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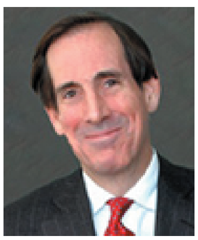
'Here's Johnny!': Carnacing the Future of the SEC's Preemption Overreach



BY C. EVAN STEWART

Predicting the future is—for the most part—a fool's errand. Of course, when Johnny Carson (Jimmy Fallon's pre-pre predecessor) played Carnac the Magnificent on *The Tonight Show*, he was pretty good at it.[1] From time to time, I have tried my hand at predicting the legal future; and having had pretty good success heretofore,[2] it feels like it might be time to try again.

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For a number of years, I have been predicting a test case/show down between lawyers who follow the ethical dictates of the states in which they are licensed to practice law *versus* the conflicting dictates of the rules and regulations promulgated by the Securities and Exchange Commission after Congress passed the Sarbanes-Oxley Act in 2002.[3] Previously, I was willing to bet a nickel on who would win;[4] now, given a recent ruling of the U.S. Court of Appeals for the Second Circuit,[5] I am ready to push a whole lot more chips into the pot.

The Birth of Section 307. At the dawn of the Millennium, a number of corporate failures so rocked American capitalism (e.g., Enron, WorldCom, Adelphia, Tyco, etc.) that the politicians in Washington felt compelled to pass some reform, any reform.[6] That led to the Sarbanes-Oxley Act in 2002.

As this legislation was being "crafted" in the halls of Congress, Senator John Edwards got up on the floor of the Senate, opined that "some lawyers have forgotten

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[1] For readers not familiar with Carson's Carnac routine, he would sit, resplendent in a feathered turban and cape, holding a sealed envelope up to his forehead. Carnac would divine the answer to the question in the envelope, open the envelope, and then read the question. The favorite "answer/question" of his loyal second banana, Ed McMahon, was: "Sis, boom, bah" — "Describe the sound made when a sheep explodes."

[2] *See, e.g.*, C.E. Stewart, "Class Actions: Is Bigger Always Better?" *New York Law Journal* (Jan. 25, 2011); C.E. Stewart, "The Policies and Politics of Antitrust," *New York Law Journal* (Aug. 16, 2007); C.E. Stewart, "A Dangerous Intersection of the Securities and Antitrust Laws," 38 *Sec. Reg. & L. Rep.* (Jan. 9, 2006); C.E. Stewart, "Securities Regulation and the Antitrust Laws: Navigating the Law Enforcement Schemes," 35 *Sec. Reg. & L. Rep.* (Feb. 3, 2003).

[3] *See, e.g.*, C.E. Stewart, "Sarbanes-Oxley: Panacea or Quagmire for Securities Lawyers?" *New York Law Journal* (March 21, 2003); C.E. Stewart, "This is a Fine Mess You've Gotten Me Into: The Revolution in the Legal Profession," *NY Business L.J.* (Summer 2006); C.E. Stewart, "The Pit, the Pendulum, and the Legal Profession: Where Do We Stand After Five Years of Sarbanes-Oxley?" 40 *Sec. Reg. & L. Rep.* (Feb. 18, 2008); C.E. Stewart, "New York's New Ethics Rules: What You Don't Know Can Hurt You!" *NY Business L.J.* (Fall 2009).

[4] Which, for me, is a lot.

[5] *United States ex rel. Fair Lab Practices Assocs. v. Quest Diagnostics*, 2011 BL 90888 (S.D.N.Y. Apr. 5, 2011), *aff'd*, 2013 BL 295703 (2d Cir. Oct. 25, 2013).

[6] Of course, those "failures of capitalism" pale by comparison to what occurred in the latter half of 2008. *See* J. Nocera, "Lehman Had to Die, It Seems, So Global Finance Could Live", *N.Y. Times*, Sept. 12, 2009, at A1; D. Wessel, "Government's Trial and Error Helped Stem Financial Panic", *Wall St. J.*, Sept. 14, 2009, at A1; *See also* C.E. Stewart, "Casablanca and the Crisis in Capitalism: Which 'Reforms' Will Save Us?" 40 *Sec. Reg. & L. Rep.* (Nov. 17, 2008).

