"New York Lawyers: Be Afraid, Be Very Afraid…!"

By C. Evan Stewart

As careful readers of the *NY Business Law Journal* should know,[1] all of life's important lessons can be learned from *Godfather* (Paramount 1972) and *Godfather Part II* (Paramount 1974).[2] Notwithstanding, let me start by quoting from Michael Corleone in *Godfather Part III* (Paramount 1990)—which is otherwise a terrible movie: "Just when I thought I was out… they pull me back in."

Since 2003, I have been worried about what would happen *when* (not if) a lawyer follows the dictates of the state in which she is licensed to practice instead of following the very different dictates mandated by the rules and regulations promulgated by the U.S. Securities and Exchange Commission after the Sarbanes-Oxley Act of 2002 went into effect.[3] A few years ago, I thought I knew the answer,[4] but now I am somewhat less sure. Because of the dangers posed to lawyers (and, in particular, to New York lawyers), this uneasy state of affairs needs to be fully aired.

The SEC vs. the States

Under the SEC's Sarbanes-Oxley modus operandi, a capital markets lawyer *may* disclose "material violations" (past, current, future) to the Commission. If a lawyer does not handle this "permissive" disclosure obligation correctly, she can be subject to a liability whipsaw: If she fails to disclose to the SEC and she is wrong, the SEC (and possibly the plaintiffs' bar) can go after her; if she discloses to the SEC and she is wrong, clients and stockholders can sue her. (This places a pretty high premium on lawyers *always* being right!) In judging the appropriateness of her conduct, the SEC (with the benefit of hindsight) will judge her under the "reasonable lawyer" standard (i.e., *not* based upon what she actually knew), and the Commission has at its disposal the full panoply of sanctions under the Securities Exchange Act of 1934 to punish the offending lawyer.

A number of states have *generally* come into line with the SEC's "permissive" disclosure mandate, but a number of others have not.[5] Besides Washington and California,[6] another principal outlier is New York. Under New York Rule 1.6, New York lawyers *may* use their discretion to make permissive disclosure (1) to prevent death or substantial bodily harm, or (2) to prevent a crime. New York specifically carves out *financial fraud* from permissive disclosure; furthermore, disclosure of *past* client conduct is prohibited. New York also *declined* to adopt in Rule 1.13 a provision allowing lawyers representing corporations to "report out" if they are unable to get their clients to "do the right thing" (i.e., follow their advice) and the corporations face "substantial injury" relating to that advice (taken or not taken).[7]

Preemption (per the SEC)

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 staff in the final release implementing its Sarbanes-Oxley rules and regulations also wrote: "[T]his… 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."[8]

Some non-compliant states immediately challenged the SEC on the preemption issue;[9] in responding to those states, the SEC cited the U.S. Supreme Court's decision in *Sperry v. State of Florida*—a ruling that is demonstratively inapposite on its face.[10] Not only did that brouhaha end up in an unresolved standoff, but when the New York State Bar authorities put forward New York's non-conforming Rule 1.6 in 2009, they did so (1) in full awareness that its Rule 1.6 would place materially different disclosure obligations on New York State lawyers than those required by the SEC, and (2) in full awareness of the SEC's position on preemption.

With the preemption issue thus pretty well teed up, what have the courts done with the issue (to date)?

Quest Diagnostics

On October 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.[11] 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 opposing opinions: Prof. Andrew Perlman of Suffolk University Law School supported Bibi, testifying that Bibi was entitled to "spill his guts" because

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he believed Unilab's actions were criminal; Prof. 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.

On appeal, the Second Circuit 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). But in order to get to that ruling, the court first had to address Bibi's contention that the False Claims Act preempted 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. He then reviewed whether the federal statute did anything to change that traditional approach, but found that "[*n*]*othing* in the False Claims Act evidences a clear legislative intent to pre-empt state statutes and rules that regulate an attorney's disclosure of client confidences." As authority for the "clear legislative intent" standard, 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."[12]

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This determination seemingly left the SEC in a pretty precarious position. Why? Because there is not one scintilla of evidence that Congress manifested *any* intent to supplant state-based rules for lawyers when it passed Sarbanes-Oxley.[13]

Hays v. Page Perry

The following year, the U.S. District Court for the Northern District of Georgia weighed in on this topic in *Hays v. Page Perry*.[14] Dismissing a malpractice action against a law firm, Judge Thomas Thrash held that the firm had no duty to report its client's possible securities fraud to the SEC.

