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Conflicting Currents: The Obligation to Maintain Inviolable Client Confidences and the New SEC Attorney Conduct Rules

Corporations Committee of the Business Law Section of the California State
Bar*

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In January 2003, the Securities and Exchange Commission (the “SEC”) adopted new rules governing the conduct of attorneys appearing and practicing before it.¹ Those rules require attorneys to report “up-the-ladder” within the client organization, and purport to immunize attorneys who disclose client confidences to the SEC in certain circumstances.² The SEC has also proposed rules that would mandate reporting of client confidences outside the client to the SEC.³ The provisions of the rules, both as proposed and as adopted, raise important issues regarding traditional, state law obligations of attorney-client confidentiality.

California attorneys have an obligation to maintain their clients’ secrets. This obligation springs from several independent sources: the State Bar Act,⁴ the California Evidence Code,⁵ and the California Rules of Professional Conduct as approved by the California Supreme Court.⁶ The State Bar Act requires attorneys “[t]o maintain inviolate the confidence[s], and at every peril . . . to preserve the secrets, of his or her client[s].”⁷ Similarly, the Evidence Code requires an attorney to assert the attorney-client privilege whenever a party seeks disclosure of a privileged communication.⁸ The obligation to maintain client confidences and preserve client secrets embedded in these statutes reflects the long-standing recognition that society benefits when clients receive advice informed by full and frank communication with their legal counsel. The obligation also reflects a policy that attorneys should avoid conflicts of interest with their clients.⁹

The Corporations Committee of the Business Law Section of the California State Bar (the “Corporations Committee”) has prepared this article to examine the existing legal conflicts between a California attorney’s

1. Implementation of Standards of Prof’l Conduct for Attorneys, Securities Act Release No. 33-8185, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,823 (87,069 *et. seq.*) (Jan. 29, 2003).

2. *Id.*

3. Implementation of Standards of Prof’l Conduct for Attorneys, Securities Act Release No. 33-8150, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,802 (86,513 *et. seq.*) (Nov. 21, 2002).

4. CAL. BUS. & PROF. CODE §§ 6000-6238 (West 2003) (referred to in the text as the “Business and Professions Code”).

5. CAL. EVID. CODE §§ 950-962 (West 2003) (referred to in the text as the “Evidence Code”).

6. CAL. RULES OF PROF’L CONDUCT R. 1-100 to 5-400 (2001) (referred to in the text as the “California Rules of Conduct”).

7. CAL. BUS. & PROF. CODE § 6068(e) (West 2003). *See infra* notes 95-98 and accompanying text. Clause (2) was added to Section 6068(e) in 2003 (effective July 1, 2004). *Id.* References to Section 6068(e) in this article and in prior cases should be understood as a reference only to clause (1).

8. CAL. EVID. CODE § 955 (West 2003).

9. CAL. RULES OF PROF’L CONDUCT R. 3-310(E). *See infra* notes 100-102 and accompanying text. As discussed *infra* in note 95, it is possible to understand Section 6068(e) as imposing an obligation on an attorney to maintain his or her client’s trust by avoiding conflicts and maintaining the confidentiality of the client’s communications.

statutory obligations to maintain client confidences and the SEC's new attorney conduct rules.¹⁰ Part I of this article discusses the background of the SEC's attorney conduct rules, Part II reviews the statutory and fiduciary duties of California attorneys to maintain client confidences, and Part III analyzes the SEC's authority to adopt its new attorney conduct rules and to give them preemptive effect.

I. BACKGROUND OF THE SEC ATTORNEY CONDUCT RULES

A. *The Sarbanes-Oxley Act and Related Rulemaking*

The SEC's recent attorney conduct rulemaking has its genesis in Section 307 of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act" or, simply, the "Act").¹¹ Enacted during the aftermath of allegations of massive financial fraud at some of the country's largest and best-known companies, this legislation received overwhelming bipartisan support.¹² President George W. Bush signed the Act on July 30, 2002.¹³

Section 307 of the Act was proposed in an amendment to the Sarbanes-Oxley bill by Senator John Edwards on July 10, 2002.¹⁴ The amendment was adopted by the Senate unanimously, and accepted by the House in conference.¹⁵ As enacted, Section 307 provides:

10. In March 2004, the Corporations Committee and the Committee on Professional Responsibility and Conduct of the California State Bar (COPRAC) jointly issued a summary Ethics Alert to all members of the California Bar, highlighting the major issues presented by the new SEC rules and the impact they have on California attorneys. CORP. COMM. OF THE BUS. LAW SECTION & COMM. ON PROF'L RESPONSIBILITY AND CONDUCT, STATE BAR OF CAL., ETHICS ALERT: THE NEW SEC ATTORNEY CONDUCT RULES V. CALIFORNIA'S DUTY OF CONFIDENTIALITY (2004), available at <http://calbar.ca.gov/calbar/pdfs/SEC-ethics-alert.pdf>. The Ethics Alert was published on the State Bar's website and announced in the April 2004 issue of the CALIFORNIA BAR JOURNAL, the official publication of the State Bar of California. *Sarbanes-Oxley Rules Create Ethical Minefield for Lawyers*, CAL. ST. B.J., April 2004, at 1 & 6, available at <http://calbar.ca.gov/calbar/pdfs/SEC-ethics-alert.pdf>. On behalf of the Corporations Committee, the members of the Drafting Committee acknowledge that discussions, analysis, and drafting conducted jointly with COPRAC in preparation of the Ethics Alert served as a valuable resource in the preparation of this article. Nonetheless, the content of this article is the sole responsibility of the Corporations Committee and as such may not be interpreted as representing an official position taken by COPRAC on any of the matters addressed in this article.

11. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as 15 U.S.C. § 7245 (West Supp. 2004)).

12. The House of Representatives passed the Act by a 423-3 vote and the Senate passed the Act by a 99-0 vote. Mike Allen, *Bush Signs Corporate Reforms Into Law; President Says Era of "False Profits" Is Over*, WASH. POST, July 31, 2002, at A4.

13. Statement by President George W. Bush Upon Signing H.R. 3763, 38 WEEKLY COMP. PRES. DOC. 1286 (July 30, 2002).

14. Senator Edwards practiced law in North Carolina before election to the Senate in 1998 and, according to the North Carolina State Bar, remained active until April 12, 2000. See *infra* note 31 and accompanying text for the comments of the North Carolina Bar Association (a separate, voluntary organization) on the initial proposal of the SEC under Section 307 of the Act.

15. See Jennifer Wheeler, *Section 307 of the Sarbanes-Oxley Act: Irreconcilable Conflict With the ABA's Model Rules and the Oklahoma Rules of Professional Conduct?*, 56 OKLA. L. REV. 461, 464-65 (2003).

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 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.¹⁶

The SEC responded quickly to the mandate of Section 307 by proposing new attorney conduct rules on November 21, 2002 (hereinafter the “Proposing Release”).¹⁷ As initially proposed, the rules would have required attorneys to report evidence of material violations of law “up-the-ladder” within an organization *and*, if the attorney did not receive an appropriate response, to withdraw from the engagement under certain circumstances.¹⁸ The SEC adopted final rules with respect to “up-the-ladder” reporting that were published in an adopting release dated January 29, 2003 (hereinafter the “Adopting Release”).¹⁹ These rules (hereinafter the “Part 205 Rules” or,

16. Sarbanes-Oxley Act § 307.

17. Implementation of Standards of Prof'l Conduct for Attorneys, Securities Act Release No. 33-8150, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,802 (86,513 *et. seq.*) (Nov. 21, 2002).

18. *Id.* The Business Law Section and the Corporations Committee of the California State Bar jointly submitted a comment letter to the SEC with respect to the Proposing Release. Letter from the Corp. Comm. & Bus. Law Section to Jonathan G. Katz, Secretary, Sec. and Exch. Comm'n (December 16, 2002), available at <http://www.sec.gov/rules/proposed/s74502/tghoxiq1.htm>. It asserted four points: (i) the proposed rules conflict with California law; (ii) the conflict is not necessary because it arises from the “noisy withdrawal” portion of the proposed rules that depart from the letter and spirit of the Act; (iii) it is unclear that the SEC can impose its interpretation of evidentiary and professional rules in contexts not involving the SEC; and (iv) the “reporting up” requirements of the Act establish a mechanism whereby close or controversial legal issues are exposed to scrutiny by independent directors. *Id.*

19. Implementation of Standards of Prof'l Conduct for Attorneys, Securities Act Release No. 33-8185, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,823 (87,069 *et. seq.*) (Jan. 29, 2003).

simply, the “Rules”) became effective on August 5, 2003.²⁰ The Rules, as adopted, did not include an obligation on the part of an attorney to “report out” to the SEC.²¹ Nonetheless, the Adopting Release stated that the reporting out component remains under consideration by the SEC.²² Moreover, the Rules do include a purported “safe harbor” provision for attorneys who elect to report out to the SEC in certain circumstances.²³

B. The Operative Requirement: Duty to Report Evidence of a Material Violation

The basic mandate of the Part 205 Rules is set forth in Rule 205.3(b)(1):

If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report such evidence to the issuer’s chief legal officer (or the equivalent thereof) or to both the issuer’s chief legal officer and its chief executive officer (or the equivalents thereof) forthwith.²⁴

The relative brevity of Rule 205.3(b)(1) belies its complexity. It is, indeed, heavily dependent on several defined terms which are used directly in it and other terms set forth in existing provisions of the federal securities laws.²⁵ Several of the terms defined in the Rules refer to still other defined terms.²⁶

20. 17 C.F.R. § 205 (2004).