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their responsibility,'' and proposed that lawyers be legislatively required to live up to pre-existing standards set forth in American Bar Association Model Rule 1.13 (the so-called ''chain-of-command'' review process).[7] This led to the enactment of Section 307 and Congress' directive to the Securities and Exchange Commission that it should thereafter ''explain'' what Congress meant when it enacted Section 307.[8]

The SEC's First Cut at Section 307. Acknowledging that it was adopting an ''expansive view'' of the mandate given it by the Congress for interpreting Section 307, the SEC in late 2002 put forward a number of far-reaching proposals in its first release for comment (over 90 pages, single spaced),[9] including: (i) federalizing lawyer conduct for the first time in U.S. history; (ii) establishing a requirement that a lawyer (if not satisfied with the corporate response to his or her concerns) withdraw, inform the Commission of that withdrawal, and disaffirm any implicated documents submitted to the SEC upon which he or she worked (a ''noisy withdrawal''); (iii) creating sets of circumstances whereby a lawyer would be *allowed* to disclose client confidences to the SEC with respect to ongoing or past activities (while asserting that such communications would not constitute a waiver of the privilege);[10] (iv) appearing to establish attorney obligations to comply with Section 307 based upon an ''objective'' standard of knowledge (i.e., what a ''reasonable'' lawyer would have done), as opposed to what had *always* been the standard for judging attorney conduct – ''actual'' knowledge; (v) requiring lawyers to document their compliance with the statute in order to avoid sanctions; and (vi) subjecting attorneys to a full panoply of sanctions under the Securities Exchange Act of 1934 for, *inter alia*, negligent conduct.

Noisy Withdrawal v. Noisy Withdrawal 'Lite.' The SEC's first release was met with a flurry of comment and criticism. The SEC's ''noisy withdrawal'' proposal brought on the greatest amount of reaction, most of it negative. The proposal not only went far beyond the obvious scope of Sarbanes-Oxley (as the SEC itself acknowledged), it also:

- reflected confusion between the professional responsibility concepts of withdrawal, noisy withdrawal, and the disclosure of client confidences to third parties;

- was inconsistent with current practices as to lawyers' confidentiality obligations in and amongst the great majority of states (which for more than 200 years had exclusive responsibility for attorneys' professional responsibility obligations);[11]

- in fact, constituted a radical departure from then-existing attorney obligations;[12]

- would have provided a liability whipsaw for lawyers (i.e., liability to clients and shareholders if you noisily withdrew and you were wrong; liability to third parties and regulators if you did *not* noisily withdraw and you were wrong—in short, a heads I lose, tails you win proposition);[13]

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[7] *See* 148 Cong. Rec. at 56551 (July 10, 2002). Senator Edwards appears to have been influenced by several legal academics who argued that if only lawyers had somehow acted as better ''gatekeepers'' of the capital markets, all of the various crises in capitalism could have been prevented. *See*, *e.g.*, R. Cramton, G. Cohen, S. Koniak, ''Legal and Ethical Duties of Lawyers After Sarbanes-Oxley,'' 49 *Villanova L. Rev.* 725 (2004). There is, however, no evidence (at least in the public record) that had lawyers in fact been better ''gatekeepers'' there would have been any material impact in preventing any of the corporate scandals. *See* C.E. Stewart, ''Holding Lawyers Accountable in the Post-Enron Feeding Frenzy,'' 34 *Sec. Reg. & L. Rep.* (Sept. 30, 2002).

Beyond the dubious, evidentiary proposition underlying the motivation for Section 307, the almost cavalier/afterthought addition of that legislative provision has come in for some well-deserved criticism. *See*, *e.g.*, R. Jones, ''Sarbanes-Oxley's Insight: The Role of Distrust,'' 3 *Journal of Business and Technology* 437 (2008); S. Bainbridge, ''Sarbanes-Oxley: Legislating in Haste, Repenting in Leisure,'' 2 *Corp. Governance L. Rev.* 6, 6-8 (2006). *See also* C.E. Stewart, ''The Wrong Track to Reforming Corporate Governance,'' *New York Law Journal* (Oct. 10, 2006); C.E. Stewart, ''The Yin & Yang of Corporate Governance,'' *New York Law Journal* (Oct. 11, 2005).