In a prior ruling, Thrash had opined that "Georgia law…never obligates a lawyer to report even the most serious client misconduct to regulators."[15] On a motion to have the judge reconsider his prior ruling, he was even more emphatic, finding the plaintiff's theory "a strange perversion of lawyers' professional responsibilities" and its legal claim "profoundly flawed". If the plaintiff were to be correct, he reasoned, there would be dire consequences: "The risk of civil penalties would cause attorneys, out of self-preservation, to err on the side of disclosure when in doubt. Consequently, such a rule could even deter potential clients from seeking advice from a lawyer." [16]

Thrash also (correctly) noted that another flaw in the plaintiff's approach was that it "conflate[d] attorney-client confidentiality with the attorney-client *evidentiary* privilege." Violating the former (an ethical rule), of course, could subject a disclosing attorney to being disbarred;[17] the privilege, on the other hand, is something that is owned by the client (not her attorney), and can be waived *only* by the client.

Wadler v. Bio-Rad Labs

Notwithstanding these two decisions, in December 2016, a California-based federal Magistrate Judge went in another direction in *Wadler v. Bio-Rad Laboratories*.[18] Sanford Wadler, the former general counsel for Bio-Rad, sued his former employer after he was fired. Wadler claimed that the termination was in retaliation for his informing the board of directors of purported Foreign Corrupt Practices Act violations. On the eve of the trial, Bio-Rad filed a motion in limine to exclude virtually all of Wadler's evidence on the ground that it was covered by the company's attorney-client privilege. Magistrate Judge Joseph Spero ruled against the motion, opining not only that Bio-Rad was untimely in seeking the requested relief, but also that (1) federal common law applied to privilege issues and, as such, Wadler was permitted under ABA Model Rule 1.6 to use privileged communications to establish his claim;[19] and (2) the State of California's restrictive confidentiality obligations were preempted by the SEC's Sarbanes-Oxley rules and regulations governing attorney conduct.

As to the Magistrate Judge's preemption ruling, he lifted his decision almost verbatim from an amicus brief filed by the SEC. The Magistrate Judge wrote that the SEC's rules and regulations are "entirely consistent" with ABA Model Rule 1.6, the "vast majority" of states, and federal common law. He was essentially right on the first point, but manifestly not on the second two.[20] More important to the Magistrate Judge was the fact that "the SEC has now endorsed this interpretation of its own regulation" in its amicus brief, and the SEC's interpretation of its "own regulation" was entitled to deference.[21]

Sorry, but a *Chevron* deference analysis does not have *any* relevance to federal preemption. [22] The fact that the SEC believes—by its own invocation, but *absent any indication* of Congressional intent—that there is preemption is evidence of nothing. The Magistrate Judge wrote that this outcome was "one of the methods Congress chose"—but that is simply not true; as noted above, Congress said *zero* about preemption, and the Magistrate Judge cited nothing to support his claim. [23]

Conclusion

The SEC's position on preemption seems (at the very least) on *extremely* weak ground—even the former head of the Commission's Enforcement Division believes the SEC's preemption position is baseless. [24] But the SEC—despite having a pretty lackluster track record in litigation[25]—has shown dogged determination in pursuing strategic objectives through the litigation process over many years—for example, in the case of holding secondary actors (such as lawyers) accountable under the Securities Exchange Act of 1934.[26] Thus, even if *Bio-Rad* is not well-grounded as a matter of law, the Commission does have it as a precedent to go after lawyers who follow their states' ethical standards and not the Sarbanes-Oxley protocols. This fact of life should give every New York licensed lawyer significant cause for concern.