21. *Id.*

22. Simultaneously with issuing the Adopting Release, the SEC issued a release proposing a separate variant on the “noisy withdrawal” requirement in which the obligation would be placed on the reporting company rather than on the attorney. Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 33-8186, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,824 (87,111 *et seq.*) (Jan. 29, 2003).

23. 17 C.F.R. § 205.6(c) (2004). See *infra* notes 63-69 and accompanying text.

24. § 205.3(b)(1).

25. The following definitions (set forth in the provision indicated) are particularly critical:

Attorney	§ 205.2(c)
Appearing and practicing before the Commission	§ 205.2(a)
In the representation of an issuer	§ 205.2(g)
Evidence of a material violation	§ 205.2(e)
Issuer	§ 205.2(h)
Material violation	§ 205.2(i)
Report	§ 205.2(n)

26. For example, “evidence of a material violation” uses the defined term “material violation,” which is defined using the defined term “breach of fiduciary duty.” § 205.2(e), (i).

The definitions in the Rules are further complicated by the use of double negatives.²⁷

C. The Unexpectedly Broad Scope of the Rules

Many lawyers may be surprised to find that they are, or may be, subject to the Part 205 Rules. To determine whether an attorney is subject to the Rules, three definitions must be considered: the Rule applies (i) only to “attorneys”, who are (ii) “appearing and practicing before the Commission [SEC]” and (iii) “in the representation of an issuer.”

The term “attorney” is defined to include both licensed attorneys and anyone who holds himself or herself out as being admitted, licensed or otherwise qualified to practice law. Under the Rules, an attorney will be considered to be appearing and practicing before the SEC if he or she does any of the following:

(i) Transact[s] any business with the [SEC], including communications in any form;

(ii) Represent[s] an issuer in a[n] [SEC] administrative proceeding or in connection with any [SEC] investigation, inquiry, information request, or subpoena;

(iii) Provid[es] advice in respect of the United States securities laws or the [SEC]’s rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the [SEC], including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or

27. For example, the definition of “evidence of a material violation” reads in part as follows: “credible evidence, based upon which it would be *unreasonable*, under the circumstances, for a prudent and competent attorney *not to conclude* that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.” § 205.2(e) (emphasis added). In a recently published article, three law professors noted:

Law is intended to guide action in the world. Yet it is barely possible to read the SEC’s definition out loud without tripping (or, as we have discovered when presenting this definition in various fora, chuckling) over the words, let alone trying to remember the definition without reading it or trying to work out its “logic.” Indeed, the provision is a gross violation of the SEC’s own “plain English” rules. . . .

Roger C. Cramton et al., *Legal and Ethical Duties of Lawyers After Sarbanes-Oxley*, 49 VILL. L. REV. 725, 753 (2004). Other examples of the use of double negatives in definitions under the Rules can be found in the definitions of “reasonable” and “reasonably believes.” § 205.2(l), (m).

(iv) Advises an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the [SEC's] rules or regulations. . .to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the [SEC].²⁸

The latter two categories of activities do not require any direct communication with, or appearance before, the SEC. Thus, these are not based on commonly understood notions of what it means to appear *and* practice before an agency. Rather, these categories focus on the substance of the communication between lawyer and client. Given that the SEC's definition of "appearing and practicing" does not require any direct interaction between an attorney and the SEC, the definition is at odds with its plain meaning.²⁹ Many attorneys may not recognize that their interactions with clients are now subject to SEC regulation under the Rules. For example, an executive compensation lawyer who advises an issuer in negotiating an employment contract with the issuer's chief executive officer will be appearing and practicing before the SEC, assuming such lawyer knows that the agreement will be filed with the SEC, and he or she provides advice in respect to the U.S. securities laws or the SEC rules and regulations.³⁰ Lawyers who do not specialize in SEC practice may find that they lack the knowledge and training to know whether they are subject to the Part 205 Rules, much less what they must do to comply with them.³¹

28. § 205.2(a)(1)(i)-(iv). The definition of "appearing and practicing" excludes an attorney who: (i) performs any of the listed activities "other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship; or (ii) [i]s a non-appearing foreign attorney." § 205.2(a)(2). See § 205.2(j) for the definition of a non-appearing foreign attorney.

29. In adopting such an unusually expansive and counterintuitive definition of "appearing and practicing," the SEC has gone beyond the plain meaning of the statute and has arguably exceeded its rulemaking authority. The limits on an agency's power to adopt rules is discussed in Part III of this article. See *infra* notes 204-244 and accompanying text.

30. Such contract is required to be filed as an exhibit to, among other things, an issuer's annual report on Form 10-K pursuant to Item 601(b)(10)(iii)(A) of Regulation S-K. 17 C.F.R. § 229.601(b)(10)(iii)(A) (2004). The Adopting Release makes it clear that "an attorney must have notice that a document he or she is preparing or assisting in preparing will be submitted to the Commission to be deemed to be 'appearing and practicing'" under the revised definition. Implementation of Standards of Prof'l Conduct for Attorneys, Securities Act Release No. 33-8185, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,823, at 87,072 (Jan. 29, 2003). It is unclear what meaning will be ascribed to "in respect of" in the definition. It may be read to require that the substance of the advice concerns securities laws or SEC rules and regulations. However, it might mean simply relating or relevant to those laws or regulations. See Cramton et al., *supra* note 27, at 742-43; see also Dan K. Webb & Scott P. Glauber, *Up the Ladder: Litigator Responsibilities under the Sarbanes-Oxley Act*, LITIGATION, Summer 2004, at 21, 23.

31. See Letter from J. Norfleet Pruden, III, President, and Lynn F. Chandler, Chair, Sarbanes-Oxley Task Force of the Professionalism Comm., North Carolina Bar Association, to Jonathan G. Katz, Secretary, Sec. & Exch. Comm'n (Jan. 21, 2003), available at <http://www.sec.gov/rules/proposed/s74502/jnpruden1.htm>; Letter from Tod Aronovitz, President, and Ian M. Comisky, Board of Governors, The Florida Bar, to Jonathan G. Katz, Secretary, Sec. & Exch. Comm'n (April 7, 2003), at <http://www.sec.gov/rules/proposed/s74502/flbar040703.htm>.

[T]he definition of "lawyer" [sic] in the rule is so broad that it includes attorneys who may have tangential relationships with SEC reporting matters, such as patent work, review of corporate minutes, or closings on sales of corporate properties. These attorneys, who have neither the means nor the knowledge to comply with Section 205,

Even if an attorney is appearing and practicing before the SEC, the Rule requires that the appearance or practice must be “in the representation of an issuer.”³² This phrase is defined as “providing legal services as an attorney for an issuer, *regardless of whether the attorney is employed or retained by the issuer.*”³³ The term “issuer” has the definition set forth in Section 3 of the Securities Exchange Act of 1934 (hereinafter the “Exchange Act”).³⁴ However, for the purposes of the Rule, one of the following must also be applicable:³⁵

the securities of the issuer are registered under Section 12 of the Exchange Act;³⁶

the issuer is required to file reports under Section 15(d) of the Exchange Act;³⁷ or

the issuer files or has filed a registration statement that has not yet become effective under the Securities Act of 1933, and that it has not withdrawn.³⁸

would still be caught in its net.

Id.

32. 17 C.F.R. § 205.1 (2004).

33. § 205.2(g) (emphasis added).

34. 15 U.S.C. § 78c(8) (2004).

The term “issuer” means any person who issues or proposes to issue any security; except that with respect to certificates of deposit for securities, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors or of the fixed, restricted management, or unit type, the term ‘issuer’ means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; and except that with respect to equipment-trust certificates or like securities, the term “issuer” means the person by whom the equipment or property is, or is to be, used.

Id.

35. 15 U.S.C. § 78j-1(f) (2004).

36. 15 U.S.C. § 78l (2004). Generally, registration is required if a company either: (i) is listed on an exchange; or (ii) has total assets of more than \$1 million and a class of equity securities held of record by 500 or more persons. §§ 78l(b), 78l(g)(1)(B).

37. § 78o(d). Reporting under Section 15(d) is triggered by the filing of a registration statement that “has become effective pursuant to the Securities Act of 1933, as amended [15 U.S.C. § 77a et seq.].” *Id.* Generally, these will be smaller issuers with securities that are traded in the over-the-counter market but with insufficient assets or shareholders to be subject to registration under Section 12(g). This category of issuers also includes companies that have relatively few equity holders but which have publicly offered debt securities.