[8] Section 307 reads, in full, as follows: ''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 the 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.''

[9] *See* SEC Release Nos. 33-8150; 34-46868 (Nov. 21, 2002).

[10] Under the SEC's first iteration of its ''permissive'' disclosure standard, lawyers *could* disclose client confidences: (i) to prevent an ''illegal'' act (where there is/will be substantial financial injury); (ii) to reveal an ''illegal'' act (where there is substantial financial injury by an issuer or a fraud on the SEC); or (iii) to rectify an ''illegal'' act (where an issuer used the lawyer's services). The ''illegal'' act requirement was subsequently amended. *See infra* note 19 and accompanying text.

[11] A number of the academic advocates of Section 307 (and its expansive ''reading'' by the SEC) had argued that the states (pre-2003) had had a fairly uniform set of rules governing lawyers' disclosure obligations (both mandatory and permissive). Unfortunately, that contention was based upon an inaccurate review/analysis of the states' wide disparities in those areas. *See* C.E. Stewart, 'Caveat 'Reformers': Lessons *Not* to Be Learned from Enron's Collapse,'' 34 *Sec. Reg. & L. Rep.* (Feb. 25, 2002).

[12] To the extent there had been *any* authority to support the notion of a ''noisy'' withdrawal up to that point certain commentators had looked to Comment 15 to ABA Model Rule 1.6 as constituting some basis for a ''noisy'' withdrawal option. As pointed out in ABA Op. 92-366, however, comments to the Model Rules have no weight or force. Furthermore, the ABA House of Delegates–both before and after the creation of Comment 15–had specifically voted down a ''noisy'' withdrawal option.

[13] *Compare e.g. Chem-Age Indus. Inc. v. Glover*, 652 N.W.2d 756 (S.D. 2002) *with Parker v. M&T Chems. Inc.*, 566 A.2d 215 (N.J. Super. 1989). *See infra* note 19.

■ would have provided an obvious incentive for the most able and experienced lawyers to decline to represent clients in ''close'' questions;[14]

■ would have created a breach to the attorney-client privilege and lawyers' ethical duties of client confidentiality; and

■ would have led to less, rather than more, corporate compliance with the law.

Based upon perhaps some (if not all) of the foregoing concerns, the Commission beat a strategic retreat (of sorts). The SEC put the noisy withdrawal proposal on hold, and issued a new proposal in its stead.

The new proposal (dubbed by some ''noisy withdrawal lite'') was exactly the same as its predecessor, with one exception: instead of the attorney contacting the SEC to rat out the client, it would now be the client's (corporation's) obligation to report the attorney's withdrawal and to disaffirm the attorney's work product.[15] By this masterful or cynical (or both) maneuver, the Commission took off the table what it thought was at the center of most of the organized bar's earlier protests (i.e., attorneys would not be exposed to criticism/ sanctions under ''noisy withdrawal lite''). At the same time, however, the new proposal did not address the more important public policy issue posed by its predecessor: whether ''noisy withdrawal lite'' would lead to less, or more, corporate legal compliance. Like its predecessor, the SEC also put ''lite'' on hold.

That was the state of play on these two proposals in 2003. In the intervening eleven years, the Commission has not put into force either noisy withdrawal or noisy withdrawal lite. Perhaps the SEC's ''caution'' in this space has been warranted?[16]

Other SEC 'Modifications' to Section 307. While the SEC did not move forward with either noisy withdrawal proposal, its final rules under Section 307 responded to other comments/critiques and incorporated a number of amendments to its first release.[17] They included:

■ clarifying that lawyer knowledge would in fact be governed by an ''objective'' standard (as opposed to the historically used, actual knowledge standard);

■ withdrawing the requirement that lawyers document their compliance to protect against regulatory liability;

