



ETHICS ALERT

The New SEC Attorney Conduct Rules v. California's Duty of Confidentiality

*Corporations Committee of the Business Law Section
and
Committee on Professional Responsibility and Conduct*

With the passage of the Sarbanes-Oxley Act of 2002, Congress directed the Securities and Exchange Commission (“SEC”) to adopt new rules setting minimum standards for attorneys appearing and practicing before the SEC (“Appearing Attorneys”). In response, the SEC recently adopted what have become known as the Part 205 Rules. Those rules: (1) **require** Appearing Attorneys to report evidence of a material violation of the securities laws or breach of fiduciary duty to the issuer’s chief legal officer and in some cases to continue to report up the corporate ladder, as high as to the board of directors [Rule 205.3(b)(1)]; and (2) **permit** Appearing Attorneys in certain circumstances to disclose confidential information relating to the representation to the SEC without consent of the issuer [Rule 205.3(d)(2)].

The Part 205 Rules have created an ethical conundrum for California attorneys as portions of the Part 205 Rules seemingly conflict with our statutory duty to protect confidential client information. The Corporations Committee of the Business Law Section and the Committee on Professional Responsibility and Conduct have jointly prepared this ***ethics alert*** to warn California lawyers about these important issues.

PART I: THE NEW SEC ATTORNEY-CONDUCT RULES

A. *The Expansive Reach of the Part 205 Rules*

Under Rule 205.2(a), an attorney is deemed to be an Appearing Attorney not only by representing a client in an SEC proceeding, but also by: (1) providing federal securities law advice concerning any document the attorney has notice will be submitted to the SEC; or (2) advising a client regarding whether information must be submitted to, or filed with, the SEC.

Because direct interaction with the SEC is not a prerequisite to being deemed an Appearing Attorney, many attorneys may not realize that their interactions with clients are potentially subject to the Part 205 Rules. For example, an attorney who provides a summary of pending litigation for inclusion in a 10-K or 10-Q report may be subject to the SEC regulations. Accordingly, all attorneys should be alert to the possible application of the Part 205 Rules.

B. *The Duty to Report Evidence of a Material Violation “Up the Ladder” [Rule 205.3(b)(1)]*

Under Rule 205.3(b)(1), an Appearing Attorney who becomes aware of “evidence of a material violation” of the securities laws, or a breach of fiduciary duty by the issuer or its officers, directors, employees or agents, is obligated, with certain exceptions, to report the evidence to the issuer’s chief legal officer. Unless the Appearing Attorney reasonably believes that the chief legal officer has provided an appropriate response (as defined in the Rules), he or she must report the evidence up the corporate ladder, as high as the issuer’s board of directors. [Rule 205.3(b).]

C. *Permissive Disclosure of Client Confidences by the Issuer’s Counsel to the SEC [Rule 205.3(d)(2)]*

Rule 205.3(d)(2) has a much more dramatic impact on attorney-client confidentiality than Rule 205.3(b)(1), because it permits an Appearing Attorney to reveal confidential client information related to the representation to the SEC, *without* issuer consent. Disclosure is permitted if the attorney reasonably believes it necessary:

- To prevent the issuer from committing a material violation that is likely to cause *substantial* injury to the financial interest or property of the issuer or investors;
- To prevent the issuer, in an SEC proceeding, from committing *any* proscribed act likely to perpetrate a fraud upon the SEC; or
- To rectify the consequences of a material violation by the issuer that may cause *substantial* injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney’s services were used. [Rule 205.3(d)(2).]

D. *Claim of Preemption/Good Faith Defense*

In adopting the Part 205 Rules, the SEC expressly asserted that the new rules preempt conflicting state ethics rules: “Where the standards of a state . . . where an attorney is admitted or practices conflict with this part, this part shall govern.” [Rule 205.1.] Rule 205.6(c) further provides that an attorney who complies “in good faith” with the provisions of Part 205 shall not be subject to discipline or otherwise liable under any inconsistent standards imposed by any state where the attorney practices. However, the SEC’s claim of preemption has not been tested in court and some attorneys challenge that claim, raising among other questions, whether Congress intended to grant the SEC the authority to preempt state ethical statutes and rules, and standards of liability.

PART II: THE FIDUCIARY OBLIGATION OF CALIFORNIA ATTORNEYS TO PROTECT CLIENT CONFIDENTIAL INFORMATION

Protecting the confidentiality of communications between attorneys and their clients is reflected in both the attorney's fiduciary duty to maintain client secrets and the attorney-client evidentiary privilege. While the principles of confidentiality have been universally recognized in Anglo-American jurisprudence for more than 400 years, California has been amongst the most zealous in protecting client confidences. Under California law, the fiduciary duty of confidentiality is not merely aspirational, but is a legal obligation set forth in the State Bar Act: "It is the duty of an attorney . . . (e) To maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client." [Business & Professions Code Section 6068(e).] Breach of the duty to preserve client secrets and confidences may result both in liability and professional discipline. This statutory duty was first codified in California more than 130 years ago, and was not limited until last year, when the Legislature carved out an exception permitting disclosure of confidential information if an attorney reasonably believes disclosure is necessary to prevent death or substantial bodily harm. [Business & Professions Code §6068(e)(2), effective July 1, 2004.]

