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Tattlers and Trail Blazers: Attorneys' Liability for Clients' Fraud

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Unfortunately, newspaper accounts provide support for the view that there has been a precipitous decline in professionalism. Even as the fallout from the Enron-era corporate scandals works its way through the courts, newspapers are filled with allegations of the most recent fraud—the backdating of employee stock options to guarantee that the recipients would profit from their exercise. While the story is still unfolding, it appears that the practice was prevalent and resulted in inaccurate financial statements at many corporations.[1] Although to date no outside counsel has been publicly implicated in the scandal, at least one general counsel has been fired[2] and another has been indicted.[3] Today, the belief, once expressed by the Seventh Circuit, that professionals would not sacrifice their reputations to further their clients' fraud sounds naïve.[4] In his article *The Corporate/Securities Attorney as a "Moving Target" – Client Fraud Dilemmas*,[5] Professor Marc Steinberg demonstrates that the tightening of ethics standards imposes greater responsibilities on attorneys who represent clients that engage in securities fraud, and, as he observes, private claimants increasingly seek redress from attorneys for damages caused by their clients' fraud. Indeed, some firms have paid large amounts in settlement of these claims.[6] Courts, however, are skep-

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1. *See* Charles Forelle & James Bandler, *The Perfect Payday; Some CEOs Reap Millions by Landing Stock Options When They Are Most Valuable; Luck – Or Something Else?*, WALL ST. J., Mar. 18, 2006, at A1, *available at* http://online.wsj.com/public/resources/documents/info-optionsscore06-full.htm (discussing corporations that have come under investigation for alleged backdating).

2. Roberta S. Karmel, *Securities Regulation: The Stock Options Backdating Probe*, 235 N.Y. L.J. 3 (2006) (firing of McAfee's general counsel); *see also* Ashby Jones, *Tough Times for In-House Lawyers*, WALL ST. J., Oct. 16, 2006, at A12, *available at* http://www.online.wsj.com/article_print/SB116095786440793402.htm.

3. *See* Beth Bar, *Former Comverse Executives Confront Backdating Charges*, 236 N.Y. L.J. 1 (2006).

4. DiLeo v. Ernst & Young, 901 F.2d 624, 629 (7th Cir. 1990).

5. *See* Marc I. Steinberg, *The Corporate/Securities Attorney as a "Moving Target" – Client Fraud Dilemmas*, 46 WASHBURN L.J. 1 (2006).

6. *See In re* Global Crossing Sec. & ERISA Litig., 225 F.R.D. 436, 447 (S.D.N.Y. 2004) (approving settlement that included Simpson Thatcher & Bartlett LLP's payment of $19.5 million in partial settlement of claims); Nathan Koppel, *Executives on Trial: Lay Says 'Classic Run on Bank' Ruined Enron; Energy Firm's Outside Counsel Sits in the Cross Hairs of Lerach, Securities Class-Action Kingpin*, WALL ST. J., Apr. 25, 2006, at C1, *available at* http://online.wsj.com/article_print/

tical, generally, about the deterrent value of private securities fraud cases, express concern about the costs they impose on corporate defendants,[7] and, in particular, are suspicious of plaintiffs' efforts to recover from deep-pocket secondary participants like attorneys.[8] Congress has also made it more difficult for plaintiffs to bring securities fraud actions by imposing rigorous pleading standards[9] and preempting state law securities fraud class actions.[10] It would not be surprising, therefore, to find judicial reluctance to impose monetary liability on attorneys for failing to confront their clients' fraud, particularly since judges well understand "that any significant increase in attorney liability to third parties could have a dramatic effect upon our entire system of legal ethics."[11] Professor Steinberg notes the contrast: Judge Sporkin, in an administrative proceeding arising out of the savings and loan debacle, famously asked why not one professional "blew the whistle" to stop the fraud,[12] while courts, in the context of private damages claims, frequently dismiss the notion that attorneys have a duty to "tattle" on their clients.[13] Rather, courts may believe, as expressed by the Seventh Circuit, "that an award of damages under the securities laws is not the way to blaze the trail toward improved ethical standards in the legal . . . profession[]."[14] Professor Steinberg's insightful analysis of the ethical rules provides a useful opportunity to explore the state of the law on private claims for damages for attorneys' breach of these duties.

The first part of this paper examines judicial treatment, after *Central Bank of Denver v. First Interstate Bank of Denver*,[15] of federal securities claims made by purchasers and sellers of securities alleging that the issuer's attorney participated in the corporation's fraud. The second part of the paper explores the Securities and Exchange Commission's (SEC) Rules of Professional Conduct as a basis for malpractice claims

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SB114592536742234763.html (law firms increasingly are targeted in securities suits); Matthew Goldstein, *Going After the Lawyers in Refco's Stunning Fall*, THESTREET.COM, Nov. 21, 2005, http://www.thestreet.com/pf/markets/matthewgoldstein/10253733.html (regulators looking into role law firm played in collapse of brokerage firm). Other instances are cited in Steinberg, *supra* note 5, at 1 nn.2-3.

7. The U.S. Supreme Court, in a series of cases, restricted the private implied remedies under the antifraud rules of the Securities Exchange Act because of its concerns about the special dangers presented by frivolous claims. *See generally* MARC I. STEINBERG, UNDERSTANDING SECURITIES LAW §§ 7.01-7.02 (3d ed. 2001).

8. *See* Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994); *see also* discussion *infra* notes 16-17 and accompanying text.