■ stating that Section 307 (in the SEC's view) would not constitute a private right of action against lawyers (independent of Section 10b-5 claims);

■ acknowledging that the SEC did not have the authority to effect a selective waiver of the attorney client privilege;

■ announcing that Section 307 was *not* preempting conflicting or inconsistent state law governing lawyer conduct, *so long as* the states meet the *minimum* standards of the SEC's rules and regulations;[18] and

■ clarifying with respect to *permissive* disclosure that lawyers could act where there is (or was) a ''material violation'' [a defined term far broader than an ''illegal'' act]; and as to the organized bar's opposition to expanding lawyers' disclosure obligations to the SEC [by way of *permissive* disclosure], the SEC pronounced that there had been ''ample discussion'' on that subject and the matter was now closed.[19]

Not content to stop there the SEC also used its significant leverage to ''jaw-bone'' the American Bar Association later that year into abandoning its prior positions on *permissive* disclosure of client confidences, so as to bring the ABA's Model Rules into line with the SEC's new standards.[20]

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[14] Such a result would have been directly at odds with what the SEC had previously identified as being critical to ensuring greater legal compliance by clients. *See In re Carter and Johnson*, 47 SEC 471, *Fed. Sec. L. Rep.* (CCH) ¶ 82-847 at 84,145, 84,167, and 84,172-73 (Feb. 28, 1981). In that same year, the U.S. Supreme Court came to the same result/conclusion, when it extended the attorney-client privilege to all corporate employees, justifying that step on the ground that full and candid communications between lawyers and their business colleagues/clients are essential to ensuring effective compliance with the law. *See Upjohn v. United States*, 499 U.S. 383 (1981). For a full vetting of these two decisions and their interaction, see C.E. Stewart, ''Liability for Securities Lawyers in the Post-Enron Era,'' 35 *Rev. Sec. & Comm. Reg.* (Sept. 11, 2002).

[15] *See* SEC Release Nos. 33-8186, 34-47282 (Jan. 29, 2003).

[16] In 2009, a former SEC enforcement lawyer, then a partner at a prestigious New York firm, made a ''noisy withdrawal'': resigning from his representation of the Stanford Financial Group, and ''disaffirm[ing] all prior oral and written representations made by me and my associates to the SEC Staff.'' That did not work too well, as (i) his individual client at the company went to jail, (ii) he and his law firm were named as defendants in a class action by victims of Stanford's fraud, (iii) he and his law firm were sued for malpractice, and (iv) he subsequently ''resigned'' from his partnership. *See* C.E. Stewart, ''Thus Spake Zarathustra (And Other Cautionary Tales for Lawyers),'' *NY Business Law Journal* (Winter 2010). Another former SEC enforcement lawyer (now in private practice) has argued that the accounting problems involving Spiegel Inc. could have been avoided if the SEC's noisy withdrawal provision had been in play. *See* R. McTague, ''Spiegel Examiner Says Noisy Withdrawal Would've Helped Bring Wrongdoing to Light,'' 19 *ABA/BNA Lawyers' Manual on Professional Conduct* (Sept. 24, 2002). Upon review of the written investigation made public, however, that judgment seems questionable (at best).

[17] *See* SEC Release Nos. 33-8185, 34-47276 (Jan. 29, 2003). The SEC's ''final'' document — about half the size of its first release — became effective in mid – 2003. The SEC took the view that its final release had been ''significantly modified'' as a result of the comments it received.

[18] *Id.* (While acknowledging that ''a number of commentators questioned the Commission's authority to preempt state ethics rules, at least without being explicitly authorized and directed to do so by Congress,'' the SEC then wrote: ''The language which we adopt today clarifies that this part does not preempt ethical rules in United States jurisdictions that establish more rigorous obligations than imposed by this part. At the same time, the Commission reaffirms that its rules shall prevail over any conflicting or inconsistent laws of a state or other United States jurisdictions in which an attorney is admitted or practices.'')

[19] This *permissive* disclosure standard, of course, subjects lawyers to the same potential liability whipsaw to which noisy withdrawal would subject lawyers. *See supra* note 13 and accompanying text.