38. § 77a et seq. (2004). This category includes companies that may be closely held but are in the process of “going public” by filing a registration statement with the SEC under the Securities Act of 1933. *Id.*

The Rule further provides that “the term ‘issuer’ includes any person controlled by an issuer [if] an attorney provides legal services to [that] person on behalf of, or at the behest, or for the benefit of the issuer, regardless of whether the attorney is employed or retained by the issuer.”³⁹ Accordingly, an attorney who is engaged solely by a subsidiary of an issuer may be appearing and practicing in the representation of an issuer if he or she acts on behalf, or at the behest, or for the benefit, of the issuer *even when that issuer is not actually the client of the attorney*.⁴⁰ One example of that situation is when an attorney retained by a subsidiary is asked to assist in preparing a portion of a document to be filed by the issuer with the SEC.

D. The Duty to Report “Up the Ladder”

The essential feature of the Part 205 Rules is a “reporting up-the-ladder” procedure, as specifically required by Section 307 of the Sarbanes-Oxley Act.⁴¹ The obligation to follow such procedures arises when an attorney “in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent” of an applicable Federal or state securities law, or a “breach of fiduciary duty” arising under Federal or state law or of a similar violation.⁴² In that event, such attorney is obligated forthwith to report the evidence to the issuer’s “chief legal officer” or both its chief executive officer and chief legal officer.⁴³ However, if the attorney “reasonably believes” that such report

39. 17 C.F.R. § 205.2(h) (2004) (emphasis added).

40. This is an area in which lawyers are likely to be confused. A lawyer representing a subsidiary might argue that he or she is not “appearing and practicing” before the SEC because that definition specifically excludes lawyers who provide the listed services “other than in the context of providing legal services to an issuer with whom the attorney has an attorney-client relationship.” § 205.2(a)(2)(i) (emphasis added). However, the SEC has, as noted in the text, expanded the definition of “issuer” for purposes of defining “appearing and practicing” and “in the representation of an issuer” to include any person controlled by issuers. See § 205.2(a), (g), (h). In light of this more expansive definition, the lawyer may in fact be providing listed services to an issuer with whom the attorney has an attorney-client relationship. In the Adopting Release, the SEC made it clear that it views the question of whether an attorney-client relationship exists is a federal question:

whether the provision of legal services under particular circumstances would or would not establish an attorney-client relationship under the state laws or ethics codes of the state where the attorney practices or is admitted may be relevant to, but will not be controlling on, the issue under this part.

Implementation of Standards of Prof'l Conduct for Attorneys, Securities Act Release No. 33-8185, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,823, at 87,072 (Jan. 29, 2003). Section 307 of the Sarbanes-Oxley Act, however, says nothing about Congress delegating to the SEC the authority to define when an attorney-client relationship exists – a question that has historically been the subject of state law. See *id.* at 87,071 & fn. 5. A federal agency’s authority to preempt state laws is discussed *infra* in Part III.

41. 15 U.S.C.A. § 7245 (West Supp. 2004); 17 C.F.R. § 205.3(b) (2004).

42. 17 C.F.R. §§ 205.3(b)(1), 205.2(d).

43. § 205.3(b)(1). Certain exceptions are specified in the rule. See § 205.3(b)(6). “Evidence of a material violation means credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.” § 205.2(e) (emphasis omitted). A “material violation” is defined as “a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or

would be futile, the Rules authorize the attorney to report directly to an authorized committee of the board of directors or to the entire board.⁴⁴

Upon receiving a report, the chief legal officer has two options. He or she may refer the report to the issuer's "qualified legal compliance committee" (a "QLCC") if the issuer has previously established such committee.⁴⁵ Alternatively (or if no QLCC has been established), he or she

a similar material violation of any United States federal or state law." § 205.2(i). A "breach of fiduciary duty" is defined as "any breach of fiduciary or similar duty to the issuer recognized under an applicable Federal or State statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful transactions." § 205.2(d). The Part 205 Rules do not define "chief legal officer." In the case of attorneys representing subsidiary corporations, it is unclear which violations will trigger a reporting obligation. As discussed above, the Rules define "issuer" broadly for purposes of defining "appearing and practicing" and "in the representation of an issuer." See *supra* note 40 and accompanying text. However, the SEC did not assign this broad definition to other sections of the Rules. Thus, it is possible that the violations must pertain to the parent in order to trigger a reporting obligation.

44. § 205.3(b)(4). "Reasonably believes" is defined to mean that "an attorney believes the matter in question and that the circumstances are such that the belief is not unreasonable." § 205.2(m).

45. § 205.3(b)(2). A "qualified legal compliance committee" is defined in § 205.2(k) as follows: [A] committee of an issuer (which also may be an audit or other committee of the issuer)

that:

(1) Consists of at least one member of the issuer's audit committee (or, if the issuer has no audit committee, one member from an equivalent committee of independent directors) and two or more members of the issuer's board of directors who are not employed, directly or indirectly, by the issuer and who are not, in the case of a registered investment company, "interested persons" as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19));

(2) Has adopted written procedures for the confidential receipt, retention, and consideration of any report of evidence of a material violation under §205.3;

(3) Has been duly established by the issuer's board of directors, with the authority and responsibility:

(i) To inform the issuer's chief legal officer and chief executive officer (or the equivalents thereof) of any report of evidence of a material violation (except in the circumstances described in §205.3(b)(4));

(ii) To determine whether an investigation is necessary regarding any report of evidence of a material violation by the issuer, its officers, directors, employees or agents and, if it determines an investigation is necessary or appropriate, to:

(A) Notify the audit committee or the full board of directors;

(B) Initiate an investigation, which may be conducted either by the chief legal officer (or the equivalent thereof) or by outside attorneys; and

(C) Retain such additional expert personnel as the committee deems necessary; and

(iii) At the conclusion of any such investigation, to:

(A) Recommend, by majority vote, that the issuer implement an appropriate response to evidence of a material violation; and

(B) Inform the chief legal officer and the chief executive officer (or the equivalents thereof) and the board of directors of the results of any such investigation under this section and the appropriate remedial measures to be adopted; and

(4) Has the authority and responsibility, acting by majority vote, to take all other appropriate action, including the authority to notify the Commission in the event that the issuer fails in any material respect to implement an appropriate response that the qualified legal compliance committee has recommended the issuer to take.

§ 205.2(k).

must “cause such inquiry into the evidence of a material violation as he or she reasonably believes is appropriate to determine whether the material violation described in the report has occurred, is ongoing, or is about to occur.”⁴⁶ If this inquiry results in a determination that “no violation has occurred, is ongoing, or is about to occur,” the chief legal officer is required to notify the reporting attorney and provide the basis for the determination.⁴⁷ If the chief legal officer is unable to make that determination, then the chief legal officer is required to “take all reasonable steps to cause the issuer to adopt an appropriate response and . . . advise the reporting attorney [of those steps].”⁴⁸

A reporting attorney “who receives what he or she . . . believes [to be] an appropriate and timely response” has fulfilled his or her obligations under the Part 205 Rules.⁴⁹ If not, however, the attorney is obligated under the Rules to report the evidence of a material violation to:

(i) The audit committee of the issuer’s board of directors;

(ii) Another committee of the issuer’s board of directors consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, “interested persons” as defined in Section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19)) (if the issuer’s board of directors has no audit committee); or

46. § 205.3(b)(2).

47. *Id.*

48. *Id.* “Appropriate response” is defined to mean:

[A] response to an attorney regarding reported evidence of a material violation as a result of which the attorney reasonably believes:

(1) That no material violation, as defined in paragraph (i) of this section, has occurred, is ongoing, or is about to occur;

(2) That the issuer has, as necessary, adopted appropriate remedial measures, including appropriate steps or sanctions to stop any material violations that are ongoing, to prevent any material violation that has yet to occur, and to remedy or otherwise appropriately address any material violation that has already occurred and to minimize the likelihood of its recurrence; or

(3) That the issuer, with the consent of the issuer’s board of directors, a committee thereof to whom a report could be made pursuant to §205.3(b)(3), or a qualified legal compliance committee, has retained or directed an attorney to review the reported evidence of a material violation and either:

(i) Has substantially implemented any remedial recommendations made by such attorney after a reasonable investigation and evaluation of the reported evidence; or

(ii) Has been advised that such attorney may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer’s officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation.

§ 205.2(b).