9. For an overview of the Private Securities Litigation Reform Act (PSLRA) see STEINBERG, *supra* note 7, § 7.12.

10. *See* discussion of the Securities Litigation Uniform Standards Act (SLUSA), *infra* notes 88-89 and accompanying text.

11. Abell v. Potomac Ins. Co., 858 F.2d 1104, 1124 (5th Cir. 1988), *vacated on other grounds sub nom.* Fryar v. Abell, 492 U.S. 914 (1989).

12. Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901, 920 (D.D.C. 1990).

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

14. *Id.*

15. 511 U.S. 164 (1994).

brought by or on behalf of the corporation itself against its attorneys for failing to report fraud by the corporate management that injured the corporation. The third part considers additional state law theories. I conclude, in the fourth part, that the likelihood that courts will impose liability on attorneys for involvement in their clients' fraud is not substantial.

I. LIABILITY UNDER FEDERAL SECURITIES LAWS

Derived from its authorizing statute, § 10(b), which refers to "manipulative" and "deceptive" devices, Rule 10b-5 generally prohibits two forms of securities fraud. Most cases of corporate fraud involve misrepresentations of material facts ("deception") and are covered by Rule 10b-5(b). Other forms of securities fraud involving conduct and not misrepresentations (e.g., classic stock manipulation) are picked up by Rule 10b-5(a) and (c). In *Central Bank*, the Supreme Court, relying principally on the statutory language, stated that there was no aiding and abetting liability for any type of Rule 10b-5 fraud. The Court, however, reaffirmed that anyone, including attorneys and accountants, could be liable for a Rule 10b-5 violation, "assuming *all* of the requirements for primary liability under Rule 10b-5 are met."[16] Because the specific allegations in *Central Bank* involved misrepresentations, the Court, in particular, noted that recognition of aiding and abetting liability would impermissibly dispense with a showing of plaintiff's reliance on the defendant's statements.[17] Since *Central Bank*, lower courts have grappled with the dividing line between primary and secondary liability with respect to both types of Rule 10b-5 fraud.

Rule 10b-5(b) requires, first and foremost, a misstatement or omission of a material fact. Omissions of material facts, however, do not constitute Rule 10b-5 fraud unless there is a duty to disclose the information, and courts have been reluctant to recognize a disclosure duty outside of a fiduciary relationship.[18] *Schatz v. Rosenberg*[19] provides a vivid illustration of this principle. In that case, plaintiffs sold their business to a buyer who later declared bankruptcy and defaulted on payment. They alleged that the law firm representing the buyer committed fraud because it kept silent even though it knew of its client's insolvency. To bolster the claims, they introduced an opinion from the state bar association that the attorney had an ethical duty either to disclose the information or to withdraw from representation. The Fourth Circuit affirmed the trial court's dismissal of the complaint, finding that the law

16. *Id.* at 191.
17. *Id.* at 180.
18. *See* Steinberg, *supra* note 5, at 4-5 & nn.18-21.
19. 943 F.2d 485 (4th Cir. 1991).

firm only "papered the deal" and did not participate in the negotiations. Therefore, the lawyer did not make any misrepresentations, and, according to the court, his ethical obligation did not create a legal duty to disclose under federal securities laws.[20]

Perhaps the outcome in *Schatz* is correct, since the buyers could not have had any reasonable expectation that the seller's attorney would be looking out for them. After all, the transaction was a classic example of arms-length bargaining. In contrast, where the plaintiffs are investing in the enterprise, the argument can be made that the corporation's attorney does owe them a duty since the plaintiffs are becoming participants in a joint enterprise with the corporate client and, if the investment is stock, are also becoming the ultimate owners of the attorney's client. An analogy can be found in classic insider trading liability under Rule 10b-5, which is premised on a fiduciary relationship between the shareholders (including purchasers, who by the transaction become shareholders) and corporate insiders, including temporary insiders like the corporate attorneys.[21] Courts have not, however, distinguished *Schatz* on this basis, and have not recognized a fiduciary relationship between an attorney representing a corporate client and its investors who were misled by the corporation's public misstatements.[22] In order to be liable, an attorney must make a misrepresentation of a material fact on which investors relied. *Rubin v. Schottenstein, Zox & Dunn*[23] provides a useful contrast with *Schatz*. In that case the attorney for the corporation in which the plaintiffs were investing told them that everything was "fine" with the bank, when, in fact, as the attorney knew, the plaintiffs' investment would constitute a default under the corporation's loan agreement with the bank. The Sixth Circuit, reversing the lower court's summary judgment for the attorney, held that liability could be imposed on the attorney for his voluntary disclosure of false information, not because of any fiduciary relationship between the attorney and the investors.[24]

20. *Id.* at 487-89, 497.

21. *See* United States v. O'Hagan, 521 U.S. 642, 653 (1997); Dirks v. SEC, 463 U.S. 646, 655 n.14 (1983).

22. *See* Abell v. Potomac Ins. Co., 858 F.2d 1104, 1125-26 (5th Cir. 1988), *vacated on other grounds sub nom.* Fryar v. Abell, 492 U.S. 914 (1989) (holding that attorneys for the bond issuer's underwriters had no duty to discover and disclose fraud to the purchasers of the bonds); Greenberg Traurig of N.Y., P.C. v. Moody, 161 S.W.3d 56, 80 (Tex. App. 2004) (holding that a law firm had no duty to investigate and disclose to investors adverse information about the CEO and the corporation). In contrast, the corporation's general counsel, who remained silent when the CEO misrepresented the corporation's financial condition to suppliers, could be liable for negligent misrepresentations under state law; he owed them a duty to disclose because of the confidence they placed in him because of his position. Schnelling v. Budd, 291 F. Supp. 2d 1186, 1193 (D. Nev. 2003).