[20] *See* J. Glater, ''Bar Association in a Shift on Disclosure,'' *N.Y. Times* A12 (Aug. 12, 2003); *see also* C.E. Stewart, ''Liability for Securities Lawyers in the Post-Enron Era,'' 35 *Rev. Sec. & Comm. Reg.* (Sept. 11, 2002). One area where the ABA did not ''cave'' was the requirement of an attorney's actual knowledge (vs. the SEC's adoption of the objective standard-i.e., what a reasonable lawyer should have known).

Preemption and Section 307. As noted above, the Commission (without any sense of irony or humor) opined in its final release that Section 307 does **not** preempt conflicting or inconsistent state law governing lawyer conduct, *so long as* the states meet the minimum standards of the SEC's rules and regulations.[21] Of course, that obviously equates to a claim of preemption. The SEC also added a ''good faith'' provision—a lawyer might be shielded from federal securities law sanctions if the lawyer, acting in accord with inconsistent state disciplinary standards, ''complies in good faith'' with the SEC's rules and regulations.

In July of 2003, the Washington State Bar Association (WSBA) promulgated a ''proposed interim formal opinion,'' in which the WSBA warned Washington licensed lawyers that complying with the SEC's permissive disclosure standards would likely conflict with the state's applicable ethical standards and that such conduct could therefore get said lawyers into disciplinary hot water with the WSBA. The WSBA also cautioned its state licensed lawyers not to take much comfort in the SEC's ''good faith'' safe harbor.[22]

Shortly before the WSBA formally approved its opinion, the SEC's general counsel wrote a public letter to the WSBA's officials on July 23, 2003.[23] In his letter, the Commission official: (i) urged the WSBA not to approve the opinion; (ii) argued that Supreme Court precedent was such that Washington State's rules—insofar as they might be inconsistent with Section 307—would be preempted;[24] and (iii) warned the WSBA not to frustrate (or attempt to frustrate) the ''good faith'' safe harbor.

Rather than dissuade the WSBA, the SEC general counsel's letter prompted the Corporations Committee, Business Law Section, of the State Bar of California to issue its own challenge to the SEC. By a letter dated Aug. 13, 2003, the California Committee: (i) made clear that California does not allow lawyers to disclose client confidences; (ii) expressed numerous policy considerations in favor of its state's law and rules (e.g., they undergird the attorney-client relationship, they encourage greater law enforcement, disclosing client confidences can have serious consequences to lawyers and clients, etc.); (iii) opined that it was unclear whether the SEC had the authority to adopt the permissive disclosure provisions of Section 307; (iv) further opined that those provisions of Section 307 did not preempt California's laws and rules; and (v) expressed that the California Bar had no authority to refuse to enforce California's statutes on the basis of federal preemption unless (and until) a California appellate court had so ruled.[25]

After the foregoing to and fro, there was no ''meeting of the minds'' between and amongst Washington, California, and the SEC.[26] Where do the other states stand on issue of preemption? Well, one state—North Carolina—has publicly agreed with the SEC on the preemption issue.[27]

Most other states have tended to shy away from a direct confrontation with the Commission. After the ABA's Model Rules were changed to bring them into line with Section 307's strictures on disclosure of client confidences, a number of states undertook their own reviews to see what they should do. Perhaps not surprisingly, the results reflect a wide disparity of approaches.[28]

Certain states have adopted the ABA Model Rules without substantive change.[29] A number of other states have tinkered with some of the ''chain-of-command'' review process and attorney disclosure obligations.[30] Another group of states simply have chosen to follow the old version of the Model Rules (both as to chain-of-command and lawyer disclosures);[31] while some states have not changed their prior chain-of-command process, as well as their idiosyncratic views of lawyer disclosure obligations.[32] Finally, certain states have tinkered with (or rejected) the Model Rule's chain-of-command process, and have also not adopted the corresponding disclosure provisions.[33]

As New York Goes, So Goes . . .? In 2009, New York State ushered in new legal ethics standards to great fanfare (e.g. an ''extraordinarily positive result,'' ''a major achievement for New York,'' ''a big step forward,''

[21] *See supra* note 18.