49. § 205.3(b)(8).

iii) The issuer's board of directors . . .⁵⁰

The reporting attorney is further obligated to explain to the board or committee the reasons why he or she believes that the response was not appropriate.⁵¹

If the issuer has previously established a QLCC and the attorney has already provided a report of the "evidence of a material violation" to that committee, the attorney is not required to make the committee or board report described above.⁵² The advantage of establishing a QLCC, from the attorney's perspective, is that the attorney discharges his or her reporting obligations under the Part 205 Rules by making a report to that committee and does not have to make a determination of whether he or she has received an "appropriate response" to it.⁵³

E. Disclosure of Evidence of a Material Violation to the SEC ("Noisy Withdrawal")

As originally set forth in the Proposing Release, the Part 205 Rules would have required an attorney to withdraw from representing the issuer and, within one business day of withdrawing, to give written notice to the SEC of the attorney's withdrawal.⁵⁴ The notice would have had to indicate that the withdrawal was based on "professional considerations."⁵⁵ The withdrawal would have been required if the attorney did not receive an appropriate response to his or her report of a material violation, *and* he or she "reasonably believe[s] that a material violation is ongoing or is about to occur *and* is likely to result in substantial injury to the financial interest or property of the issuer or of investors."⁵⁶ The Proposing Release would also have required the attorney promptly to

disaffirm to the [SEC] any opinion, document, affirmation, representation, characterization, or the like in [any] document filed with or submitted to the [SEC], or incorporated into such a document, that the attorney has prepared or assisted in preparing

50. § 205.3(b)(3). The attorney is obligated to report to the board of directors "if the issuer's board of directors has no committee consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, 'interested persons' as defined in Section 2(a)(19) of the Investment Company Act of 1940." § 205.3(b)(3)(iii) (citation omitted).

51. § 205.3(b)(9).

52. § 205.3(c)(1).

53. *Id.*

54. See Implementation of Standards of Prof'l Conduct for Attorneys, Securities Act Release No. 33,8150, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,802, at 86,541 (Nov. 21, 2002).

55. *Id.*

56. *Id.* (emphasis added).

and that the attorney reasonably believes is or may be materially false or misleading.⁵⁷

This “noisy withdrawal” requirement was not adopted by the SEC as part of the Rules.⁵⁸ In the Adopting Release, however, the SEC did not reject that proposed component and instead merely deferred the issue for further consideration.⁵⁹ The Commission simultaneously proposed for comment an alternative “noisy withdrawal” proposal, which would require the issuer (rather than the attorney) to provide notice to the SEC in a public filing of an attorney’s withdrawal from representation of the issuer.⁶⁰ The comment period on the SEC’s alternative proposal expired April 7, 2003.⁶¹ Three California State Bar committees, including the Corporations Committee, submitted letters of comment to the SEC opposing adoption of these additional requirements.⁶²

57. *Id.* (emphasis added).

58. *Id.* at 86,519. However, an element of “reporting out” to someone other than the client may be embedded in the Rules. See 17 C.F.R. § 205.3(b) (2004). As discussed above, an attorney may be subject to the Rules even though he or she represents a subsidiary of an issuer and has no attorney-client relationship (at least insofar as state law is concerned) with the subsidiary’s parent. See *supra* note 40 and accompanying text. To the extent that the Rules are interpreted to require the attorney to report to the chief legal officer of the parent or the parent’s board or audit committee, the Rules require the attorney to report to someone other than his or her client. 17 C.F.R. § 205.3(b) (2004). In the Adopting Release, the SEC explains the reporting obligation of an attorney for a subsidiary as follows:

An attorney who represents a subsidiary or other person controlled by an issuer at the behest, for the benefit, or on behalf of a parent issuer who becomes aware of evidence of a material violation that is material to the issuer should report the evidence up-the-ladder through the issuer, as set forth in Section 205.3(b) of the rule.

Implementation of Standards of Prof’l Conduct for Attorneys, Securities Act Release No. 33-8185, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,823, at n.58 (Aug. 5, 2003). In this regard it should be noted that the interests of the parent and the subsidiary may not be the same, and could even be in conflict, and that the subsidiary under the SEC’s expanded definition of “issuer” need not be wholly-owned by the parent. See *supra* notes 39-40 and accompanying text.

59. See Sec. & Exch. Comm’n Chairman William H. Donaldson, Remarks at the Practicing Law Institute (hereinafter the “PLI Speech”) (Nov. 6, 2003) (“The noisy withdrawal rules remain under consideration today, as does an alternative that would require attorneys to notify the company of their resignation and the company to report the resignation to the Commission.”), available at <http://www.sec.gov/news/speech/spch110603whd.htm>; see also Sec. & Exch. Comm’n Chairman William H. Donaldson, Testimony Before Senate Committee on Banking, Housing and Urban Affairs (Sept. 9, 2003) (“The Commission has not decided how it wishes to proceed with respect to ‘noisy withdrawal.’”), available at <http://www.sec.gov/news/testimony/0903tswhd.htm>.

60. Implementation of Standards of Prof’l Conduct for Attorneys, Securities Act Release No. 33-8186, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,824, at 87,117 (Jan. 29, 2003).

61. *Id.*

62. See Letter from Kevin E Mohr, Chair, Comm. on Prof’l Responsibility & Conduct, to Jonathan G. Katz, Secretary, Sec. & Exch. Comm’n (Apr. 4, 2002), available at <http://www.sec.gov/rules/proposed/s74502/copracsbc040403.htm>; see also Letter from Timothy G Hoxie, Chair, Business Law Section, to Jonathan G. Katz, Secretary, Sec. & Exch. Comm’n (Apr. 7, 2003), available at <http://www.sec.gov/rules/proposed/s74502/tghoxie1.htm>; see also Letter from Laura Lee Blake, Executive Comm. Chair, and Erik J. Olson, Executive Comm. member, Litigation Section, to Jonathan G. Katz, Secretary, Sec. & Exch. Comm’n (Apr. 4, 2003), available at <http://www.sec.gov/rules/proposed/s74502/lssbc040403.htm>.

F. Permissive Disclosure of Client Confidences

The final Rules incorporate a provision that permits, but does not require, an attorney to disclose evidence of a material violation to the SEC *without* the issuer's consent.⁶³ Rule 205.3(d)(2) states that an attorney covered by the Rules may reveal to the SEC:

confidential information related to the representation [of the issuer] to the extent the attorney reasonably believes necessary:

- (i) 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;
- (ii) To prevent the issuer, in a [SEC] investigation or administrative proceeding from committing perjury, . . . suborning perjury, . . . or committing any act proscribed in [Section 1001 of Title 18] that is likely to perpetrate a fraud upon the [SEC];⁶⁴ or
- (iii) To rectify the consequences of a material violation by the

63. 17 C.F.R. § 205.3(d)(2) (2004). The Rule permits disclosure without the consent of the "issuer." *See id.* However, it does not explicitly permit disclosure without the consent of the client. *See id.* As discussed above, an attorney may be appearing and practicing before the SEC in the representation of an issuer even though he or she is providing legal services to a subsidiary. *See supra* notes 39-40, 58 and accompanying text. Because the expanded definition of "issuer" does not apply to Rule 205.3(d)(2), the rule fails to take into account the situation in which the issuer and the client are not one and the same. *See* 17 C.F.R. § 205.2 (2004).

64. 18 U.S.C. §1001(a) (2004) provides:

(a) Except as otherwise provided in this section, whoever, in any matter within the jurisdiction of the executive, legislative, or judicial branch of the Government of the United States, knowingly and willfully—

- (1) falsifies, conceals, or covers up by any trick, scheme, or device a material fact;
- (2) makes any materially false, fictitious, or fraudulent statement or representation;
- or
- (3) makes or uses any false writing or document knowing the same to contain any materially false, fictitious, or fraudulent statement or entry; shall be fined under this title or imprisoned not more than 5 years, or both.

(b) Subsection (a) does not apply to a party to a judicial proceeding, or that party's counsel, for statements, representations, writings or documents submitted by such party or counsel to a judge or magistrate in that proceeding.

(c) With respect to any matter within the jurisdiction of the legislative branch, subsection

(a) shall apply only to —

- (1) administrative matters, including a claim for payment, a matter related to the procurement of property or services, personnel or employment practices, or support services, or a document required by law, rule, or regulation to be submitted to the Congress or any office or officer within the legislative branch; or
- (2) any investigation or review, conducted pursuant to the authority of any committee, subcommittee, commission or office of the Congress, consistent with applicable rules of the House or Senate.

18 U.S.C. §1001(a) (2004).

issuer that caused, or 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.⁶⁵

Note that this permissive disclosure rule permits disclosure of confidential information even to "rectify the consequences of a material violation [that occurred in the past] . . . that caused . . . substantial injury . . . in the furtherance of which the attorney's services were used."⁶⁶ Disclosure is therefore permitted even if there is no prospective threat of ongoing or future substantial injury.⁶⁷

It is also noteworthy that the permissive disclosure rule allows the attorney to consider the interests of "investors" and not simply his or her client.⁶⁸ It is unclear what investors the SEC intended to cover. The term might be limited simply to shareholders, but it could include holders of debt securities or even investors in the securities markets more generally. In each of these cases, conflicts of interest could exist as between the corporation and any such investor and there could potentially be numerous combinations of conflicts as among those investors. Determining which interest is that of the entity itself or how to balance inconsistent interests would create serious dilemmas for an attorney subject to the Rules.

