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THE ETHICAL DUTY OF THE CORPORATE LAWYER

By John Lessing and Kay Lauchland (Associate Professors, Faculty of Law, Bond University)

Introduction

It is important to understand the distinction between the lawyer as advocate or litigator and the corporate lawyer (which includes tax and other business planning specialists). [1]

The first distinction concerns the relationships with the client. Litigators tend to see themselves as a shield between their oppressed or exploited client and the state or plaintiff's lawyers. They function in an adversarial environment and are usually consulted on an ex post basis after the contested events have occurred.

Corporate lawyers, by contrast, usually advise on an ex ante basis and could (traditionally at least) be seen as 'wise counsellors' who had a continuing relationship with their clients unlike the litigator who was more usually hired to assist the client with a particular matter.

Corporate lawyers were thus typically in a position to point out the implications of various courses of action to their clients and thus to influence the client's conduct.

[1] Coffee (p192) discusses this distinction in some detail

This meant that corporate lawyers were in a position to guide their clients into adapting appropriate moral conduct.[2]

The relationship between corporate lawyers and their clients has changed in the last few decades – due to the increasing role of in-house lawyers. The latter have become more popular due to the increasing cost of hiring 'outside' lawyers, which are now hired more on a transaction specific basis.[3]

It can be argued that this development makes it less likely that the outside corporate lawyer will act in the traditional 'wise counsellor' role.[4] However, this argument is not entirely convincing as the outside lawyer would still be consulted on an <u>ex</u> <u>ante</u> basis and is also more likely to be less reliant on one particular client for its income.[5] By contrast, in-house lawyers can hardly be described as independent professionals as they are *entirely* dependent on the one corporation to pay their salaries although they are the ones who are now more likely to have the ongoing relationship with the corporation and the knowledge that accompanies this role.

A further complicating factor is that the in-house lawyers often have a significant say in which outside lawyers are hired by the corporation. Indeed, the in-house lawyer may be viewed as the real client by the outside lawyer.

The second distinction between corporate lawyers and advocates or litigators relates to the different skill sets required by each. The latter require particular skills in oral

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[2] There is some evidence that Wall Street Lawyers historically used their position in this way. See Erwin Smigel, *The Wall Street Lawyer* (1964) p6 – cited by Coffee on p233.
[3] See if there are any figures on the number of in-house lawyers in Australia.
[4] See Coffee p194.
[5] This is particularly so due to the growth in large law firms and the accompanying lateral mobility of the specialist partner. See Coffee pp223-229 for a discussion of the growth of the role of 'a house counsel' and the accompanying change in the role of outside counsel in the U.S. He argues that this has led to a fragmentation of work and responsibility. 'At its worst (and Enron may have exemplified this), each division consults its own outside lawyers, and their legal advice does not reach the top in a consistent or undistorted fashion.' (at p225).

advocacy and knowledge of procedural rules. As 'transaction engineers', corporate lawyers require particular skills in 'negotiation, drafting, business planning, and the ability to maintain a comprehensive, almost encyclopaedic, understanding of extremely complex and integrated business transactions'.[6] Corporate lawyers are particularly occupied with negotiating, planning and structuring of these business transactions. However, they have also assumed greater responsibility for assisting clients in preparing disclosure documents and shareholder communications. And it is particularly when fulfilling these functions that investors have come to rely on the verification role of the corporate lawyer.

Position in the United States

A significant area where it could be argued that the securities lawyer has a gatekeeping role is in the due diligence process that accompanies the preparation of a disclosure document. In the U.S., this can be traced back to the first of the federal securities statute, the Securities Act of 1933.[7]

Underwriters and the directors of the issuer usually delegated responsibility for conducting the due diligence investigation to their lawyers who appreciated that they could not simply rely on the statements made by their clients and adopted a genuinely investigative approach. This approach was endorsed by the courts which required the lawyers to examine the documentary evidence and not simply rely on the client's statements.[8]

This obligation to investigate their own client's statements clearly distinguished securities lawyers from advocates or litigators – whose role is not to question the