[22] *See* Washington Interim Formal Ethics Opinion 197 (available at http://www.wsba.org/lawyers/ethics/formalopinions/ethicsopinion197.htm (2003).

[23] *See* July 23, 2003 letter of Giovanni Prezioso (available at http://www/sec.gov.news/speech/spch072303gpp.htm).

[24] *Citing Sperry v. State of Florida*, 373 U.S. 379 (1963). As the SEC itself noted when it implemented its final rules ''interpreting'' Section 307, however, there was substantial pushback from the organized bar as to whether the SEC had in fact been authorized by Congress to preempt state law (*see supra* note 18). Both the ABA and the Association of the Bar of the City of New York, for example, took issue with the SEC's assertion of federal preemption.

[25] The following year, the Committee published an article embellishing these positions. *See* ''Conflicting Currents: The Obligation to Maintain Inviolate Client Confidences and the New SEC Attorney Conduct Rules,'' 32 *Pepp. L. Rev.* 89 (2004).

[26] Former SEC general counsel, Giovanni Prezioso, gave this advice to lawyers in an April 3, 2004 speech to the ABA's Section of Business Law: ''I would urge any lawyer who would like to make a disclosure under the Commission's rules, but who is concerned with a potential conflict with state bar rules, to consult with us, either directly or through counsel. We on the staff would appreciate the opportunity to work with a lawyer facing such a conflict, either in addressing the issues before state bar authorities or, if necessary, in court. My expectation is that the Commission would be favorably disposed to supporting attorneys seeking to rely on the preemptive effect of its rules.'' (available at http://www.sec.gov/news/speech/spch040304gpp.htm).

[27] *See* North Carolina Formal Ethics Opinion 2005-9 (2006). Interestingly, Washington State did amend its professional responsibility code in 2006, bringing it into substantial compliance with the new model rules promulgated by the ABA. *See* ''Washington State Overhauls Ethics Rules, Adopting *MJP*, Updates from ABA Models,'' 75 *U.S.L.W.* 2085 (Aug. 15, 2006).

[28] *See* C.E. Stewart, ''The Pit, the Pendulum, and the Legal Profession: Where Do We Stand After Five Years of Sarbanes-Oxley?'' 40 *Sec. Reg. & L. Rep.* (Feb. 18, 2008).

[29] *E.g.*, Alaska, Arizona, Arkansas, Connecticut, Hawaii, Idaho, Indiana, Iowa, Louisiana, Massachusetts, Nebraska, South Carolina, and Vermont.

[30] *E.g.*, District of Columbia, Maryland, Minnesota, North Dakota, Texas, Utah, and Virginia.

[31] *E.g.*, Alabama, Colorado, Delaware, Florida, Georgia, Kansas, Kentucky, Michigan, Mississippi, Missouri, Montana, Nevada, New Hampshire, New Mexico, North Carolina, Oklahoma, Pennsylvania, Rhode Island, South Dakota, West Virginia, Wisconsin, and Wyoming.

[32] Both Illinois and New Jersey, for example, require *mandatory* disclosure in certain circumstances. *See, e.g.*, *Balla v. Gambo Inc.*, 584 N.E. 2d 104 (Ill. 1991).

[33] *E.g.*, Kansas and Ohio.

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etc.).[34] What did New York State decide to do vis-à-vis the SEC's Section 307?

Under New York's Rule 1.6, New York lawyers may use their discretion to make *permissive* disclosure (i) to prevent death or substantial bodily harm, or (ii) to prevent a crime. New York lawyers may also now withdraw an opinion which *was* based upon ''materially inaccurate information or *is being* used to *further* a crime or fraud'' (emphasis added). And while this latter provision sort of embraces (to some extent) the notion of a ''noisy withdrawal'' (thus going beyond the SEC), New York's other provisions are less ''liberal'' than the SEC's standards. Most importantly, New York specifically carved out **financial fraud** from permissive disclosure; furthermore, disclosure of past client conduct remains unaffected (i.e., no can do). As a further deviation from the SEC, New York declined to adopt in Rule 1.13 a provision that would allow a lawyer representing a corporation to ''report out'' if he or she was unable to get the corporation to ''do the right thing'' (i.e., follow his or her advice) and the corporation faced ''substantial injury'' relating to the advice (taken or not taken).[35]