G. Good Faith Defense

The SEC's Part 205 Rules state that "[a]n 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 is admitted or practices."⁶⁹

H. The SEC's Claim of Preemption

The SEC recognized the potential conflict between the duty of attorney-client confidentiality as mandated under various state attorney regulatory systems and the invitation in the Part 205 Rules for attorneys to disclose

65. 17 C.F.R. § 205.3(d)(2) (2004).

66. 17 C.F.R. § 205.3(d)(2)(iii).

67. The word "rectify" means to "make, or set right; remedy; to make good." WEBSTER'S THIRD NEW INT'L DICTIONARY OF THE ENGLISH LANGUAGE UNABRIDGED 1899 (3d. ed. 2002). Thus, the term should be understood to refer necessarily to past acts. After all, something cannot be put right if it has not already gone wrong. Nonetheless, the failure to put something right may result in continuing harm – but this is not inevitably the case.

68. 17 C.F.R. § 205.3(d)(2)(iii) (2004).

69. § 205.6(c). This rule specifically exempts attorneys practicing outside the United States from complying with Part 205 "to the extent that such compliance is prohibited by applicable foreign law." *Id.* While the SEC's decision to exempt attorneys practicing outside the United States might be viewed as a pragmatic response to the realities of international practice, it does represent a curious bias in favor of foreign legal systems over the legislatures and courts of the fifty states and the District of Columbia. For example, if an attorney admitted in California is practicing in a foreign jurisdiction with exactly the same confidentiality obligations as California, the SEC would exempt the attorney on the basis of the foreign country's rules but not those of California.

their client's confidential information to the SEC.⁷⁰ It did so by declaring that the Rules preempt conflicting state law. Section 205.1 ("Purpose and Scope") states:

This part sets forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in the representation of an issuer. These standards supplement applicable standards of any jurisdiction where an attorney is admitted or practices and are not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with the application of this part. **Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, this part shall govern.**⁷¹

The SEC acknowledged in the Adopting Release that "[a] number of commenters questioned the Commission's authority to preempt state ethics rules, at least without being explicitly authorized and directed to do so by Congress."⁷² On the other hand, it cited another comment letter which noted:

[T]he Constitution's Commerce Clause grants the federal government the power to regulate the securities industry, that the Sarbanes-Oxley Act requires the Commission to establish rules setting forth minimum standards of conduct for attorneys appearing and practicing before it, and that, under the Supremacy Clause, duly adopted Commission rules will preempt conflicting state rules.⁷³

The Adopting Release concluded: "[T]he Commission reaffirms that its rules shall prevail over any conflicting or inconsistent laws of a state or other United States jurisdiction in which an attorney is admitted or practices."⁷⁴ Indeed, Section 205.6 ("Sanctions and discipline") states:

(c) An attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under

70. § 205.1.

71. *Id.* (emphasis added).

72. Implementation of Standards of Professional Conduct for Attorneys, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,823, at 87,071 (Feb. 5, 2003). The commenters questioning the SEC's authority to preempt state law included the Corporations Committee, the Litigation Section of the California State Bar, the Bar Association of San Francisco, the Association of the Bar of the City of New York, and the American Bar Association. See *infra* notes 213-31 and accompanying text.

73. Implementation of Standards of Professional Conduct for Attorneys, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,823, at 87,071 (Feb. 5, 2003).

74. *Id.*

inconsistent standards imposed by any state or other United States jurisdiction where the attorney is admitted or practices.⁷⁵

I. The SEC's July 2003 Public Statement

On July 9, 2003, the Ethics 2003 Committee of the Washington State Bar Association (the "WSBA") submitted a proposed interim formal ethics opinion for adoption by the WSBA Board of Governors regarding the effect of the SEC's Part 205 Rules on the obligations of Washington attorneys under the Washington Supreme Court's Rules of Professional Conduct.⁷⁶ It stated that, notwithstanding the permissive disclosure provisions of the SEC's Rule 205.3(d)(2), a Washington lawyer "should not reveal such confidences and secrets unless authorized to do so under the [Washington Rules of Professional Conduct]."⁷⁷ The proposed opinion further stated that, in the absence of case law on the validity of the SEC's professed preemption of contrary state law, "a Washington attorney cannot . . . fairly claim to be complying in 'good faith' with the SEC Regulations [Part 205], . . . if (s)he took an action that was contrary to this Formal Opinion."⁷⁸

In response, the SEC authorized issuance of a public statement by its general counsel, Giovanni P. Prezioso, in the form of a letter to the President of the WSBA (hereinafter the "Public Statement").⁷⁹ In the Public Statement, Mr. Prezioso stated:

The [Supreme] Court has consistently upheld the authority of federal agencies to implement rules of conduct that diverge from and supersede state laws that address the same conduct. . . . In particular, where, as here, a conflict arises because a state rule prohibits an attorney from exercising the discretion provided by a federal regulation, the federal regulation will take priority.⁸⁰

In the Public Statement, the SEC emphatically supported the preemptive scope of the Part 205 Rules, and declared its disagreement with the position

75. 17 C.F.R. § 205.6(c) (2004).

76. See Highlights from the July 9, 2003 meeting 10-11, available at <http://www.wsba.org/lawyers/groups/ethics2003/archivedhighlights.doc>. The proposed version of the opinion is no longer available on the WSBA's website. According to the summary of meetings of the WSBA Ethics 2003 Committee, the final version adopted on July 26, 2003, reflected only "minor revisions" from the version submitted in proposed form on July 9, 2003. *Id.* at 9.

77. ETHICS 2003 COMMITTEE OF THE WASH. STATE BAR ASS'N, INTERIM FORMAL ETHICS OPINION, RE: THE EFFECT OF THE SEC'S SARBANES-OXLEY REGULATIONS ON WASHINGTON ATTORNEYS' OBLIGATIONS UNDER THE RPCS I (2003), available at <http://www.wsba.org/lawyers/groups/ethics2003/formalopinion.doc>.

78. *Id.*

79. Letter from Giovanni P. Prezioso, General Counsel, Sec. & Exch. Comm'n, to J. Richard Manning, President, Wash. State Bar Ass'n (July 3, 2003), available at <http://www.sec.gov/news/speech/spch072303gpp.htm>.

80. *Id.* (citations omitted).

asserted in the proposed Washington ethics opinion.⁸¹ Specifically, the Public Statement made the following three points: 1) Rule 205.3(d)(2), permitting attorney disclosure of client confidences, supersedes state laws or rules of conduct that prohibit disclosure of client confidences; 2) under Rule 205.6(c), an attorney complying in good faith with the Commission's attorney conduct rules, "shall not" be subject to discipline or other liability under inconsistent state law or rules; and 3) the Part 205 Rules "would also be frustrated" if the Washington State Bar authorities "initiated" a disciplinary proceeding against an attorney who complied in "good faith" with the SEC's Part 205 Rules.⁸²

The third point, that even the "initiation" of a disciplinary proceeding against an attorney appearing and practicing before the SEC who discloses client confidences to the SEC would violate the Part 205 Rules, represents an aggressive assertion of the preemptive scope of the SEC's attorney conduct rules.⁸³

The SEC's Public Statement generated significant comment. The Corporations Committee addressed the statement in detail in a letter to Mr. Prezioso dated August 13, 2003.⁸⁴ The Corporations Committee's letter emphasized the following points. First, California's law and rules of professional conduct prohibit lawyers from disclosing client confidences.⁸⁵ Second, the ability of clients to confer fully with their attorneys without fear of disclosure is essential to our judicial system.⁸⁶ Third, disclosure of client confidences can have serious consequences for both the client and the attorney.⁸⁷ Fourth, it is unclear whether the SEC had the authority to adopt Rules 205.3(d) or 205.6(c) or that either of those rules preempts state laws and rules.⁸⁸ Finally, the State Bar of California has no power to refuse to enforce California statutes on the basis of federal preemption unless an appellate court has so ruled.⁸⁹

Notwithstanding the SEC's Public Statement, the Board of Governors of the WSBA adopted the interim ethical rule by an 11-0 vote (with one

81. *Id.*

82. *Id.*

83. *See id.* Because the question of an attorney's "good faith" in complying with Rule 205.3(d)(2) could only be established after a hearing to determine good faith (it would be a rare attorney who would concede lack of good faith before such a hearing), the effect of this view of preemption would be to prohibit all disciplinary hearings against attorneys disclosing client confidences based upon the SEC's Part 205 Rules, whether the disclosure was made in good faith or not.

84. Letter from the Corp. Comm. to Giovanni P. Prezioso, General Counsel, Sec. & Exch. Comm'n (Aug. 13, 2003) (on file with author).