23. 143 F.3d 263 (6th Cir. 1998) (en banc).

24. *Id.* at 265-66; *see also* Trust Co. of La. v. N.N.P., Inc., 104 F.3d 1478, 1491 (5th Cir. 1997) (holding that the attorney who contracted to provide custodial services and made misrepresentations about the collateral was liable to plaintiffs, who were third party beneficiaries of the contract).

Accordingly, in the context of a law firm's representation of a corporate client, where the attorneys assist in the preparation of SEC filings and other communications to the public, a critical issue[25] after *Central Bank* is whether the attorney made a misstatement. Lower courts are struggling to develop a workable test for identifying primary violators. The Second Circuit, in *Wright v. Ernst & Young, L.L.P.*,[26] adopted a "bright-line" rule: a secondary actor could not be liable unless the misstatement was "attributed to [him] at the time of its dissemination," because, in its view, reliance on a misstatement necessarily entails knowledge of the speaker's identity.[27] Under the "bright-line" rule, attorneys will not be held liable where the only allegations are that they "played a significant role in drafting, creating, reviewing or editing allegedly fraudulent letters or press releases,"[28] and there are no allegations that there were misstatements attributable to the law firm that were disseminated to the plaintiffs or the investing public.[29] In contrast, the Ninth Circuit has stated that it is sufficient to establish a defendant's liability if he has substantially participated in the preparation of the fraudulent statements, even if that preparation did not lead to his actual making of the misstatements.[30]

Thus, the positions taken by the Second Circuit and the Ninth Circuit are at opposite ends of the spectrum. The Second Circuit takes the requirement of reliance to an extreme by requiring knowledge of the identity of the speaker, and the Ninth Circuit essentially renames the "substantial assistance" test for aiding and abetting as "substantial participation." *Klein v. Boyd*,[31] a Third Circuit opinion that was vacated pending an en banc rehearing that never occurred, set forth a middle ground. It held that when the attorney plays a substantial role in the

25. In addition, (1) the defendant must act with scienter, *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976); (2) the defendant must know, or at least should have known, that his misstatement would be disseminated to investors, *Anixter v. Home-Stake Prod.*, Co., 77 F.3d 1215, 1226 (10th Cir. 1996); (3) the plaintiffs must rely on the misstatement, *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 180 (1994); and (4) the misstatement must cause the injury, *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 172-73 (2d Cir. 2005). Cases holding that attorneys may be liable for misstatements in opinion letters that were provided to investors include *Kline v. First W. Gov't Sec., Inc.*, 24 F.3d 480 (3d Cir. 1994) and *Ackerman v. Schwartz*, 947 F.2d 841 (7th Cir. 1991).

26. 152 F.3d 169 (2d Cir. 1998).

27. *Id.* at 175.

28. Ziemba v. Cascade Int'l, Inc., 256 F.3d 1194, 1202-03 (11th Cir. 2001).

29. A district court in the Second Circuit announced a modified version of the bright-line test in *In re Global Crossing, Ltd. Sec. Litig.*, 322 F. Supp. 2d 319, 331 (S.D.N.Y. 2004), holding that the accounting firm could be liable, even though not identified in the document, when it helped to create the false statements and the firm's role as the corporation's auditor was well known to investors.

30. *See* Howard v. Everex Sys., Inc., 228 F.3d 1057, 1061 & n.5 (9th Cir. 2000); *In re* Software Toolworks, Inc., 50 F.3d 615, 628 n.3 (9th Cir. 1994); *see also* Wenneman v. Brown, 49 F. Supp. 2d 1283 (D. Utah 1999) (finding allegations that a law firm drafted documents in connection with a scheme to sell unregistered shares sufficient to allege primary liability).

31. [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,136 (3d Cir. Feb. 12, 1998), *vacated pending rehearing en banc*, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,165 (3d Cir. Mar. 9, 1998). Because the parties settled, the en banc hearing never occurred.

creation of a document that is disseminated to investors, he can be considered its author or co-author if he knows (or is reckless in not knowing) that investors will rely on the statement and is aware (or is reckless in not being aware) that the document contains a material misstatement or omission. The lawyer speaking "behind the scenes" is subject to the duty to speak truthfully, even though the document is not attributed to him.[32]

Until recently, courts did not have much occasion to focus on claims brought under Rule 10b-5(a) and (c), where the gravamen of the securities fraud is conduct and not misrepresentations. But, perhaps as a consequence of *Wright,* plaintiffs are now more frequently alleging wide ranging fraudulent schemes.[33] The Second Circuit, in *SEC v. U.S. Environmental, Inc.*,[34] held that a broker who followed the directions of a stock promoter and executed stock trades to further the promoter's manipulative scheme could be primarily liable for stock manipulation so long as he knew (or was reckless in not knowing) that the trades were manipulative, even if he did not share the promoter's specific purpose to manipulate the market for that stock. The court distinguished the broker from defendants who were not found primarily liable in other cases: the broker did not simply fail to disclose information when he had no duty to do so, or fail to prevent another party from engaging in a fraudulent act when there was no duty to prevent it. Instead, he engaged in manipulative conduct.[35]

U.S. Environmental thus suggests that corporate attorneys could be held liable for their substantial participation in a corporate fraud if the claim is based on conduct and not misrepresentations. Just as stock brokers can commit fraud by knowingly executing phony trades, lawyers can commit fraud by knowingly advising their clients, and drafting the documentation, for phony transactions. However, the Supreme Court has sent conflicting messages about what constitutes proscribed conduct under Rule 10b-5(a) and (c). In *Santa Fe Industries, Inc. v. Green*,[36] a private claim for damages, it defined "manipulation" narrowly, viewing it as virtually a term of art;[37] by contrast, in *SEC v. Zandford*,[38] an en-

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32. Chavin v. McKelvey, [1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,325 (S.D.N.Y. Oct. 29, 1998); *see also* Carley Capital Group v. Deloitte & Touche, L.L.P., 27 F. Supp. 2d 1324, 1334 (N.D. Ga. 1998) (holding that primary liability did not require identification of the maker of the misrepresentation).