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[6] Coffee, p193
[7] For a discussion of the historical development of due diligence, see Coffee p202-207.
[8] See eg. *Escott v Bar Chris Construction Co* 283 F. Supp. 643 (S.D.N.Y. 1968)

client's version of events. Furthermore, it appears that by at least the 1970s the U.S. corporate and securities bar did accept that they had an 'ethical obligation to tell an accurate story, which they had duly investigated in preparing registrative statements and other SEC filings'.[9]

At this stage then, it could be argued that the securities lawyer's ethical responsibilities were in accordance with the requirements of a gatekeeper:[10]

(i) independence from the client;

(ii) professional scepticism of the client's representations;

(iii) a duty to the public investor who relies on the lawyer; and

(iv) a duty to resign when the integrity of the lawyer's work would otherwise be compromised.

However, this thorough process of conducting due diligence was costly and took up considerable time. In the deregulatory climate that existed in the U.S. in the 1980s, the SEC allowed two significant concessions. First, it allowed established issuers to issue a shortened prospectus that incorporated by reference previously filed reports. Second, the SEC allowed issuers to register securities for issue over the next two years. These two concessions significantly reduced the opportunity for a thorough due diligence process and thus the role of the securities lawyers – substantially restricting it to initial public offerings.

In spite of relaxing the fundraising requirements, the SEC did initiate some actions against prominent securities lawyers in the 1970s. For example, in one case the SEC

[9] See Coffee p205 and the references cited there.
[10] Coffee p204-205.

alleged the lawyers of two companies (National Student Marketing Corporation and Interstate National Corporation) had assisted management to enter into a merger without providing full disclosure to shareholders about the waiving of an important condition. The SEC alleged that the lawyers should have stopped the merger to obtain shareholder approval because the approval that had previously been granted was based on the assumption that the condition would be fulfilled.[11] The ABA argued that lawyers did not make business decisions for their clients and certainly did not report then to the SEC. This was in spite of the ABA's own Canons of Ethics which stated that a lawyer who discovered deception by his client was obliged to advise the client to forego the advantage but, if the client refused, 'he should promptly inform the injured person or his counsel, so that they may take appropriate steps.'[12]

One of the law firms settled but the federal district court held that the other firm had aided and abetted a securities fraud. In one particularly interesting part of its judgment, the Court stated: 'In view of the obvious materiality of the information, especially to attorneys learned in securities law, the attorneys' responsibilities to their corporate client required them to take steps to ensure that the information would be disclosed to the shareholders.[13] In 1974, even before the decision in the *NSMC* case was given, the ABA decided to rewrite its Disciplinary Rules to make it clear that lawyers could not disclose client fraud even when their client refused to comply with their advice to do the right thing. The ABA also issued a statement questioning the SEC's approach in the *NSMC* case and asserting that any lawyer should only be required to disclose otherwise confidential information 'by statue after full and careful

[11] The lawyers had the power to stop the merger as it was also conditional on delivery of their own 'closing opinions'. *SEC v National Student Marketing Corp.,* 457 F.Supp. 682 (D.D.C. 1978). For a more detailed discussion of this and other cases, see Coffee p207-213.
[12] See Canons of Professional Ethics, Canon 41 (1968) as quoted by Coffee on p236.
[13] 457 F. Supp. 682, 713.

consideration of the public interests involved' and that this 'should be revisited unless clearly mandated by law.'[14]

However, the SEC did not back down. In 1979 it commenced in-house administrative proceedings against two securities lawyers, Carter and Johnson. It was alleged that the two lawyers were aware that their client, National Telephone company, was issuing false disclosures to the market and that they had not taken appropriate action to prevent this. Despite being in financial difficulty the company, through its chief executive, continued to release overly optimistic press releases. Although the two lawyers advised the chief executive to disclose the true position, they did not take further action and, importantly, did not advise the board of the company's true position. The SEC charged the two lawyers with unethical conduct and the Administrative Law Judge found them guilty as charged and barred the two lawyers from appearing before the SEC for defined periods.[15]