85. *Id.*

86. *Id.*

87. *Id.*

88. *Id.*

89. *Id.*

abstention).⁹⁰ In a letter to Mr. Giovanni Prezioso, the President of the Washington Bar Association explained Washington's position as follows:

It remains to be seen whether the Washington Supreme Court will adopt rules of professional responsibility in greater conformity with the ABA model rules, or whether Washington will continue to require greater protection of client confidences than is mandated in some states. However, in the interim, and until our Supreme Court or a higher court has directed otherwise, Washington lawyers must continue to observe their ethical obligations under the Washington Rules of Professional Responsibility. This includes continuing to protect client confidences as required by Washington RPC 1.6.⁹¹

In a speech to the ABA Section of Business Law on April 3, 2004, Mr. Prezioso defended the permissive reporting out rule, and confirmed: "[I]t is our view that, where a federal rule says you may do something and a state rule says you may not, there is a conflict and the federal rule should prevail."⁹² He invited lawyers to provide the SEC with a test case:

I would urge any lawyer who would like to make a disclosure under the Commission's rules, but who is concerned about 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.⁹³

90. Highlights From August 13, 2003 Meeting 9-10, available at <http://www.wsba.org/lawyers/groups/ethics2003/archivedhighlights.doc>. The text of the final interim ethics opinion as thus adopted by the WSBA Board of Governors is available at <http://www.wsba.org/lawyers/groups/ethics2003/formalopinion.doc> (noting that it is "interim" in view of the absence of case law and of pending proposals to revise Rule 1.6 of the WSBA Rules of Professional Conduct).

91. Letter from J. Richard Manning, President, Wash. State Bar Ass'n, to Giovanni Prezioso, General Counsel, Sec. & Exch. Comm'n (Aug. 11, 2003), available at <http://www.wsba.org/lawyers/groups/ethics2003/manninglettertosec.doc>.

92. Giovanni P. Prezioso, Remarks at the ABA Section of Bus. Law 2004 Spring Meeting (Apr. 3, 2004), available at <http://www.sec.gov/news/speech/spch040304gpp.htm>.

93. *Id.* There is some irony in the General Counsel of the SEC suggesting that the protections afforded by acting through an attorney be utilized to undermine one of those same protections - confidentiality. More importantly, the SEC's active encouragement of violations of Section 6068(e) in reliance on the SEC's rules could result in violations by SEC attorneys of California's Rules of Professional Conduct as well as the local rules of the federal district courts in California (which have adopted California's State Bar Act and Rules of Professional Conduct). See *infra* note 191. California lawyers may not "knowingly assist in, solicit, or induce any [violation of the] rules or the State Bar Act," including Section 6068(e). CAL. RULES OF PROF'L. CONDUCT R. 1-120. Thus, if it should turn out that either the SEC's claim of preemption is not sustained or that under the facts of a particular case the safe harbor is not available, SEC attorneys might be exposed to discipline to the extent they are either members of the California Bar or appearing in the federal courts in California. The Corporations Committee drew this matter to the attention of Mr. William Lenox in a letter dated April 30, 2004, on the occasion of his appointment as head of the Ethics Office of the SEC. Letter from the Corp. Comm. to William Lenox, Ethics Counsel, Sec. & Exch. Comm'n (April 30, 2004), available at http://www.calbar.ca.gov/calbar/pdfs/sections/buslaw/corporations/2004-04-30_Corp-Com_Letter-to-Wm-Lenox.pdf.

II. THE OBLIGATION OF CALIFORNIA ATTORNEYS TO MAINTAIN CLIENT CONFIDENCES

A. *The Statutory Obligation: Its Justifications and Countervailing Policies*

Attorney-client confidentiality has been a core and universally recognized value of Anglo-American jurisprudence for hundreds of years.⁹⁴ The duty of confidentiality for California lawyers is set forth in Business and Professions Code Section 6068(e), which states: "It is the duty of an attorney . . . [t]o maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client."⁹⁵ This statutory duty was first codified in California more than 130 years ago. California has been among the most zealous states in guarding and

94. *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981) ("The attorney-client privilege is the oldest of the privileges for confidential communications known to the common law."); *Mitchell v. Super. Ct.*, 691 P.2d 642, 645 (Cal. 1984) ("The attorney-client privilege has been a hallmark of Anglo-American jurisprudence for almost 400 years."); *In re Jordan*, 526 P.2d 523, 526 (Cal. 1974) ("[T]he protection of confidences and secrets is not a rule of mere professional conduct, but instead involves public policies of paramount importance which are reflected in numerous statutes.") (quoting *In re Jordan*, 500 P.2d 873, 879 (Cal. 1972)).

95. CAL. BUS. & PROF. CODE § 6068(e) (West 2004). It should be noted that Section 6068(e) is comprised of two parts. The first part requires an attorney to maintain inviolate the "confidence" of his or her client. *Id.* The second part requires the attorney to preserve his or her client's "secrets." *Id.* It is possible that these two parts of the statute mean the same thing. This interpretation would assign the same meanings to "confidence" and "secrets." One might justify this interpretation by arguing that the redundancy simply reflects the legislature's intent to underscore the importance of the obligation. It is also possible that Section 6068(e) could be read to impose different, but related obligations. "Confidence" can also refer to "firm trust" or faith in someone. *See* BLACK'S LAW DICTIONARY 294 (7th ed. 1999). Assigning this meaning to confidence would give a different meaning to the first part of Section 6068(e) - imposing a duty on attorneys to maintain their clients' full trust. CAL. BUS. & PROF. CODE §6068(e). This implies a broader obligation that includes not only a duty to keep the client's secrets but also a duty to refrain from conflicts of interest. Sir Francis Bacon eloquently pointed out the relationship between trust and confidentiality:

The greatest trust, between man and man, is the trust of giving counsel. For in other confidences, men commit the parts of life; their lands; their goods, their children, their credit, some particular affair; but to such as they make their counselors, they commit the whole: by how much the more, they are obliged to all faith and integrity.

FRANCIS BACON, A HARMONY OF THE ESSAYS 310-11 (Edward Arber ed., Kings College 1871) (1610) (altered from Old English version).

Advocates of this interpretation can point to the fact that "confidence" is singular in the statute while "secrets" is plural. § 6068(e). Had the legislature intended to use "confidence" as the equivalent of a "secret," one would expect that the plural form would have been used. If Section 6068(e) embraces two duties, it should be noted that the duty of confidentiality requires more of the attorney since that is a duty that he or she must maintain at his or her every peril.

For convenience, this article uses the "duty of confidentiality" and like terms to refer to the statutory obligation of an attorney to maintain the confidentiality of his or her client's secrets. This usage, however, should not be considered to derogate an interpretation of Section 6068(e) that imposes a broader duty to maintain the confidence of the client.

protecting client confidences and secrets.⁹⁶ There were no express exceptions to this statutory duty until July 1, 2004.⁹⁷ On that date, an amendment to Section 6068(e) took effect permitting an attorney to disclose confidential information when the attorney reasonably believes that disclosure of a client secret is necessary to prevent a criminal act reasonably likely to result in death or substantial bodily harm.⁹⁸

The insistence that a lawyer preserve the secrets of his client is most commonly justified on the grounds that it is necessary to the client in obtaining good legal advice.⁹⁹ A client cannot reasonably be expected to lay the full facts of his or her case before counsel if the client knows that, by doing so, he or she may well be creating evidence that could be used against him or her. When full and frank discussion is curbed, legal counsel will not have sufficient information to be able to provide the right advice or defend the client adequately. Thus, client confidentiality is essential to the effective assistance of counsel and, ultimately, to due process of law.

The public interest is also served through increased compliance with the law when clients receive competent legal advice.¹⁰⁰ Maintaining client confidentiality is further justified on the basis that it is necessary to prevent conflicts of interest between the attorney and the client. Absent the obligation of confidentiality, an attorney might be tempted to reveal a client's secrets in furtherance of the attorney's own interests.¹⁰¹ Finally, secrets can represent the property of the client, and their revelation can effectively destroy the value of the client's property.¹⁰² After all, a secret is

96. See Kevin Mohr, *California's Duty of Confidentiality: Is it Time for a Life-Threatening Criminal Act Exception?*, 39 SAN DIEGO L. REV. 307, 309 (2002).

97. CAL. BUS. & PROF. CODE § 6068(e)(2) (Deering Supp. 2004).

98. *Id.* Assembly Bill 1101 amended Section 6068(e)(2) which provides:

[A]n attorney may, but is not required to, reveal confidential information relating to the representation of a client to the extent that the attorney reasonably believes the disclosure is necessary to prevent a criminal act that the attorney reasonably believes is likely to result in death of, or substantial bodily harm to, an individual.

A.B. 1101, 2003-04, Reg. Sess. (Cal. 2003).

This change resulted in the pre-existing text being numbered as clause (1) and adding the exception as a new clause (2). *Id.* AB 1101 also amended Evidence Code Section 956.5, which provides for a similar exception to the attorney-client privilege, to conform its language to the new Business and Professions Code Section 6068(e)(2). *Id.* The California Supreme Court adopted California Rule of Professional Conduct, Rule 3-100, to specify the conditions under which a California lawyer may, but is not required to, reveal confidential information pursuant to Section 6068(e)(2). Rule 3-100 took effect on July 1, 2004. See Cal. Sup. Ct. Order No. 125414 (June 24, 2004).