33. The elements under these paragraphs are: "(1) committed a deceptive or manipulative act, (2) [made] with *scienter*, that (3) the act affected the market for securities or was otherwise in connection with their purchase or sale, and that (4) defendants' actions caused the plaintiffs' injuries." *In re* Parmalat Sec. Litig., 376 F. Supp. 2d 472, 491-92 (S.D.N.Y. 2005).

34. 155 F.3d 107 (2d Cir. 1998).

35. *Id.* at 112.

36. 430 U.S. 462 (1977).

37. *Id.* at 473.

38. 535 U.S. 813 (2002).

forcement action, it viewed manipulative conduct more expansively.

The trial in *In re Enron Corp. Securities, Derivative & ERISA Litigation*[39] is scheduled to begin in spring 2007 and may bring the issue of attorneys' liability to center stage. Purchasers of Enron securities filed this securities fraud class action against a number of defendants, including several law firms. The trial court previously denied a motion to dismiss the complaint against one law firm, Vinson & Elkins, but granted the motion as to Kirkland & Ellis.[40] While the court described Enron as a Ponzi scheme and discussed generally liability based on conduct, its decision focused on liability based on misrepresentations. In doing so, it relied heavily on a "co-creator" test as explicated by the SEC in its amicus brief. Specifically, the court found that an attorney could be held liable "if he or she writes misrepresentations for inclusion in a document to be given to investors, even if the idea . . . came from someone else,"[41] and even if the statement is not publicly attributed to him.

The court's middle-ground position is made clear in its discussion of the allegations against Vinson & Elkins. It strongly suggested that allegations that the law firm had to know of the ongoing fraud, that it structured and provided advice on illicit transactions, and that it chose to engage in illegal activity for lucrative fees were insufficient to impose liability on the law firm. What made the law firm's involvement more than "substantial participation" was the allegation that the law firm drafted many of the public statements about Enron's business and financial situation. "[I]n light of its alleged voluntary, essential, material, and deep involvement as a primary violator in the ongoing Ponzi scheme, Vinson & Elkins was not merely a drafter, but essentially a co-author of the documents created for public consumption concealing [the fraud]."[42] The court, however, dismissed the complaint as to Kirkland & Ellis, finding that it only alleged the performance of routine legal services for some of the Enron-controlled entities. Specifically, the law firm "never made any material misrepresentations or omissions to investors or the public generally."[43]

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39. 235 F. Supp. 2d 549 (S.D. Tex. 2002). On November 1, 2006, the Fifth Circuit agreed to hear an appeal from several defendants, including Vincent & Elkins, challenging the district court's class-action certification. *See* Chron.com, Around the Region, http://www.chron.com/disp/story.mpl/business/4327099.html (last visited Nov. 18, 2006).

40. *In re Enron Corp. Securities, Derivative & ERISA Litigation*, 235 F. Supp. 2d at 708 (granting motion to dismiss as to Kirkland & Ellis). The law firm subsequently settled for $13.5 million. *See* Update on UC's Enron Investments and Lawsuits – University of California News Room, http://www.universityofcalifornia.edu/news/enron/ (last visited Nov. 18, 2006).

41. *In re Enron Corp. Securities, Derivative & ERISA Litigation*, 235 F. Supp. 2d at 588.

42. *Id.* at 705.

43. *Id.* at 706. The court subsequently dismissed claims against another law firm that performed services for Enron and related entities for similar reasons. *See In re* Enron Corp., No. H-01-3624, 2005 U.S. Dist. LEXIS 39927 (S.D. Tex. Dec. 5, 2005).

Therefore, at least according to the *Enron* court, attorneys can be liable when their substantial participation in the clients' fraud includes crafting public misstatements on which the public relies, without the necessity of identifying them as the maker of those statements. Whether the Fifth Circuit will adopt this legal test awaits another day (assuming that the trial goes forward and evidence provides sufficient support for the allegations).

The collapse of Parmalat, the Italian Enron, has produced a series of opinions in the Southern District of New York exploring theories of primary liability.[44] After the corporation's insolvency, investors brought suit against the banks, accounting firms, and law firm, seeking to hold them liable, under Rule 10b-5(a) and (c), for their role in structuring and participating in a series of complex sham transactions to improve the corporation's bottom line.[45] Plaintiffs alleged that the law firm, which was set up to act as Parmalat's New York office, was the "nerve center" of the fraud and that its attorneys used their legal skills to design and perpetrate the transactions that comprised the fraudulent scheme. Specifically, Parmalat engaged in fictitious transactions with two shell companies that were "created and controlled by" the corporation's principal attorney.[46] The court held that these allegations were sufficient to state a claim of primary liability.[47]

