

Developments in Professional Conduct

New Federal Rules of Professional Responsibility: How Will Antitrust Lawyers be Affected?

Layne E. Kruse

Section 307 of the Sarbanes-Oxley Act of 2002,¹ signed by President Bush on July 30, 2002, requires the Securities and Exchange Commission to promulgate rules within 180 days of its enactment setting “minimum standards of professional conduct” for attorneys. When the new rules are issued in January 2003, they may have an impact on all attorneys who advise public companies. Senator Michael Enzi (R-Wyo.), a co-sponsor of the legislation, explained that “it is clear we need some hard and fast rules, and not just an arcane honor code rarely adhered to, so the necessary measure of client duty is placed in the hearts and minds of the legal profession.”² The ABA lobbied against this provision, and indeed, critics have argued that it will lead to the federalization of the legal practice. This article answers key questions about the statute, and in particular, whether it will have an impact on antitrust lawyers.

What Specific Duties Are Required Under § 307?

Section 307, which is entitled “Rules of Professional Responsibility for Attorneys,” requires 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 chief executive officer.” If these officers do not “appropriately respond,” the attorney must report the evidence to the audit committee, to another committee consisting entirely of outside directors, or to the full board. As explained by the chief sponsor of the provision, Senator John Edwards (D-N.C.), when attorneys “see something occurring or about to occur that violates the law . . . they must act as an advocate for the shareholders, for the company itself, for the investors.”³ However, Senator Edwards emphasized that it applied only to “material” violations. “That means no reporting is required for piddling violations or violations that don’t amount to anything. The obligation to report is triggered only by violations that are material violations that a reasonable investor would want to know about.”⁴

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¹ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

² 148 CONG. REC. S6524 at S6555 (daily ed. July 10, 2002) (Sen. Enzi).

³ *Id.* at S6552 (Sen. Edwards); *id.* at S6554 (Sen. Enzi) (“lawyers are expected to represent the corporation in the best interests of the shareholders”). Sen. Edwards, a former plaintiffs’ personal injury attorney, also explained: “[L]awyers’ obligation should be to the Board of Directors—not to the CEOs, who they play squash with every week.” WALL ST. J., July 25, 2002, at B1. *See also* 148 CONG. REC. S6524 at S6551 (daily ed. July 10, 2002) (Sen. Edwards).

⁴ *Id.* at S6552 (Sen. Edwards).

Will the New Rules Apply to All Attorneys Who Advise Public Companies?

The initial question for antitrust lawyers is whether the statute and new rules will apply “minimum standards” to all lawyers who advise public companies. Section 307 directs the Commission “in the public interest and for the protection of investors,” to set forth “minimum standards of professional conduct for attorneys appearing and practicing before the commission in any way in the representation of issuers.” Thus, the rules will clearly apply to lawyers who actually practice before the SEC, whether they work as corporate counsel or with law firms. Senator Enzi indicated that it was aimed at lawyers who prepare the SEC filings. He explained that this provision would require the SEC to enact standards for “attorneys appearing and practicing before the Commission; not all attorneys, just attorneys appearing and practicing before the Commission; that is, those who are dealing with documents that deal with companies listed by the Securities and Exchange Commission.”⁵

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For law firms, however, that advise public companies on numerous issues, including antitrust problems, as well as disclosures under the securities laws, interpreting Section 307 as applying to attorneys who practice only before the SEC may have little practical impact. The key question is whether knowledge of any attorney in a law firm can be imputed to other attorneys in the same firm that practice before the SEC. The new rules may clarify this issue, but given that knowledge within a firm is often imputed, the knowledge of the law firm, as a whole, including knowledge of “evidence” of antitrust violations or violations of other laws may determine what needs to be reported to upper corporate management.

What Is the Origin of Section 307?

Senator Edwards added the language of Section 307 as an amendment to the corporate governance bill. It was co-sponsored by Senator Enzi and Senator Jon Corzine (D-N.J.)⁶ As acknowledged in the *Congressional Record*, however, the impetus for Section 307 arose from a “bipartisan” group of forty law professors, who had originally proposed to the SEC in January 2002 that new rules be created for lawyer conduct. After the SEC declined to issue the new rules, Congress decided to act.⁷ The provision that finally passed in Congress, however, has language even broader than the law professors’ proposal, which had sought a rule on reporting only actual “knowledge” of fraud.

How Does Section 307 Compare to the ABA Model Rule 1.13?

The fact that an attorney has disclosure obligations to upper management within a corporation is not new. ABA Model Rule of Professional Conduct 1.13, which explains the duty of lawyers to an organizational client,⁸ is premised on whether a lawyer “knows” that an officer or employee “is

⁵ *Id.* at S6555 (Sen. Enzi).

⁶ WALL ST. J., July 25, 2002, at B1.