99. See, e.g., *Mitchell v. Super. Court*, 691 P.2d 642, 646 (Cal. 1984) (explaining that the "fundamental purpose" furthered by the privilege is "the right of every person to freely and fully confer and confide in one having knowledge of the law, and skilled in its practice, in order that the former may have adequate advice and a proper defense") (citation omitted).

100. See, e.g., *Upjohn Co. v. United States*, 449 U.S. 383, 392-93 (1981) (describing how the certainty of the privilege enables clients to seek advice on how to obey the law).

101. For example, Harvard Law School Professor Alan Dershowitz recently criticized the attorneys who defended the well-known businesswoman Martha Stewart. Alan M. Dershowitz, *Was Stewart's Dream Team a Nightmare?*, L.A. TIMES, July 14, 2004, at B13. He alleges that client confidences apparently were leaked in an effort to preserve the attorneys' reputation after Ms. Stewart's conviction. *Id.*

102. The law recognizes the independent, economic value of secrets. For example, California has

only a secret until it is disclosed. In this sense, any law or rule that permits revelation of a client's secret also authorizes the taking of the client's property.

Counterpoised against these justifications for preserving secrets is a societal interest in full disclosure. In the courtroom, society has an interest in ensuring that judges and juries have access to all relevant facts.¹⁰³ Law enforcement will arguably be more effective in detecting and preventing crimes when secrecy is not protected and there are no sanctions for revealing secrets.¹⁰⁴ In the commercial sphere, disclosure of secrets helps buyers and sellers decide whether they want to do business and whether the price is appropriate.¹⁰⁵ It has also been argued that public companies have less of a "moral claim" to protection.¹⁰⁶

adopted the Uniform Trade Secrets Act, CAL. CIV. CODE § 3426.1—11 (West 1997 & Supp. 2004). Non-commercial secrets also have value to clients and this value is recognized in the tort law of privacy and criminal sanctions for blackmail. It seems the use of the term "secrets" in Section 6068(e) should be understood to embrace all of these different types of secrets. *See generally* CAL. BUS. & PROF. CODE § 6068(e) (West 2003).

103. *See In re Grand Jury Impaneled January 21, 1975*, 541 F.2d 373, 382 (3d Cir. 1976) (recognizing that the goals of the criminal justice system require "that every relevant fact be developed and presented to the fact-finder").

104. This interest is advanced by statutes that protect so-called "whistleblowers" who "blow the whistle" by revealing the secrets of others. *See, e.g.*, 18 U.S.C.A. § 1514A (West Supp. 2004) (prohibiting publicly traded companies from "discharg[ing], demot[ing], suspend[ing], threaten[ing], harass[ing], or in any other manner discriminat[ing] against an employee in the terms and conditions of employment" because the employee has engaged in specified whistle blowing activities); CAL. LAB. CODE § 1102.5 (West Supp. 2004) (prohibiting employers from, among other things, retaliating against an employee "for disclosing information to a government or law enforcement agency, where the employee has reasonable cause to believe that the information discloses a violation of state or federal statute, or a violation or noncompliance with a state or federal rule or regulation"). In some cases, disclosure is even mandated. For example, the recently enacted California Disclosure Act imposes million-dollar fines on issuers organized in California that fail to report specified misdeeds to the Attorney General or the appropriate regulator. CAL. CORP. CODE §§ 2207, 17655 (West Supp. 2004). *See Keith Paul Bishop, California Legislature Tells Sarbanes-Oxley Issuers to Confess or Else*, 18 INSIGHTS 30 (2004). However, fear of exposure may cause clients to forego legal advice that, if obtained, would promote compliance. California Governor Schwarzenegger recently voiced this concern in vetoing AB 2713, a bill that would have provided an exception to Section 6068(e) for government lawyers: "This bill will ensure that advice is not conveyed in every situation and therefore it is too broad to affect [sic] the intended purposes." Press Release, Governor Arnold Schwarzenegger, AB 2713 Veto Message (Sept. 28, 2004), available at http://www.governor.ca.gov/govsite/pdf/vetoes/AB_2713_veto.pdf.

105. Pro-disclosure policies are most obviously reflected in laws and rules requiring full disclosure in the context of securities transactions. *E.g.*, CAL. CORP. CODE § 25401 (West 1977).

It is unlawful for any person to offer or sell a security in this state or buy or offer to buy a security in this state by means of any written or oral communication which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

Id.

106. Cramton et al., *supra* note 27, at 815.

B. California's Historic Emphasis on Confidentiality

The California courts have been unambiguous in their support of an attorney's duty to maintain client confidences. For example, the California Supreme Court has said, "While it is perhaps somewhat of a hyperbole to refer to the attorney-client privilege as 'sacred,' it is clearly one which our judicial system has carefully safeguarded with only a few specific exceptions."¹⁰⁷ In a later decision, the Supreme Court declared, "Protecting the confidentiality of communications between attorney and client is fundamental to our legal system."¹⁰⁸ The comments of Presiding Court of Appeal Justice Shinn in a much earlier opinion also underscore the heavy burden of the attorney's obligation to maintain his or her client's confidences:

The privilege of confidential communication between client and attorney should be regarded as sacred. It is not to be whittled away by means of specious argument that it has been waived. Least of all should the courts seize upon slight and equivocal circumstances as a technical reason for destroying the privilege. Here the attorney was compelled to testify against his client under threat of punishment for contempt. Such procedure would have been justified only in case the defendant with knowledge of his rights had waived the privilege in open court or by his statements and conduct had furnished explicit and convincing evidence that he did not understand, desire or expect that his statements to his attorney would be kept in confidence. *Defendant's attorney should have chosen to go to jail and take his chances of release by a higher court.*¹⁰⁹

California attorneys have also historically supported California's insistence on maintaining client confidences. In 1983, during debates at the American Bar Association House of Delegates concerning adoption of the ABA Model Rules, representatives of California bar organizations opposed a proposal to permit attorneys to voluntarily reveal confidential information to prevent a client from committing fraud.¹¹⁰ As a compromise, the ABA included in the comments to Model Rule 1.6 permission for a lawyer who believes his or her services have been used in furtherance of fraud to stage a so-called "noisy withdrawal" by publicly disavowing documents the lawyer prepared.¹¹¹ In the late 1990's, when the ABA's Ethics 2000 Commission

107. *Mitchell v. Super. Ct.*, 691 P.2d 642, 646 (Cal. 1984).

108. *People ex rel. Dep't of Corps. v. Speedee Oil Change Sys., Inc.*, 980 P.2d 371, 378 (Cal. 1999) (quoted with approval in *People v. Super. Ct.*, 23 P.3d 563, 571 (Cal. 2001)).

109. *People v. Kor*, 277 P.2d 94, 100-01 (Cal. Ct. App. 1954) (concurring opinion) (emphasis added). It is worth noting that the third Justice on the panel concurred in the opinion of the court and in the judgment (as did Justice Shinn) but also specifically concurred in the comments of Justice Shinn. *Id.* (Valée, J., concurring). The final observation of Justice Shinn reverberates today: "This is not intended as a criticism of the action of the attorney. It is, however, a suggestion to any and all attorneys who may have the misfortune to be confronted by the same or a similar problem." *Id.*

110. *The State Bar of California Annual Report*, CALIFORNIA LAWYER, Dec. 1983, at 59, 60-61.

111. *See* MODEL RULES OF PROF'L CONDUCT R 1.6, cmt. (1983) ("Neither this Rule nor Rule

studied the Model Rules to make recommendations for updating and revising them, Californians again stood front and center in opposing exceptions to attorney-client confidentiality.¹¹²

That opposition also prevailed in 2001, when the ABA House of Delegates voted to reject additional exceptions to confidentiality that would permit a lawyer to make disclosures to prevent or rectify fraud.¹¹³ In the face of subsequent, high-profile corporate scandals, ABA President Robert Hirshon appointed a task force to examine, among other things, the ethical responsibilities of lawyers.¹¹⁴ The task force proposed rule amendments permitting a lawyer to reveal information relating to the representation of a client to the extent the lawyer believes necessary to prevent the client from committing a crime or fraud that would lead to “substantial injury to the

1.8(b) [regarding use of confidential information to the client’s disadvantage] nor Rule 1.16(d) [regarding withdrawal from the representation] prevents the lawyer from giving notice of the fact of withdrawal, and the lawyer may also withdraw or disaffirm any opinion, document, affirmation, or the like.”). See also MODEL RULES OF PROF’L CONDUCT R. 1.6, cmt. 14 (2003).