The New York State Bar authorities made the foregoing deviations from Section 307 (i) in full awareness that NYS's Rule 1.6 would place materially different disclosure obligations on lawyers than those set forth in Section 307, and (ii) in full awareness of the SEC's position on preemption. It is also noteworthy that the SEC monitored what New York State was considering and what it ultimately promulgated.[36] So what if a New York lawyer follows the ethical dictates of New York State and that conduct is inconsistent with the SEC's standards? Perhaps we now have a very good predictor of what the answer to that important question will be.

Quest Diagnostics. On Oct. 25, 2013, the U.S. Court of Appeals for the Second Circuit affirmed the district court's 2011 dismissal of a False Claims Act *qui tam* action by Mark Bibi, a former general counsel of Unilab.[37] Bibi, together with two other, former Unilab executives, had sued Unilab's new owner, Quest Diagnostics, on the ground that the company *had* engaged in a pervasive kickback scheme. At the district court level, legal academic ethics experts proffered dramatically opposed opinions: Professor Andrew Perlman of Suffolk University Law School supported Bibi, who had testified that he was entitled to ''spill his guts'' because he believed Unilab's actions were criminal; Professor Stephen Gillers of New York University Law School opined that Bibi's disclosure violated his professional obligations to his former client. The district court sided with Gillers, and dismissed the case.

The Second Circuit, in *Quest Diagnostics*, upheld the important ethical obligation that lawyers have in protecting client confidences (under Rule 1.6) and not breaching said confidences (especially to profit thereby).[38] But in order to get to that ruling, the court had to first address Bibi's contention that the False Claims Act preempts New York State's Rules of Professional Conduct.

Judge José Cabranes, writing for the panel, initially noted that courts have ''consistently'' looked to state ethical rules to determine whether attorneys had conducted themselves properly.[39] He then looked at whether the federal statute did anything to change that traditional rule, finding that ''[*n*]*othing* in the False Claims Act evidences a clear legislative intent to preempt state statutes and rules that regulate an attorney's disclosure of client confidences.''[40] As authority for the ''clear legislative intent'' standard, Judge Cabranes cited two Supreme Court precedents, both of which stand for the proposition that ''we [the U.S. Supreme Court] assume a federal statute has not supplanted state law unless Congress has made such an intention clear and manifest.''[41]

The Envelope Please . . . So with the Second Circuit's determination in *Quest Diagnostics* and the applicable standard of ''clear legislative intent,'' where does that leave the SEC's claim of preemption for Section 307. In one man's view, without a leg to stand on.

First of all, it is clear that Section 307 was a hasty, almost-after thought, shoe-horned into a cobbled-together legislative monstrosity. [42] Second, neither the father of Section 307 nor the very language of Section 307 said *anything* about preemption; [43] this would seem to be pretty compelling evidence of the exact opposite of ''clear legislative intent.''[44] And third, the SEC, by its own admission, acknowledged that its regulations reflected an ''expansive view'' of what Congress had enacted;[45] of course, as detailed above, what the SEC did was a lot more than just being ''expansive.''[46]

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[34] *See* C.E. Stewart, ''New York's New Ethics Rules: What You Don't Know Can Hurt You!'' *NY Business Law Journal* (Fall 2009).

[35] New York also did not adopt the ''reasonable lawyer'' standard, opting instead to judge lawyers' behavior on an actual knowledge standard. This is a *very* important safeguard for lawyers, protecting them from harsh, 20-20 hindsight judgment. *See, e.g., In re Jordan H. Mintz and In re Rex R. Rogers*, SEC Release Nos. 59296 & 59297 (Jan. 26, 2009).

[36] *See* J. Rogers, ''New York State Bar Parts Ways with ABA on Disclosure of Fraud, Use of Screening,'' *ABA/BNA Lawyers' Manual on Professional Conduct* 587 (Nov. 14, 2007); *See* M. Bologona, ''Thomson Says Securities Lawyers Need to Show 'Professional Courage','' 39 *Sec. Reg. & L. Rep.* (May 14, 2007).