⁷ 148 CONG. REC. S6524 at S6552 (daily ed. July 10, 2002) (Sen. Edwards); *id.* at S6552 (Sen. Enzi); *id.* at S6557 (Sen. Sarbanes).

⁸ Model Rule 1.13 has been codified in most states and is titled “Organization As a Client.” Rule 1.13 adopts the “entity theory,” as opposed to the “group theory” of representation. Under the entity theory, the entity or organization is the client, not the individual members or officers of the organization, unless there is a specific undertaking to represent them. The group theory is based on the idea that an attorney represents several clients jointly and each constituent of the organization is a “client” with concurrent representation. THE RESTATEMENT ON THE LAW GOVERNING LAWYERS, REPRESENTING AN ORGANIZATION AS CLIENT § 96, adopts a similar “entity” representation theory. *See* 2 GEOFFREY HAZARD & WILLIAM HODES, THE LAW OF LAWYERING at 17-4 through 17-5 (3d ed. Supp. 2002).

engaged in action” or “intends to act” in “violation of law.” Model Rule 1.13(b). The Rule then requires the lawyer to “proceed as reasonably necessary in the best interest of the organization without involving unreasonable risk of disrupting the organization and of revealing information relating to the representation to persons outside the organization.” Rule 1.13 (b) also requires that a lawyer take “reasonable remedial actions whenever the lawyer learns” that an officer, employee, or other person “has committed, or intends to commit a violation of a legal obligation or a violation of law which reasonably might be imputed to the organization” and the “violation is likely to result in substantial injury to the organization” and the violation is related to a matter within the scope of the lawyer’s representation of the company. Rule 1.13 even explains that one remedial measure is reference “to a higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act in behalf of the organization, as determined by applicable law.”

Rule 1.13, like Section 307, does not identify the appropriate remedial action. Senator Edwards acknowledged that under Section 307:

We have not specified how a CEO or a general counsel should act to rectify the violation. That is because the truth is that the appropriate response to cure the problem will vary dramatically, depending on the circumstances. The CEO can do a short investigation, for example, and figure out that no violation occurred, then the obligation stops there. But if there is a serious violation of the law, the appropriate response is clear: The CEO has to act promptly to remedy the violation. If he doesn’t, the lawyer has to go to the board. It is that simple.⁹

Key differences, nevertheless, exist between the ABA Model Rule 1.13 and Section 307. As previously indicated, Rule 1.13 is limited to knowledge that an employee has committed or intends to commit a violation of law. In contrast, the new statute requires action based on mere knowledge of “evidence of a material violation.” Model Rule 1.13 also gives lawyers more discretion on how to handle evidence of wrongdoing, as long as they believe they were acting in the company’s best interest.¹⁰ Rule 1.13 has been described as having a “pro-client” orientation. The lawyer is directed to “minimize” the risk of disrupting the normal work of the organization and to “minimize” the risk of revealing confidential information to others. “Rule 1.13(b) is no charter for whistleblowers.”¹¹ Rule 1.13 gives an attorney the right to take into consideration “the seriousness of the violation and its consequences, the scope and nature of the lawyer’s representation, the responsibility in the organization and the apparent motivation of the person involved . . . and any other relevant considerations.” In other words, in contrast to Section 307, the Model Rule provides considerable discretion to the lawyer. The new statute’s sponsors want “hard and fast” rules.

Do Attorneys Report on Antitrust Violations?

For antitrust lawyers, the main question is whether Section 307 is limited to “evidence” of a violation of “securities laws.” The language was specifically broadened from the law professors’ proposal to the SEC to encompass other types of conduct. Section 307 refers to a “breach of fiduciary duty or similar violation.” The antitrust laws, of course, are not “securities” laws, as defined

⁹ 148 CONG. REC. S6524 at S6552 (daily ed. July 10, 2002) (Sen. Edwards).

¹⁰ See *id.* at S6555 (Sen. Enzi).

¹¹ 2 HAZARD & HODES, *supra* note 8, at 17–32; see 148 CONG. REC. S6524 at S6552 (daily ed. July 10, 2002) (Sen. Edwards). Similarly, in the *Restatement*, there is concern about a measured response by counsel based on numerous considerations. RESTATEMENT ON THE LAW GOVERNING LAWYERS § 96, comment f.

under the federal securities statutes. But does the term “similar violation” include antitrust or environmental or any type of violation? Will the new SEC rules provide guidance on this question? As reported in the press, Senator Edwards wanted the law to require lawyers to report “state law violations of fiduciary duty or similar violations, in addition to federal securities laws violations.” He added the broad language knowing that “these state law violations are not criminal, as could be the case with securities laws violations that are under investigation.”¹² ABA Model Rule 1.13(b), moreover, is not limited to a certain type of violation. It applies to “a violation of law which reasonably might be imputed to the organization, and is likely to result in substantial injury to the organization”¹³ Whether Section 307 applies to almost any type of “violation” remains to be seen in the rulemaking before the SEC, but it appears that the sponsors of Section 307 did not intend to limit the scope of the statute, as long as the conduct injures the corporation.