Strangely, the Commissioner adopted a more conciliatory approach on appeal - conceding that the ethical obligation of corporate lawyers had not been 'firmly and unambiguously established.[16]

The Commission subsequently drafted a standard but it was narrowly worded - applying only to securities lawyers whose clients engaged in 'substantial and continuing failure' to satisfy the disclosure obligations - in which case the lawyer was obliged to take further steps such as informing the board or resigning if the client persisted with its violation.[17]The Commission no longer argued that the lawyer had an

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[14] 31 Business Law 543 (1975) at 544-545 – as quoted by Coffee p211.
[15] *In re Carter & Johnson* [1981 Transfer Binder], Fed. Sec. L Rep. (CCH), Para. 82, 847 (March 25, 1981). – as quoted by Coffee in n 47 on p237.
[16] Ibid. at p84, 170 – quoted by Coffee in n 48 on p237.
[17] Ibid. at p84, 172 – quoted by Coffee in n 49 on p237.

obligation to report the violation to the SEC. The SEC has not brought further actions against lawyers under Rule 102 (e) which enables it to restrict the right of lawyers and accountants to practice before the Commission, except in cases where the lawyers have been criminally convicted.[18] However, it has attempted to use federal securities laws but with limited success.[19]

It was the banking regulators that stepped up the pressure on lawyers after the collapse of over a thousand savings and loans institutions in the U.S. in the 1980s. The government's relevant regulatory body (the quaintly named Office of Thrift Supervision – OTS) had significant powers at its disposal, for example in the case against *Kaye, Scholer*, the principal law firm representing Lincoln Savings and Loan, the OTS froze the firm's assets and then personal assets of three partners. The law firm promptly settled the case for $41 million. The OTS had alleged that *Kaye, Scholer* misrepresented facts to the Federal Home Loan Banking Bond and that it did not reveal material information of which it was aware. All in all, the US government brought over 90 civil or administrative actions against the law firms that represented the failed institutions and recovered over US $1.7 billion from claims against accountants and lawyers.[20]

The SEC may have been encouraged by the success of the banking regulators. In 1992 it took action against the chief executive officer of Salomon Brothers which had

[18] Coffee, p212. See also Edward Greene, 'Lawyer Disciplinary Proceedings Before the Securities and Exchange Commission', 14 Sec. Leg. L. Rep.168 (1982)
[19] Coffee p212-213 where he also discusses the ABA's redrafting of its rules on when a lawyer may disclose client confidences concluding: 'Client confidentiality was thus not an absolute value; it could yield to the attorney's need to protect himself and to his desire to warn other attorneys, but not to a need to protect persons injured by his clients…'
[20] See Coffee p213 for a brief overview of the action taken by the OTS. For a more detailed discussion, see Howell E. Jackson, 'Reflections on Kaye, Scholer: Enlisting Lawyers to Improve the Regulation of Financial Institutions', 66 S. Ca L. Rev 1019 (1993); Nancy Amoury Combs, 'Understanding Kaye, Scholer: The Autonomous Citizen, the Managed Subject and the Role of the Lawyer', 82 Calif. L. Rev. 663 (1994); Harris Weinstein, 'Attorney Liability in the Savings and Loan Crisis', 1993 U. Ill. L. Rev. 53, n 124; Lawrence Fox, 'OTS v Kaye, Scholer: An Assault on the Citadel', 48 Bus. Law 1521 (1993); John C. Coffee, Jr., 'Due Process for Kaye, Scholer?'; *Legal Times*, March 16, 1992 at 22.

submitted false and fraudulent bids in auctions of government securities. The bids had been submitted by an employee but the CEO was aware of them. The general counsel had advised the CEO that the conduct should be reported but he had not done so. The SEC subsequently issued a release which stated that in the circumstances in which the general counsel found himself, he had only three options: (i) to report the matter to the board; (ii) to resign; or (iii) to report the matter to the relevant regulatory body.[21] This is a particularly interesting case as it involved general counsel as opposed to an outside lawyer.

