. (A disaffirmation).

    - An in-house attorney must:

        1. Notify the SEC in writing within one business day that the attorney intends to submit a disaffirmation to the SEC.

        2. Promptly submit a disaffirmation to the SEC.

D. Confidentiality.

- The SEC rules provide that an attorney may but is not required to disclose to the SEC confidential information related to the representation of an issuer if the attorney reasonably believes it is necessary to:
    - Prevent the issuer from committing an illegal act that the attorney reasonably believes is likely to result in substantial injury to the financial interest or property of the issuer or investors.
    - Prevent the issuer from committing an illegal act that the attorney reasonably believes is likely to perpetrate a fraud on the SEC.
    - Rectify the consequences of the issuer's illegal act in the furtherance of which the attorney's services were used.
- The SEC recognizes that this provision conflicts with some states ethics rules. To the extent that this provision permits disclosure of material violations to the SEC where state ethics rules prohibit it, the SEC states that it intends this provision to preempt the state rules.

E. Sanctions.

- The proposed rules provide that an attorney who violates them is subject to the full range of civil sanctions available to the SEC under the Exchange Act, including injunctive and other equitable relief, civil money penalties and cease and desist orders. Violation of the rules, however, without more, would not expose an attorney to criminal sanctions.
- The rule also provides an attorney who violates them is subject to censure or to suspension or barred from practice before the SEC pursuant to Section 602 of the Sarbanes-Oxley Act.

IV. Civil Liability of Attorneys.

- In Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994). The United States Supreme Court held that there was no private cause of action against secondary actors, such as lawyers and accountants, as aiders and abettors under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10(b)-5. The court held that lawyers could be found liable only as primary violators when a lawyer makes a misrepresentation and satisfies the additional elements for Rule 10(b)-5 cause of action, such as scienter.

- The Private Securities Litigation Reform Act of 1995 expressly authorizes the SEC to bring injunctive actions and civil actions for damages for aiding and abetting the security laws. The 9th Circuit in SEC v. Fehn, 97 F. 3d 1276 (9th Cir. 1996), cert denied, 522 U.S. 813 (1997) found an attorney liable who assisted in the preparation and review of deceptive forms 10-Q and specifically held that the Private Securities Litigation Reform Act of 1995 permitted such SEC actions which was not a private cause of action like the one in Central Bank.

- The Sarbanes-Oxley legislative history and the SEC proposal say that there is no private right of action for violation of up the ladder reporting rules.