How Will the SEC Enforce the New Rules?

As a practical matter, the greatest impact of Section 307 may be the fact that the SEC will now be enforcing rules on lawyer conduct regarding public companies, whereas before, states were primarily responsible for attorney disciplinary action. Senator Enzi’s condemnation of the state bars was clear: “[T]he State Bars as a whole have failed. They have provided no specific ethical rule of conduct to remedy this kind of situation. Even if they do have a general rule that applies, it often goes unenforced. Most States also do not have the ability to investigate attorney violations involved with the complex circumstances of audit procedures within giant corporations.”¹⁴ To justify the statute, Senator Enzi, who is an accountant, also argued that the burden imposed on lawyers is far less than that placed on auditors, who have obligations to report to the SEC.¹⁵ SEC Chairman Harvey Pitt echoed these points after the legislation passed. He told the ABA Annual Meeting on August 12, 2002, that the law was aimed at alerting lawyers “representing public companies” that they have “responsibilities requiring government definition.” In particular, Pitt explained he was disappointed about the lax response to cases of possible lawyer misconduct that the SEC had referred to state bars. The new law will give the SEC new powers to police lawyers. Not only will lawyers be subject to review and regulation by state bars, but now the SEC may take an active role in the regulation of conduct by lawyers that advise public companies.¹⁶

Another question is whether the statute will have an impact on third-party claims against attorneys. The sponsors of Section 307 made repeated statements during the debate that the statute was not meant to create a private right of action. Senator Edwards explained that “[n]othing in this bill gives anybody a right to file a private lawsuit against anybody. The only people who can enforce this amendment are the people at the SEC.”¹⁷ Likewise, Senator Enzi said that the amendment “does not create a right of action by third parties. The Fourth Circuit has made such a ruling con-

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¹² 34 Sec. Reg. & L. Rep. (BNA), July 29, 2002, at 1227.

¹³ Nor does Section 96 of the *Restatement* limit the type of violation. According to Comment f, the *Restatement* applies to “an act or failure to act . . . that, although perhaps intended to serve an interest of the organization, will foreseeably cause injury to the client, such as exposing the organization to criminal or civil liability.”

¹⁴ 148 CONG. REC. S6524 at S6555 (daily ed. July 10, 2002) (Sen. Enzi).

¹⁵ *Id.*

¹⁶ Harvey Pitt, SEC Chairman, Remarks Before Annual Meeting of ABA Business Law Section (Aug. 12, 2002), available at <http://www.sec.gov/news/speech>.

¹⁷ 148 CONG. REC. S6524 at S6552 (daily ed. July 10, 2002) (Sen. Edwards).

cerning the code of conduct applied by the IRS Rules.”¹⁸ However, Senator Enzi argued that it may impact the liability of attorneys for securities fraud violations: “The SEC has already found that attorneys who fail to take steps to prevent their clients from violating federal securities law are guilty of aiding and abetting. This amendment will put attorneys on the right course. By reporting violations to the board of directors, they can avoid being found guilty of aiding and abetting their client.”¹⁹ Section 307, moreover, may bolster arguments that lawyers have committed malpractice by not disclosing wrongful conduct as soon as possible to the CEO or to the board. Now that a federal statute clarifies the duties of lawyers on a federal scale, lawyers may have to evaluate their conduct as related to all public companies. Section 307 may set a higher conduct standard for attorneys advising public companies.

Another area of concern is the attorney-client privilege. Sponsors of the statute emphasized that Section 307 would not violate the attorney-client privilege because the client is still the board of directors and shareholders, not the CEO.²⁰ Senator Edwards explained that “there is no obligation to report anything outside the client, the corporation.”²¹ Senator Enzi, in particular, pointed out that the provision “does not empower the SEC to cause attorneys to breach their attorney/client privilege. Instead, as is the case now, attorneys and clients can assert this privilege in court.”²²

The new Rules are due in January 2003. The SEC has not yet announced a schedule for comments and proposals for rulemaking. Any attorney, however, who advises a public corporation should carefully examine each proposal. ●

¹⁸ *Id.* at S6555 (Sen. Enzi).

¹⁹ *Id.*

²⁰ 34 Sec. Reg. & L. Rep. (BNA), July 29, 2002, at 1227.

²¹ 148 CONG. REC. S6524, S6557 (daily ed. July 10, 2002) (Sen. Edwards).

²² *Id.* at S6555 (Sen. Enzi).