Although the duty of confidentiality is broader in scope than the evidentiary privilege, both share the same basic policy foundation: to ensure that every person is free to confide in an attorney, and thereby obtain effective legal advice and representation. [*People v. Speedee Oil Change Systems, Inc.* (1999) 20 Cal.4th 1135, 1146.] While the courts have historically recognized the risks of potential injustice created by the mantle of confidentiality, they have repeatedly emphasized that the benefits derived –an environment in which clients are forthright and attorneys provide useful advice, resulting in increased observance of the law – outweigh those risks. [*Mitchell v. Superior Court* (1984) 37 Cal.3d 591, 599.]

California Rule of Professional Conduct 3-600(A) provides that in representing an organization, a lawyer "shall conform his or her representation to the concept that the client is the organization itself, acting through its highest authorized officer, employee, body, or constituent overseeing the particular engagement." The lawyer's duties, including confidentiality, are therefore owed to the organization rather than to its constituents. [See *Goldstein v. Lees* (1975) 46 Cal.App.3d 614, 621.]

In the event of wrongdoing by an agent of the client corporation, the lawyer's recourse under the California Rules is limited. When a California lawyer knows that an agent of the company is acting in a manner that may be a violation of the law *or* that is likely to result in substantial injury to the company, the lawyer *may* take such actions as appear to be "in the best lawful interests of the organization." [Rule 3-600(B).] Among the available options is referring the matter up the ladder and, if the matter is sufficiently serious, referring it to the board of directors.

Whatever option is chosen, however, Rule 3-600 expressly *requires the attorney to protect all client confidences and secrets, as provided by Business & Professions Code section 6068(e)*. Thus, while a California lawyer may discuss the matter within the corporation, he or she may not disclose confidential information outside the corporation. Instead, if the corporation's highest authority persists in illegal conduct that is likely to result in substantial injury to the company, Rule 3-600(C) provides that the lawyer has the right [Rule 3-700(C)(1) & (2)], and in some cases the duty [Rule 3-700(B)(2)], to resign. [See also Rules 1-120 and 3-210.]

Notwithstanding the strong public policy considerations favoring confidentiality in California, neither the privilege nor the duty is without limits. California has historically recognized several exceptions to the evidentiary *privilege* [Evidence Code §§956-962] including one where the services of the lawyer were sought or obtained to aid in the planning or commission of a crime or a fraud. In addition, the courts have recognized exceptions to the *duty* of confidentiality. [See, e.g., *Arden v. State Bar* (1959) 52 Cal.2d 310, 320; *Carlson Collins, etc. v. Banducci* (1967) 257 Cal.App.2d 212, 227-228; *General Dynamics v. Superior Court* (1994) 7 Cal.4th 1164, 1186-1191.]

PART III: BALANCING CONFLICTING PRINCIPLES

We now examine whether and how the Part 205 Rules conflict with California duties of confidentiality, and provide some guidance to attorneys faced with seemingly conflicting duties.

Issue 1: In following the SEC Rules requiring attorneys to report material violations or breaches of fiduciary duty “up the ladder” within the organization, does a California lawyer violate California law? The answer generally appears to be “no.” While the Part 205 Rules *require* attorneys to report up the ladder within the issuer-organization, California law recognizes that the attorney’s duties run to the organization rather than its constituents, and Rule 3-600 expressly *permits* attorneys to report matters of concern up the organizational ladder. However, other considerations we do not address (e.g., reporting the conduct of a subsidiary to the board of a parent) could potentially raise conflicts.

Issue 2: Do the provisions of the Part 205 Rules permitting disclosure of client confidences to the SEC [Rule 205.3(d)(2)] conflict with California law requiring attorneys to maintain client confidences? The answer appears to be “yes.” [See, Business & Professions Code §6068(e).] While the Part 205 Rules purport to preempt state law, the preemption issue has not been resolved by any court and is currently the subject of much debate. Notwithstanding the “good faith” defense of Rule 205.6(c), if the Part 205 Rules are held *not* to preempt state law, California attorneys disclosing client confidences to the SEC could potentially be subject to State Bar discipline and/or breach of fiduciary duty claims. Even if the SEC’s claim of preemption is upheld, an attorney must take into account the risk that a court could conclude he or she did not satisfy the “good faith” defense. Thus, California attorneys cannot presume there is a safe harbor if they disclose client confidences to the SEC.

Issue 3: Given the apparent conflict between the provisions of the Part 205 Rules permitting disclosure of client confidences to the SEC and the fiduciary duty of California attorneys to maintain client secrets and confidences, it may be safer for California attorneys not to accept the SEC's invitation to disclose client confidences to the SEC, at least until such time as the preemption and good faith issues have been decided by a court of competent jurisdiction.

Concluding Remarks: Because the Part 205 Rules and the legal and ethical responsibilities of California lawyers are quite complex and are only generally summarized in this article, members should not rely on this article as a complete explanation of their potentially conflicting rights and duties. Instead, and in light of the risks presented, an attorney faced with seemingly conflicting obligations should not take any action without either carefully studying all of the applicable state and federal legal principles, or consulting with other attorneys who have expertise in the Part 205 Rules and California law on the duty of confidentiality.

A PUBLICATION OF
THE STATE BAR OF CALIFORNIA
ETHICS HOTLINE



ETHICS HOTLINER

Points of view and opinions expressed in this newsletter are solely those of the authors and contributors. They have not been adopted or endorsed by the State Bar's Board of Governors and do not constitute the official position or policy of the State Bar of California.

Nothing contained herein is intended to address any specific legal inquiry nor is it a substitute for independent legal research to original sources or for obtaining the advice of legal counsel with respect to specific legal problems.

© 2004 State Bar of California. All Rights Reserved.

Reproduction in whole or in part without permission is prohibited