[37] *See supra* note 5.

[38] Elsewhere, I have focused on the importance of the Second Circuit's ruling on this score. *See* C.E. Stewart, ''Whistleblower Law: What Rights Do Ratting Lawyers Have?'' *New York Law Journal* (March 14, 2004).

[39] *Citing Hull v. Celanese Corp.*, 513 F.2d 568, 571 n.12 (2d Cir. 1975).

[40] Emphasis added.

[41] *Bates v. Dow Agrosciences LLC*, 544 U.S. 431, 449 (2005); *Cipollone v. Liggett Grp., Inc.*, 505 U.S. 504, 516 (1992). Judge Cabranes also noted that the False Claims Act, while allowing a *quitam* suit, ''does not authorize [the plaintiff] to violate state laws in the process.'' *Citing United States ex rel. Doe v. X. Corp.*, 862 F. Supp. 1502, 1507 (E.D. Va. 1994).

[42] *See supra* note 7 and accompanying text.

[43] *See supra* note 8.

[44] This standard is not a new one. *See e.g., Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 479 (1977). And, of course, the Supreme Court recently rejected preemption vis-à-vis state-court class actions, which Congress looked like they attempted to preempt via the 1998 Securities Litigation Uniform Standards Act. *See Chadbourne & Park LLP v. Troice*, – S. Ct. – (No. 12-79, Feb. 26, 2014).

[45] *See supra* note 9 and accompanying text.

[46] *See supra* notes 11, 12, 13, 17, 18, 19, and accompanying text.

As for the precedent the SEC's general counsel cited in support of the Commission's preemption claim—*Sperry v. State of Florida*[47]—that fairs no better. On its face, *Sperry* is inapposite. There, the State of Florida sued for (and got) an injunction against an individual who prosecuted patent applications before the U.S. Patent Office. Florida's basis for its action was that the individual (a non-lawyer) had engaged in the unauthorized practice of law.

The U.S. Supreme Court in 1963 vacated the injunction because Florida did not have the power to enjoin a non-lawyer who was properly registered to practice before the U.S. Patent Office (even if such conduct constituted the unauthorized practice of law in Florida). But that is a far cry from the state of affairs involving Section 307. Why? For at least three reasons: (i) Congress's authority to establish the patent office is expressly set forth in the U.S. Constitution; (ii) Congress expressly granted the Commissioner of Patents the authority as to who can appear before the U.S. Patent Office; and (iii) *non*-lawyers appearing before the U.S. Patent Office was a time-honored practice long before Congress enacted its grant of authority. Thus, to believe that *Sperry* would somehow trump subsequent (and directly on point) Supreme Court precedent,[48] as well as the Second Circuit's right-on-point *Quest Diagnostics*, would require more than ''blood, sweat, and tears''—it would be more like a miracle![49]

Conclusion. If a test case is in fact one day coming, hopefully the prediction of this article will be borne out. Unfortunately, for the lawyer who is the SEC's guinea pig, he or she will not enjoy the years of being under the Commission's gun while awaiting the ultimate vindication by the judiciary. The 800 pound gorilla will likely not win this one, but it will surely inflict a lot of pain along the way. So, caveat counselor!

[47] *See supra* note 24.

[48] *See supra* notes 41 & 44.

[49] And given the SEC's track record in the District of Columbia Circuit Court of Appeals, perhaps, it would need divine intervention. *See*, *e.g.*, *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990); *Goldstein v. SEC*, 2006 WL 1715706 (D.C. Cir. June 23, 2006); *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011); *see also SEC v. Prince*, 942 F. Supp. 2d 108 (D.D.C. 2013) (SEC loses fraud case against securities felon). *See also* C.E. Stewart ''The SEC and Litigation: Oil and Water?'' *New York Law Journal* (Nov. 8, 2011); C.E. Stewart ''The SEC's Setbacks in Litigation,'' *New York Law Journal* (May 17, 2011).

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