The SEC suffered a setback in the *Central Bank of Denver* case in 1994 when the Supreme Court decided that Rule 106.5 did not provide a cause of action against persons who aid and abet securities fraud. [22] This decision was to some extent overcome by the Private Securities Litigation Reform Act of 1995 (the PSLRA) which authorized the Commission to sue those who knowingly aid a fraud.[23] However, the PLSRA also severely restricted private securities litigation and the *Central Bank* case remained as a limitation on private litigation against secondary participants (including lawyers) in alleged securities fraud.

It took the scandalous collapse of Enron, WorldCom and others to provide the pressure the U.S. Congress needed to attempt to prescribe the ethical responsibilities of corporate and securities lawyers. The pressure increased after the SEC conceded

[21] *In re Gutfreund*, Securities Exchange Act Release No. 34-31554, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) Para. 85,067 (Dec 3, 1992). See also James 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 (1993).

[22] *Central Bank of Denver v First Interstate Bank of Denver*, 511 U.S. 164, 169 (1994).

[23] The PSLRA amended the Securities Exchange Act of 1934 by adding s 20(e). This authorizes the SEC to sue 'any person that knowingly provides substantial assistance to another person in violation of a provision of this title…' See 15 U.S.C. § 78t (e). Note the requirement of 'knowingly'.

that it lacked the authority to enforce its *Carter & Johnson* decision.[24] The SEC did so in response to a remarkable letter it received from a group of law professors requesting the SEC to draft a rule that codified the *Carter & Johnson* case.[25]

This pressure for legislative action and the realisation that lawyers were involved in virtually every dubious transaction that contributed to the collapses led to three U.S. Senators[26] introducing am amendment that became s 307 of the Sarbanes – Oxley Act. It instructed the SEC to prescribe 'minimum standards of professional conduct for attorneys' who appeared or practiced before the SEC. These rules were to require lawyers representing public companies 'to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the company or any agent thereof' to the corporation's chief legal officer or chief executive. If they did not take appropriate action, the rule should require the lawyer to report to the corporation's audit committee, its independent directors, or the board as a whole.[27]

The SEC responded by drafting rules as required by s 307. However, the definition of 'material violation' is complex and requires 'credible evidence' which is open to interpretation where the lawyer does not wish to comply. Furthermore, the obligation to report further to the audit committee or the board only applies if the lawyer does not receive an 'appropriate response within a reasonable time'.[28] Again, 'appropriate

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[24] Letter from David Becker, General Counsel, U.S. Securities and Exchange Commission to Richard Painter and others, dated March 28, 2002 – as cited by Coffee in n 78 on p240.
[25] See letter dated 7 March 2002 to Harvey L. Pitt from Richard Painter and Several Professors of Securities Regulation and/or Professional Responsibility of Noted Law Schools. – cited by Coffee n 77 on p240. The letter bore the heading: 'Expressing Concern About the Role of Professionals in the Enron Matter and Other Frauds on Investors.' For further explanation of this, see Symposium, 'The Evolving Legal and Ethical role of the Corporate Attorney After the Sarbanes- Oxley Act of 2002', 52 Am. U.L. Rev. 613 (2003).
[26] John Edwards, a lawyer; Michael Enzi, an accountant; and Jon Corzine, an investment banker.
[27] See Coffee p217-223 for a critical evaluation of the rules that were subsequently introduced by the SEC.
[28] See 17 C.F.R. 205(3) (b) (3) – quoted by Coffee on p218 where there is a more detailed discussion of the SEC rules.

response' is given a complex definition and includes a broad escape clause where a second lawyer advises that a 'colourable defence' can be asserted.[29]

Nevertheless, the rules do impose some gatekeeping responsibilities upon the lawyers who practice before the commission is as much as they do impose reporting duties that did not exist before – even if they are far less than those imposed on auditors.[30]

The SEC rules only apply to securities lawyers. However, in response to Enron, the ABA did relax its restrictions on client confidentiality in its Model Rules which potentially apply to all lawyers. A lawyer *may* now reveal information if the lawyer reasonably believes it necessary to prevent 'a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services.[31] As regards mandatory reporting 'up the ladder', the ABA rules only require this if the lawyer has actual knowledge of a material violation of law – not the objective standard in the SEC rules – and need not do so if the 'lawyer reasonably believes that it is not in the best interest of the organisation to do so'.[32] This appears to be a significant loophole.