Endnotes

1. *See* C.E. Stewart, *Exes and the Attorney Client Privilege*, NY Bus. L.J. (Summer 2017) (footnote 32).
2. *E.g.* "It's not personal, Sonny. It's strictly business."; "Leave the gun; take the cannoli."; "Keep your friends close, your enemies closer."; "A man who doesn't spend time with his family can never be a real man."; "I'm gonna make him an offer he can't refuse."; "[D]on't ever take sides with anyone against the family again. Ever."; "I'm a businessman. Blood is a big expense."; "It's a Sicilian message. It means Luca Brasi sleeps with the fishes."; "Goddamn FBI don't respect nothin'."; "I believe in America."; "Certainly, he can present a bill for such services; after all, we are not Communists."; "I made my bones when you were still dating cheerleaders."; "In Sicily, women are more dangerous than shotguns."; "Never tell anyone outside the family what you're thinking!".
3. *See, e.g.*, C.E. Stewart, *Sarbanes-Oxley: Panacea or Quagmire for Securities Lawyers?* N.Y.L.J. (March 21, 2003); C.E. Stewart, *This Is a Fine Mess You've Gotten Me Into: The Revolution in the Legal Profession,* N.Y. Bus. 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 Bus. L.J. (Fall 2009); C.E. Stewart, *Here's Johnny: Carnacing the Future of the SEC's Preemption Overreach*, 46 Sec. Reg. & L. Rep. (April 28, 2014); C.E. Stewart, *Navigating State-Based Ethics Rules and Sarbanes-Oxley Requirements*, N.Y.L.J. (Sept. 21, 2015); C.E. Stewart, *The Fork in the Road: The SEC and Preemption*, N.Y.L.J. (May 10, 2017).
4. *See* "Fork," "Navigating," and "Here's Johnny!," *supra* note 3.
5. There are, in essence, five different groupings of states in their approaches to Rule 1.6. *See The Pit, the Pendulum, and the Legal Profession*, and *Here's Johnny!*, *supra* note 3.
6. Washington's and California's interplay with (and challenge to) the SEC's disclosure regime is set forth in detail in *Here's Johnny! See supra* note 3.
7. New York also does not use 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 judgments. *See, e.g., In re Jordan H. Mintz* and *In re Rex R. Rogers,* SEC Release Nos. 59296 & 59297 (Jan. 26, 2009).
8. *See* SEC Release Nos. 33-8185, 34-47276 (Jan. 29, 2003) (emphasis added).
9. *See supra* note 6.
10. 373 U.S. 379 (1963). In *Sperry*, 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 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 the SEC's Sarbanes-Oxley rules and regulations. Why? For at least three reasons: (1) Congress's authority to establish the patent office is expressly set forth in the U.S. Constitution; (2) Congress expressly granted the Commissioner of Patents the authority to determine who can appear before the U.S. Patent Office; and (3) *non*-lawyers appearing before the U.S. Patent Office was a time-honored practice long before Congress enacted its grant of authority.
11. *United States ex rel. Fair Lab Practices Assocs. v. Quest Diagnostics*, 734 F.3d 154 (2d Cir. 2013), *aff'm*, 2011 U.S. Dist. LEXIS 37014 (S.D.N.Y. April 15, 2011). I recently wrote about this decision and the *Bio-Rad Labs* decision in the *NY Business Law Journal* with respect to their importance vis-à-vis lawyers' whistleblower claims. *See Lawyers as Rats: An Evolving Paradigm?* (Winter 2018).
12. *Bates v. Dow Agrosciences*, 544 U.S. 431, 449 (2005) (emphasis added); *Cipollone v. Ligget Grp.,* 505 U.S. 504, 516 (1992). *Accord Chadbourne & Parke v. Troice*, 134 S. Ct. 1058 (2014); *Gregory v. Ashcroft*, 501 U.S. 452, 458 (1991); *Santa Fe Industries v. Green*, 430 U.S. 462, 479 (1977); *Fla. Lime & Avocado Growers v. Pauli*, 373 U.S. 132, 144 (1963). *See also ABA v. FTC*, 430 F.3d 457, 466 (D.C. Cir. 2005) (Congress did not delegate to the FTC the authority to regulate the practice of law under Gramm-Leach-Bliley).
13. *See* "Here's Johnny!" *supra* note 3.
14. *See* http://www.bloomberglaw.com/public/docuement/Haysv.PagePerry_LLC_No_113CV3925TWT_2015_8L_71863__ND_Ga_Mar_17_.
15. 26 F. Supp. 3d 1311 (N.D. Ga. 2014).
16. Indeed, 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).
17. The judge noted that while Georgia's Rule 1.13(c) allows "reporting out," that disclosure option is permissive (the drafters of the rule changed "shall" to "may"). In New York, as noted above (*see supra* note 7 and accompanying text), there is no "reporting out" option.