Difficult questions remain after the *Parmalat* cases. While painstakingly drawing a distinction between the two forms of securities fraud under Rule 10b-5, the court provides little guidance on how to apply the distinction. While both *Enron* and *Parmalat* involved massive, complex and pervasive financial frauds (both have been referred to as Ponzi schemes) that are distinct from the cases involving garden-variety misrepresentations in press releases or SEC filings, the distinction between fraud as conduct and fraud as misrepresentations is elusive. In addition, *Parmalat* does not provide much guidance on when participation in a scheme becomes so substantial that the participant can be said to be "using or employing" a deceptive device, the statutory language the court focused on.[48] While the judge admonished that basing liability on conduct is not an "end-run" around *Wright*, the two lines of cases seem

44. *See In re* Parmalat Sec. Litig., 376 F. Supp. 2d 472 (S.D.N.Y. 2005) (discussing the liability of the banks); *In re* Parmalat Sec. Litig., 375 F. Supp. 2d 278 (S.D.N.Y. 2005) (discussing the liability of the accountants); *In re* Parmalat Sec. Litig., 383 F. Supp. 2d 616 (S.D.N.Y. 2005) (discussing the liability of the law firm).

45. Plaintiffs also alleged that the defendants made false and misleading public statements under Rule 10b-5(b), but the court dismissed these claims because of the bright-line rule of *Wright*.

46. *Parmalat*, 383 F. Supp. 2d at 625-26.

47. *Id.* at 627; *see also In re* Global Crossing, Ltd. Sec. Litig., 322 F. Supp. 2d 319, 335-37 (S.D.N.Y. 2004) (holding that accounting firm may be liable under Rule 10b-5(a) and (c) as the architect and creator of the accounting schemes used to inflate the company's financials).

48. For example, even the classic manipulative scheme in *U.S. Environmental* involves at least an implicit misrepresentation that the trade is a bona fide transaction.

on a collision course. Indeed, the Eighth Circuit disagrees with the *Parmalat* court's expansive view of fraudulent conduct. In its view, the only form of fraudulent conduct covered by Rule 10b-5 is stock manipulation; thus, unless the plaintiff alleges that the defendant made a misrepresentation or engaged in stock manipulation, he cannot be liable under Rule 10b-5.[49]

While the causes for the massive and brazen frauds like Enron, Parmalat, Worldcom, *et alia*, are many and varied, elimination of aiding and abetting liability as a deterrent surely played a part.[50] Whether the attempts by some lower courts to broaden the category of primary violators will survive review by the Supreme Court remains to be seen. The best solution would be a congressional amendment allowing aiding and abetting liability in private actions. The failure of the Sarbanes-Oxley Act to provide additional remedies for defrauded investors is one of the legislation's significant failings.[51]

II. ATTORNEY MALPRACTICE

Professor Steinberg analyzes the SEC Rules of Professional Conduct, adopted pursuant to the Sarbanes-Oxley Act, which set forth minimum standards of professional conduct for securities attorneys.[52] While the adoption of these Rules engendered much debate and consternation, the obligations they impose on outside counsel are neither novel nor onerous. The Rules set forth the incontrovertible proposition that the attorney owes his professional and ethical duties to the corporate entity.[53] They do not impose any duty on the attorney to investigate whether his client is engaged in fraud. They do not require the attorney to report any fraud outside the corporation. Rather, the attorney cannot close his eyes when he becomes aware of corporate fraud. He must report it to the corporation's chief legal officer (CLO) in the first instance, and if the CLO's response is unsatisfactory, he must continue to report up the ladder. What triggers the reporting obligation "is the gateway to the entire set of obligations created by the SEC rules,"[54] and unfortunately the SEC drafted a virtually incomprehensible definition,

49. *In re* Charter Commc'ns, Inc., Sec. Litig., 443 F.3d 987, 992-93 (8th Cir. 2006).

50. Prior to *Central Bank*, courts imposed liability on both lawyers and accountants for aiding and abetting. *See* JAMES D. COX, ROBERT W. HILLMAN & DONALD C. LANGEVOORT, SECURITIES REGULATION CASES AND MATERIALS 760 (5th ed. 2006).

51. The only provision enhancing private remedies is the increased period for the statute of limitation. 15 U.S.C. § 78aa-1(a) (1994).

52. *See* 17 C.F.R. § 205.1 (2005).

53. 17 C.F.R. § 205.3(a) (2005); *see also* United States v. Munson, No. 03 CR 1153, 2004 WL 1672880, at *2 (N.D. Ill. July 28, 2004) (refusing to dismiss indictment against a lawyer who assisted executives in manipulating corporate earnings and charging him with depriving the corporation of "honest services" in violation of mail and fraud statutes).

54. George M. Cohen, Roger C. Cramton & Susan P. Koniak, *Defective Trigger of SEC Rule Implementing Sarbanes-Oxley's Duty to Report*, 73 U.S.L.W. (BNA) 2419, 2422 (2005).

complete with a double negative. If, in furtherance of his professional responsibilities, the attorney becomes aware of "evidence of a material violation" by the corporation or any of its officers, directors, employees or agents, he must report it.[55] "*Evidence of a material violation* means credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur."[56] Unfortunately, in the words of three law professors who were deeply involved in the rule-making process, "[t]he double-negative formulation makes the standard difficult to understand, interpret or apply."[57]

In this section I examine whether attorneys could be held liable to the corporate client for failing to report management fraud. The elements of a claim for attorney malpractice are generally stated as follows: "(1) the duty to use such skill, prudence and diligence as members of the profession commonly possess; (2) breach of that duty; (3) a proximate connection between the breach and the injury; and (4) actual loss or damage."[58] Many commentators assume that attorneys who do not report up the ladder could be found liable for malpractice[59] and would be liable for damages caused to the entity if he breaches the duty he owes to his client to bring evidence of fraud to the attention of its highest governing body, so that the fraud can be stopped and further damage to the corporation averted. The question, however, is not free from doubt.