There is little doubt that the legal profession has become more competitive over the last few decades – both for individual partners and for clients. There is increased lateral mobility by highly specialized lawyers whose clients will follow them due to their superior skills. This has led to 'eat what you kill' compensation practices that

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[29] The term 'colourable defence' dies not require a conclusion that the defence has merit but merely that it is non-frivolous.' See SEC Release 33-8185.

[30] Note the SEC dropped its original proposal to require a 'noisy withdrawal' by lawyers who do not receive an appropriate response to their report of a material violation after this was strongly opposed by the profession.

[31] See Model Rule 1.6 (b) (2) (adopted by the ABA House of Delegates, August 2003.)

[32] See ABA Model Rule 1.13 which also permits a lawyer to make a noisy withdrawal 'but only if and to the extent the lawyer reasonable believes necessary to prevent substantial injury to the corporation'. As Coffee points out (at p221): 'This is a permissive standard and few attorneys can be expected to blow the whistle voluntarily on their client.'

reward the partner who brings in the business. It appears that corporations have been demanding more aggressive advice from their lawyers in recent years.[33] Furthermore, research has shown that lawyers in large firms undergo a socialization process that leads them to identify with the interest of their corporate clients.[34] Considering this, the question may validly be asked whether it is realistic to expect the lawyer to also consider the public interest in addition to the wishes of the client. Traditional legal ethics do not require this but rather emphasize the lawyer's duty to serve the client.[35]

Coffee argues that one must look beyond legal ethics and moral exhortations if the lawyer is to develop a role as gatekeeper.[36] He proposes a rather narrow gatekeeper role for the independent corporate lawyer that would involve monitoring the corporation's disclosures - as a midway solution between the attempts by the American Bar Association to resist the imposition of gatekeeping responsibilities and the views of academic lawyers and others (including the regulators) that the lawyer has a role in promoting justice.[37] His proposed solution is to mandate that certain corporate disclosure documents be reviewed and certified by an independent (or outside) counsel who would be required to state that, after reasonable inquiry, they believed the disclosure not to be materially misleading. This builds on expertise which lawyers engaged in due diligence already possess and which they are best qualified to perform. This seems a sensible proposal as it is not imposing a vague

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[33] See Coffee p228.

[34] See Professor Robert Nelson's research for the American Bar Foundation in 'Partners With Power: Social Transformations of the Large Law firm (1988) – as quoted by Coffee on p228.

[35] eg. The ABA's Model Rules of Professional Conduct state that a lawyer 'shall abide by a client's decision regarding the objectives of representation.' (Rule 1.2)

[36] p229-232. He also argues that the recent amendments to the SEC rules, such as the 'up-the-ladder' reporting rules, are easy for lawyers to evade whilst the ABA's Model Rules are triggered only by an 'actual knowledge' standard. So these do not make the lawyer a true gatekeeper.

[37] For a review of the historical narrowing down in the U.S. of legal ethics roles until they 'came to say little more by way of admonition than that the lawyer should not commit crimes or assist clients known to be planning them', see Coffee pp197-216 At p201 he concludes 'Gradually, but inexorably, the bar had drained the ethical content from its "professional roles." Aspirational statements had proved troubling because there was always the risk that courts might actually enforce them, and "black letter" rules could more easily be distinguished, evaded or, if necessary, amended.'

obligation to act in the public interest but specific obligations with which corporate and securities lawyers are familiar. Making it mandatory would shift the authority and influence back to the outside or independent lawyer whilst utilizing their expertise in the public interest. It would indeed give them a gatekeeping function – somewhat similar to that exercised by the auditing profession since the statutory audit was required by the British Companies Act in 1844.