18. 2016 WL 7369246 (Dec. 20, 2016).

19. As previously discussed in *Lawyers as Rats* (*see supra* note 11), the Magistrate Judge—on this issue—followed the lead of the Fifth Circuit in *Willy v. Administrative Review Board*, 423 F.3d 485 (5th Cir. 2005). That appellate court had allowed an in-house lawyer to affirmatively use—without limitation—attorney-client privileged materials to prove his claim. This use was permitted (according to the Fifth Circuit—and now Magistrate Judge Spero) because the ABA changed Model Rule 1.6 to add the words "claim or" before "defense" (and this is now the normative standard nation-wide); previously the Model Rule had allowed for the revealing of client confidences "to establish a defense on behalf of the lawyer."

    Unfortunately, there are more than a few problems with this analysis: (1) the ABA Model Rules are not in effect *anywhere*—and they certainly do *not* constitute federal common law; (2) the change to Model Rule 1.6 to add "claim or" has not been adopted by a great number of states (e.g., California, New York, etc.); and (3) both decisions suffer from the same problem identified by Judge Thrash: they equate the attorney-client privilege—an evidentiary concept, and a privilege owned by the client—with a lawyer's ethical obligation to maintain client confidences. This last "problem" is no small one; even if a lawyer may no longer be ethically obligated to keep client confidences, that has no bearing on whether she can unilaterally breach the attorney-client privilege—and it is *extremely* unlikely that a former employer would waive the privilege to allow a former attorney to sue her company.

20. *See* C.E. Stewart, *Lawyers as Rats: An Evolving Paradigm?* NY Bus. L.J. (Winter 2018); C.E. Stewart, *Whistleblower Law: What Rights Do Ratting Lawyers Have? N.Y.L.J.* (March 14, 2014); C.E. Stewart, *New Confidentiality Rules: Traps for the Unwary*, N.Y.L.J. (May 25, 2010).

21. Gone was the SEC's earlier invocation of *Sperry* (*see supra* note 10) as its preemption "authority" (not surprisingly).

22. *See Chevron USA v. Natural Resources Defense Council*, 487 U.S. 837 (1965). And even when correctly invoked, the *Chevron* deference doctrine has become highly controversial. *See* I. Somin, *Gorsuch Is Right About Chevron Deference,* Washington Post (March 23, 2017).

23. The Magistrate Judge, ignoring all of the Supreme Court precedent focusing on "clear legislative intent" (*see supra* note 12), labeled this instead "a textbook example of 'obstacle preemption,'" citing *Nation v. City of Glendale*, 804 F.3d 1292, 1297 (9th Cir. 2015). But by the very language cited by the Magistrate Judge, such preemption is *only* warranted when a state law "stands as an obstacle to the accomplishment and execution of the full purpose and objectives of *Congress*." *Id*. (emphasis added). That is not the case here—Congress stood totally silent on this front. *See supra* note 13 and accompanying text.

24. *See* W. McLucas, I. Wertheimer, A. June, *Attorneys Caught in the Ethical Crosshairs: Secret-keepers as Bounty Hunters Under the SEC Whistleblower Rules*, 46 Sec. Reg. & L. Rep. (April 14, 2014) (citing, *inter alia*, the Second Circuit's *Quest Diagnostics* ruling).

25. *See* C.E. Stewart, *The SEC and Litigation: Oil and Water?* N.Y.L.J. (November 8, 2011); C.E. Stewart, *The SEC's Setbacks in Litigation*, N.Y.L.J. (May 17, 2007).

26. *See Lorenzo v. Securities and Exchange Commission*, No, 17-1077, ____ S. Ct. ____ (March 27, 2019); C.E. Stewart, *Fourth Time a Charm? The Supreme Court Takes Another Whack at Secondary Liability*, N.Y.L.J. (December 27, 2018).

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