The first obstacle is that Section 205.7 specifically states that the Rules do not create a private right of action against any attorney "based upon compliance or noncompliance with its provisions," and that authority to enforce compliance with the Rules is vested exclusively with the SEC.[60] The SEC stated throughout the public comment process that it did not intend that the Rules would create any private right of action.[61] While the implication of a private cause of action is a judicial determination based on legislative intent, the agency relied on comments from the sponsors of the provision that this was the intent of Congress.[62]

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55. 17 C.F.R. § 205.2(b) (2005).

56. *Id.* § 205.2(e). "Material violation," in turn, is defined at 17 C.F.R. § 205.2(i).

57. Cohen, *supra* note 54, at 2419.

58. *See, e.g.*, Loyd v. Paine Webber, Inc., 208 F.3d 755, 759 (9th Cir. 2000) (stating California law).

59. Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, 58 BUS. LAW. 143, 181 (2002); Susan P. Koniak, *Corporate Fraud: See, Lawyers*, 26 HARV. J. L. & PUB. POL'Y 195, 224 (2003). The most thoughtful pre-*Enron* analysis of this issue is found at George C. Harris, *Taking the Entity Theory Seriously: Lawyer Liability for Failure to Prevent Harm to Organizational Clients Through Disclosure of Constituent Wrongdoing*, 11 GEO. J. LEGAL ETHICS 597 (1998).

60. 17 C.F.R. § 205.7 (2005).

61. Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 47276, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,823, at 87,110 (Jan. 29, 2003).

62. Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Re-

In the public comment process, suggestions were made for a safe harbor to protect lawyers from liability when they attempted in good faith to comply with the rules. The SEC went beyond this and adopted Section 205.7 that extends to both compliance and non-compliance so that it would be "truly effective."[63] Its commentary also specifically stated that the safe harbor "is intended to preclude, among other things, private injunctive actions seeking to compel persons to take actions under this part and private damages actions against such persons."[64]

While defendants in any malpractice suits will certainly rely on Section 205.7, it remains an open question whether this defense will prevail. Section 205.7 is limited to precluding private damages claims based on the SEC rules and is consistent with the generally accepted view that an ethics rule violation by itself does not create a cause of action.[65] Section 205.7, however, should not bar claims based on common law negligence or state law malpractice claims where the violation of Section 205.7 should be admissible as evidence of the breach of the attorney's duty of care. Clients may sue their attorneys whenever the attorney has negligently breached a duty of care owed to the client that resulted in monetary harm. An attorney's failure to detect and report management fraud violates the duty of care the attorney owes to the client. This duty of care is inherent in the attorney-client relationship, predates adoption of the SEC rules and exists independently of them. The SEC Rules simply provide further evidence of the standard of care expected from corporate attorneys.

In the release accompanying the final rules, the SEC referred to the Restatement (Third) of Law Governing Lawyers and the ABA Model Rules, both of which state that violations of the professional conduct rules do not create "an implied cause of action for professional negligence or breach of fiduciary duty."[66] Significantly, the SEC did not refer to the last sentence of the Model Rule provision: "Nevertheless, since the Rules do establish standards of conduct by lawyers, a lawyer's violation of a Rule may be evidence of breach of the applicable standard of conduct."[67] Whether or not it was intended by the SEC, the omission of similar language may be interpreted as a signal from the agency that the SEC Rules should play no role in malpractice claims. This position

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lease. No. 46868, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,802, at 86,553 (Nov. 21, 2002).

63. Implementation of Standards of Professional Conduct for Attorneys, Exchange Release. No. 47276, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,823, at 87,098 (Jan. 29, 2003) [hereinafter Final Release].

64. *Id.*. The SEC also specifically referred to the safe harbor when it addressed a likely increase in malpractice insurance premiums as a cost of the regulation. *Id.* at 87,101.

65. *See* RONALD E. MALLEN & JEFFREY M. SMITH, 2 LEGAL MALPRACTICE § 19.7, at 1212 (2006).

66. Final Release, *supra* note 63, at 87,098.

67. MODEL RULES OF PROF'L CONDUCT, preface (2002).

is contrary to the weight of authority that holds that a violation of a professional conduct rule is admissible and at least relevant to prove the breach of the standard of care.[68] While ultimately the issue is for the courts, the SEC appears to be actively discouraging the use of Section 205.7 to establish a standard of care.

The courts may share the SEC's reticence. Judicial alarm over an increasing number of legal malpractice claims can lead to, in the words of one commentator, unjustified protectiveness toward lawyers.[69] Like the SEC, courts show a disinclination to recognize the breach of ethics standards as a basis of liability.[70] They reason that the ethics rules were not adopted for the purpose of providing a remedy in civil litigation and may also reflect a concern that juries may be unduly swayed to impose liability on an "unethical" attorney.[71] *Schatz,* for example, held that an ethical duty to withdraw from representation or disclose information to a third party did not create a corresponding legal duty under federal securities laws.[72]

To date, most of the few relevant cases[73] stem from the savings and loan debacle of the 1980s, when the federal regulators pursued claims against law firms that represented failed financial institutions to recoup losses caused by management fraud.[74] Two of these cases are particularly relevant today.

