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Expert Analysis

The Fork in the Road: The SEC and Preemption

By **C. Evan Stewart**

Since 2003, I have been predicting a test case/showdown between lawyers who follow the dictates of the states in which they are licensed to practice law versus the conflicting dictates of the rules and regulations promulgated by the U.S. Securities and Exchange Commission after the Sarbanes-Oxley Act of 2002 went into effect.[1] And while I thought I knew how such a test case/showdown would (should) end up,[2] a recent judicial development has shaken my certitude (but only a little, because—as we will see—the ruling is wrong).

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 that "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. 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 and Exchange Act of 1934 to punish the offending lawyer.

A number of the states have *generally* come into line with the SEC's "permissive" disclosure mandate; but a number of others have not.[3] Besides Washington and California,[4] another principal outlier is New York. Under New York's 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).[5]

Preemption (Part I)

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."[6]

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Some non-compliant states immediately challenged the SEC on the preemption issue;[7] 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.[8] Not only did that brouhaha

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end up in an unresolved standoff, 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 it's 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 sayeth the courts (to date)?

'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.[9] Bibi, together with two other former Unilab executives, 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, who had testified that he was entitled to "spill his guts" because 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 had to first 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 have conducted themselves properly. He then looked at whether the federal statute did anything to change that traditional rule, 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*.[10]

Judge Cabranes' ruling would seem to provide the answer to the SEC's preemption claim quite definitively, and in the negative. Why? Because there is *absolutely no evidence of any kind* that Congress expressed or manifested (or even implied) *any* intent to supplant state-based rules for lawyers when it passed Sarbanes-Oxley.[11] And if there is a further need for added authority on this point, the former Director of Enforcement of the SEC has publicly opined that the Commission's claim of preemption is legally infirm.[12]

'Wadler v. Bio-Rad Labs'

With the *Quest Diagnostics* precedent, I felt that the SEC would have tough-sledding (at the very least) in convincing other courts of their preemption claim. But then came a decision in December 2016 by a federal magistrate judge in California: *Wadler v. Bio-Rad Laboratories.*[13]

Sanford Wadler, the former general counsel of 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; and (2) the state of California's restrictive confidentiality obligations were preempted by the SEC's Sarbanes-Oxley rules and regulations governing attorney conduct.

Putting to one side the timeliness issue, let us examine these other rulings of Magistrate Judge Spero.[14] As for federal common law and its interaction with ABA Model Rule 1.6, the Magistrate Judge followed the lead of the Fifth Circuit in *Willy v. Administrative Review Board*.[15] 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 that this is now the normative standard nation-wide); previously the Model Rule had only allowed for the revealing of client confidences "to establish a defense on behalf of the

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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 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.[16]

Not surprisingly, the foregoing flaws blended into and affected the magistrate judge's preemption ruling. Lifting his ruling 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 not on the second two.[17] 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 that the SEC's interpretation of its "own regulation" was entitled to deference.[18]

Sorry, but a *Chevron* deference analysis does not have *any* relevance to federal preemption.[19] 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; Congress said zero about preemption, and he cited nothing to support that claim.[20]

Conclusion

Regardless of whether *Bio-Rad* was correctly decided, it is indisputable that the judicial vote on the preemption issue, thus far, is tied, one-one. Hopefully, when (not if) the SEC staff brings a Rule 102(e) proceeding against an attorney following her state's confidentiality obligations, the commission and/or the D.C. Circuit will side with Judge Cabranes and the Second Circuit.

1. 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," 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, "New Ethics Rules: What You Don't Know Can Hurt You!" NY Business 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).

2. See "Navigating" and "Here's Johnny!," supra note 1.

3. 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 1.

4. 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 1.

5. 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).

6. See SEC Release Nos. 33-8185, 34-47276 (Jan. 29, 2003).

7. See supra note 4.

8. 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.

9. *United States ex rel. Fair Lab. Practices Assocs. v. Quest Diagnostics*, 734 F.3d 154 (2d Cir. Oct. 25, 2013), aff'm, 2011 U.S. Dist. LEXIS 37014 (S.D.N.Y. April 15, 2011).

10. *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 & Avacodo 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).

11. See "Here's Johnny!," supra note 1.

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

13. 2016 WL 7369246 (Dec. 20, 2016).

14. The magistrate judge also ruled that there were waivers of certain privileged materials used by the company in presentations made to the government. I am in agreement with that ruling. See C.E. Stewart, "Think Twice: The Good, Bad and Ugly of Corporate Investigations," N.Y.L.J. (March 27, 2006); C.E. Stewart, "When the Government Comes Knocking," N.Y.L.J. (March 14, 2005); C.E. Stewart, "The Attorney-Client Privilege: The Best of Times, the Worst of Times," The Professional Lawyer (March 2000).

15. 423 F.3d 485 (5th Cir. 2005).

16. See 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).

17. See supra note 16.

18. Gone was the SEC's earlier invocation of *Sperry* (see supra note 8) as its preemption "authority" (not surprisingly).

19. See *Chevron U.S.A. v. Natural Resources Defense Council*, 467 U.S. 837 (1984). 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).

20. The magistrate judge, ignoring all of the Supreme Court precedent focusing on "clear legislative intent" (see supra note 10), 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.