In *FDIC v. O'Melveny & Myers,*[75] the Ninth Circuit held that the law firm that represented a failed savings and loan association (S&L) could be liable to the S&L's receiver for malpractice because it failed to uncover management fraud in the course of its representation of the client in connection with two estate syndications. Part of its engagement was to perform a due diligence review to confirm the accuracy and completeness of the disclosures in the private placement memoranda. Starting with the basic proposition that "it is an attorney's duty to protect his client in every possible way,"[76] the court held that the law firm could be liable to its client if it was negligent in failing to detect and report that management was cooking the books and misrepresenting the S&L's fi-

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68. GEOFFREY C. HAZARD, JR. & W. WILLIAM HODES, THE LAW OF LAWYERING § 4.1, at 4-6 (3d ed. Supp. 2002); *see also* MALLEN & SMITH, *supra* note 65, at 1217. Some commentators go further in minimizing the significance of the disclaimer. *See* Harris, *supra* note 59; David B.Wilkins, *Who Should Regulate Lawyers?*, 105 HARV. L. REV. 799, 806 n.25 (1992).

69. *See also* HAZARD & HODES, *supra* note 68, § 4.10, at 4-29 - 4-30.

70. *See, e.g.*, Schatz v. Rosenberg, 943 F.2d 485, 492 (4th Cir. 1991); *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002).

71. *See* MALLEN & SMITH, *supra* note 65, § 19.7, at 1211-19.

72. *See supra* notes 19-20 and accompanying text.

73. Harris attributes the paucity of caselaw to the propensity of attorneys to settle these claims. Harris, *supra* note 59, at 636. Koniak attributes it to the reluctance of corporate managers to sue law firms. Koniak, *supra* note 59, at 224.

74. For a more extensive discussion of the cases, see Harris, *supra* note 59, at 619-32.

75. 969 F.2d 744 (9th Cir. 1992), *rev'd on other grounds*, 512 U.S. 79 (1994).

76. *Id.* at 748 (internal quotation marks omitted).

nancial condition. While many subsequent decisions distinguish *O'Melveny & Myers* by finding that other attorneys had a more limited engagement that did not include a duty to investigate,[77] none challenges the proposition that an attorney who uncovers evidence of management fraud is committing malpractice if he does not report up the ladder.

FDIC v. Clark[78] provides a more specific discussion of what constitutes attorney negligence. The bank's management perpetrated a fraud that involved the purchase of stolen money through loans procured through the bank. The jury found two instances where the attorneys, partners in a law firm, had received sufficient notice of the fraud that they should have investigated further. One attorney received a complaint that was filed against the bank about irregularities in its loan procedures; another attorney negotiated a settlement of the lawsuit. Moreover, neither attorney adequately informed the board of directors about this law suit. There was evidence that had the directors been fully informed they would have conducted an investigation and would have discovered the fraud. Applying Colorado law that "(a)n attorney owes his client a duty to employ that degree of knowledge, skill, and judgment ordinarily possessed by members of the legal profession,"[79] the court found that this evidence supported a verdict of negligence.[80]

The FDIC, which acts as the receiver for failed S&L's, was the plaintiff in both *O'Melveny & Myers* and *Clark.* Outside of this situation, there have been few malpractice suits, suggesting reluctance on the part of management to pursue these claims. Because state corporate law limits the situations where shareholders can bring derivative suits to pursue corporate claims,[81] it is unlikely that there will be very many malpractice suits brought by or on behalf of the corporation.

III. OTHER STATE THEORIES

Investors may seek to hold attorneys responsible under additional state law theories: negligent misrepresentations and secondary liability.[82] Attorneys may be liable if, in the course of their representation of their client, they made negligent misrepresentations to investors. Ac-

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77. *See, e.g.*, Loyd v. Paine Webber, Inc., 208 F.3d 755, 760 (9th Cir. 2000) (holding that attorneys do not have a general duty to investigate whether his client is engaged in fraud).

78. 978 F.2d 1541 (10th Cir. 1992); *see also* BCCI Holdings (Luxembourg), S.A. v. Clifford, 964 F. Supp. 468 (D.D.C. 1997) (discussing a corporation's negligence claims against its attorneys).

79. *Clark*, 978 F.2d at 1550 (quoting Myers v. Beem, 712 P.2d 1092, 1094 (Colo. Ct. App. 1985)).

80. *See In re* Am. Cont'l Corp./Lincoln Sav. & Loan Sec. Litig., 794 F. Supp. 1424, 1453 (D. Ariz. 1992) ("An attorney who represents a corporation has a duty to act in the corporation's best interest when confronted by adverse interests of directors, officers, or corporate affiliates.").

81. *See* Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

82. For discussion of state securities law theories, see Marc I. Steinberg & Chris Claassen, *Attorney Liability Under the State Securities Laws: Landscapes and Minefields*, 3 BERKELEY BUS. L.J. 1 (2005).

cording to section 552(1) of the Restatement (Second) of Torts:

> [o]ne who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.[83]

Case law, however, exhibits a general disinclination to impose liability for negligent misrepresentations unless the defendant had a special duty to use care to make accurate representations. Thus, liability will be imposed only on those persons who possess unique or specialized expertise or who are in a special position of confidence or trust with the injured party.[84] In *Molecular Technology Corp. v. Valentine*,[85] for example, the court held that attorneys who reviewed and revised an offering circular could be liable for negligent misrepresentations to those buyers who relied on it, provided that they knew or should have known that the investors would be shown the offering circular.

In addition, investors may be able to pursue secondary liability claims against attorneys under state law. In *Greenberg Traurig of New York, P.C. v. Moody*,[86] a law firm performed legal services for a corporation whose CEO repeatedly violated a permanent injunction against the sale of unregistered securities. The appellate court, reversing a jury verdict against the law firm because of numerous errors, followed the prevailing law and held that the law firm owed no duty to disclose the fraud to the investors. It did hold, however, that the law firm could be liable for conspiracy to defraud the investors for its role in assisting the corporation in its efforts to obtain additional financing, when it knew that the many securities violations committed by the CEO and the corporation were undisclosed.[87] The attorneys argued that they were unaware of their client's past securities violations; however, given the seriousness of these violations, *Greenberg Traurig* suggested that the attorneys should have investigated their client before undertaking to represent it. When the CEO has a lifetime ban on selling unregistered

83. RESTATEMENT (SECOND) OF TORTS § 552(1) (1977); *see also, e.g.*, Maliner v. Wachovia Bank, No. 04-60237CIV, 2005 WL 670293, *11 (S.D. Fla. Mar. 1, 2005) (allowing plaintiff's negligent misrepresentation claim against portfolio manager).

84. Expertise alone may not be enough. *See* Mechigian v. Art Capital Corp., 612 F. Supp. 1421, 1431 (S.D.N.Y. 1985) (expressing "unwilling[ness] to hold that in every case wherein someone with expertise is hired a fiduciary relationship is created.").

85. 925 F.2d 910 (6th Cir. 1991).

86. 161 S.W.3d 56 (Tex. App. 2004); *see also* Thornwood, Inc. v. Jenner & Block, 799 N.E.2d 756 (Ill. App. Ct. 2003) (holding that a claim was stated against law firm as a co-conspirator and for aiding and abetting its client's breach of fiduciary duty).

87. *Greenberg Traurig*, 161 S.W.3d at 102; see *also* Prince v. Brydon, 764 P.2d 1370 (Or. 1988) (holding that attorney who advised limited partnership on private placement could be liable to a purchaser under state securities law for materially aiding the sale of unregistered securities, unless he could establish a reasonable care defense).

securities, the only representation the securities lawyer should be offering is an effort to rescind the prohibition.

The Securities Litigation Uniform Standards Act of 1998 (SLUSA), however, severely limits the effectiveness of these state law claims since it preempts class actions based on untrue statements or omissions of material facts in connection with the purchase or sale of most publicly traded securities.[88] Congress enacted SLUSA because it was concerned that plaintiffs' attorneys could avoid the strictures of the Private Securities Litigation Reform Act (PSLRA) by bringing securities class actions in state court. Therefore, unless there are individual investors whose damages are considerable, it is not economically feasible[89] for plaintiffs to bring state law misrepresentations or omissions claims.

IV. CONCLUSION

Judicial efforts to expand primary liability after *Central Bank* and the congressional directive to the SEC to adopt Rules of Professional Conduct stem from the Enron-era corporate scandals and the public's disgust that highly-paid lawyers were allegedly involved in every aspect of the sham transactions that deceived the marketplace. If in fact lawyers are exposed to a greater risk of liability, they have brought it on themselves.

Moreover, private actions may be necessary for adequate enforcement of attorneys' professional responsibilities. There is concern in some quarters that state disciplinary proceedings are ineffectual in enforcing professional responsibilities where large corporate law firms are concerned.[90] While the SEC's Enforcement Division recently has brought a number of enforcement proceedings against lawyers who have played some role in their clients' fraud,[91] it is the Office of the General Counsel that is responsible for enforcing the Rules of Professional Conduct, and to date there are no reports of SEC enforcement of its Rules.

So how likely is it that courts will impose liability on attorneys for damages caused by their clients' fraud? In my opinion, courts do not appear enthusiastic about using damages awards to "blaze the trail to-

88. Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (codified as amended in scattered sections of 15 U.S.C.). The Supreme Court, in *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503 (2006), made clear it would interpret SLUSA expansively.

89. SLUSA also permits a class of no more than 50 plaintiffs. 15 U.S.C. § 77p(f)(2)(A)(i)(I).

90. *See* Koniak, *supra* note 59, at 215.

91. *See* Stephen M. Cutler, Dir., Div. of Enforcement, SEC, Speech by SEC Staff: The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program (Sept. 20, 2004), *available at* http://www.sec.gov/news/speech/spch092004smc.htm. For a critical assessment of the SEC's actions, see Lewis D. Lowenfels, Alan R. Bromberg, & Michael J. Sullivan, *Attorneys as Gatekeepers: SEC Actions Against Lawyers in the Age of Sarbanes-Oxley*, 37 U. TOL. L. REV. 877 (2006).

ward improved ethical standards."[92] While some law firms have paid large amounts to settle these claims, the payments may be based on a desire to hush up the matter rather than an assessment of the probability of plaintiffs' recovery. We must await further developments to see if the *Enron* and *Parmalat* cases result in new law in this area. Furthermore, at this time the extent of attorneys' involvement in the backdating scandal is unknown. Unfortunately, as with the S&L scandals of the 1980's, this chapter in attorney regulation may close without significant improvement in attorneys' professional responsibilities.[93]

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

93. *See* Stephen M. Bainbridge, *Sarbanes-Oxley: Legislating in Haste, Repenting in Leisure* 6 (UCLA Sch. of Law, Law & Econ. Research Paper Series, Research Paper No. 06-14), *available at* http://ssrn.com/abstract=899593 (arguing that "it will become even easier for lawyers who wish to turn a blind eye to client misconduct to do so").