112. See, e.g., Letter from Demitrius Dimitriou, Richard Flamm, and Mark L. Tuft, Bar Ass’n of San Francisco, to Nancy J. Moore, Am. Bar Ass’n Comm’n on Evaluation of Rules of Prof’l Conduct (January 26, 1999) (“It is difficult for this Association to conceive how a lawyer could properly present [sic] a client and at the same time act as provided in proposed Rule 1.6(b)(2) or (3) consistent with the lawyer’s duties of loyalty and competence.”), available at <http://www.abanet.org/cpr/e2k/tuft.html>; Letter from Harry B. Sondheim, Chair, State Bar of California’s Standing Comm. on Prof’l Responsibility and Conduct, to Susan Campbell, Comm’n on the Evaluation of the Rules of Prof’l Conduct (Jan. 13, 1999) (“We urge the Commission not to focus undue attention on the relatively few instances where clients misuse confidentiality.”), available at <http://www.abanet.org/cpr/e2k/selegue.html>.

113. Although the Delegates approved a modification to the Model Rules, which would permit disclosure to prevent “reasonably certain death or substantial bodily harm,” they defeated a modification which also would have permitted disclosure to prevent a client from using the lawyer’s services to commit a fraud. A similar proposal which would have permitted disclosure to mitigate financial losses was withdrawn. See Jonathan D. Glater, *Lawyers May Reveal Secrets Of Clients, Bar Group Rules*, N.Y. TIMES, Aug. 8, 2001, at A12; see also Sarah Boxer, *Lawyers Are Asking, How Secret is a Secret?*, N.Y. TIMES, Aug. 11, 2001, at B7. One California newspaper quoted an opponent of the proposals as stating they would “turn the lawyer into a stealth informant against the client.” See Henry Weinstein, *The Nation: ABA Votes to Ease Client Secrets Rule*, L.A. TIMES, Aug. 7, 2001, at A8.

114. ABA President Robert Hirshon gave the task force the following charge:

[T]he Task Force on Corporate Responsibility, shall examine systemic issues relating to corporate responsibility arising out of the unexpected and traumatic bankruptcy of Enron and other Enron-like situations which have shaken confidence in the effectiveness of the governance and disclosure systems applicable to public companies in the United States. The Task Force will examine the framework of laws and regulations and ethical principles governing the roles of lawyers, executive officers, directors, and other key participants. The issues will be studied in the context of the system of checks and balances designed to enhance the public trust in corporate integrity and responsibility. The Task Force will allow the ABA to contribute its perspectives to the dialogue now occurring among regulators, legislators, major financial markets and other organizations focusing on legislative and regulatory reform to improve corporate responsibility.

Robert Hirshon, *Mission Statement, ABA Presidential Task Force on Corporate Responsibility* (2002) at http://www.abanet.org/buslaw/corporateresponsibility/mission_statement.html.

financial interests or property of another.”¹¹⁵ In August 2003, the ABA’s House of Delegates narrowly approved the task force’s recommendations.¹¹⁶

California’s amendment of Section 6068(e) in August 2003 through enactment of AB 1101, which created a narrow exception to the obligation to maintain client confidences, is noteworthy when considered in light of the SEC’s adoption of the Part 205 Rules in November 2002 and the ABA’s amendment of its rules in August 2003.¹¹⁷ Even more recently, the California Supreme Court adopted Rule 3-100 which expressly prohibits the disclosure of information protected by Section 6068(e)(1) except in the narrow circumstance permitted by Section 6068(e)(2) and then only if specified conditions are satisfied.¹¹⁸

California’s strong adherence to the principles of confidentiality in the attorney-client relationship is illustrated by the case of Cindy Ossias, a government attorney who revealed wrongdoing by an elected official.¹¹⁹ Ms. Ossias was the attorney in the California Department of Insurance who testified before the Assembly Insurance Committee that then Insurance Commissioner Charles Quackenbush allegedly had disregarded recommendations from a team of lawyers within the department that he levy substantial fines against insurance companies whose claims-handling activities following the Northridge earthquake had violated the law.¹²⁰ Instead, Commissioner Quackenbush had directed the insurance companies to contribute millions of dollars to foundations he had created, with foundation funds then being used to finance television commercials in which the Commissioner appeared and to “provide contracts for his political

115. MODEL CODE OF PROF’L CONDUCT R. 1.6 (2004). COPRAC again opposed the task force’s recommendations and testified that

[w]hile the proposed changes to Rule 1.6 would do nothing to solve the problems the Task Force is studying, those changes would have the seriously adverse effect of undermining the core function of a lawyer to counsel and advise his or her client – whether that client be a private or governmental entity, or an individual.

Committee on Professional Responsibility and Conduct, Testimony to the American Bar Association Corporate Responsibility Task Force 2 (November 11, 2002) (on file with author).

116. The House of Delegates passed the amendment by a vote of 218 to 201. ABA House of Delegates Reports, Annual Meeting (August 2003), available at <http://www.abanet.org/nabel/deleg11.html>. At the same time, the House of Delegates also approved by a vote of 239 to 147 a change to Model Rule 1.13 to permit a lawyer representing an organization to reveal a client’s confidences after reporting up if the lawyer reasonably believes that a violation is “reasonably certain to result in substantial injury to the organization.” *Id.*; MODEL RULES OF PROF’L CONDUCT R. 1.13 (2004).

117. Compare CAL. BUS. & PROF. CODE § 6068(e) (West 2003), with MODEL CODE OF PROF’L CONDUCT R. 1.6 (2003), and 17 C.F.R. § 205 (2002). AB 1101 was also enacted after the California Attorney General issued an opinion stating that California’s whistleblower protection statutes do not supersede the attorney-client privilege. See *infra* notes 125-32 and accompanying text.

118. Cal. Sup. Ct. Order No. 125414 (June 24, 2004).

119. See Virginia Ellis & Carl Ingram, *Whistle-Blower Emerges in Quackenbush Probe*, L.A. TIMES, June 23, 2000, at A1.

120. *Id.*

advisors.”¹²¹ Ms. Ossias also testified that she and other attorneys in the office had been instructed to shred documents.¹²²

In response to Ms. Ossias’s revelations, the State Bar opened an investigation into whether Ms. Ossias violated her duty of confidentiality.¹²³ The State Bar closed the investigation without bringing charges, noting that Commissioner Quackenbush’s successor had ratified Ms. Ossias’s conduct and had reinstated her employment, and that Ms. Ossias’s conduct was consistent with the spirit of the Whistleblower Protection Act and advanced important public policy considerations.¹²⁴ The State Bar’s decision was consistent with its tradition of exercising discretion over whether to press charges in light of the particular nature of a case. In other matters involving disclosure of client information, however, the State Bar has sought to impose discipline.¹²⁵

Closure of the State Bar investigation did not answer the question, however, of whether there is a whistleblower exception to Section 6068(e). In a subsequent legal opinion requested by Assemblymember Darrell Steinberg, the author of the 2003 amendment to Section 6068(e), the California Attorney General concluded:

1. The whistle-blower statutory protections applicable to employees of state and local public entities do not supersede the statutes and rules governing the attorney-client privilege.

2. The statutory provisions relating to the disclosure of false claims actions, communications with the Legislature, and the filing of complaints or claims or the institution of proceedings pertaining to the rights of employment by employees of state and local public entities do not supersede the statutes and rules governing the attorney-client privilege.¹²⁶

Although the Attorney General’s conclusion referred to the attorney-client privilege, the opinion discussed Business and Professions Code Section 6068(e).¹²⁷

121. *Id.*; Mike McKee, *A Secret From Client is Inviolable*, THE RECORDER, June 7, 2001, at 1.

122. Virginia Ellis & Miguel Bustillo, *Quackenbush Hearings Take Dramatic Turn*, L.A. TIMES, June 27, 2000, at A1.

123. *Id.*

124. Letter from Donald Steedman, Deputy Trial Counsel, State Bar of California, to Richard A. Zitrin, Attorney for Cindy Ossias (Oct. 11, 2000). See *State Bar Exonerates Quackenbush Whistleblower*, CAL. B.J., Jan. 2001, at 24, 30.

125. See, e.g., *Dixon v. State Bar*, 653 P.2d 321, 325 (Cal. 1982) and *In re Matter of Johnson*, 4 Cal. State Bar Ct. Rptr. 179, 190 (Rev. Dep’t 2000).

126. 84 Op. Att’y Gen. 71, 71 (2001).

127. See *id.* at 72-74. The attorney-client privilege is a privilege established by the Evidence Code. See Cal Evid. Code § 954 (West 1995); see also *infra* note 134 and accompanying text.

After the Attorney General's opinion was issued, Assemblymember Steinberg introduced a bill, AB 363, which as enrolled would have authorized attorneys representing governmental organizations to report up and out.¹²⁸ In response to the introduction of AB 363, COPRAC prepared proposed amendments to Rule 3-600.¹²⁹ After the Supreme Court declined to adopt the rule changes, the Legislature passed AB 363.¹³⁰

Nonetheless, Governor Gray Davis vetoed the bill on October 1, 2002.¹³¹ In his veto message, the Governor cited concern for the weakening of the attorney-client privilege: "While this bill is well intended, it chips away at the attorney-client relationship which is intended to foster candor between an attorney and client. It is critical that clients know they can disclose in confidence so they can receive appropriate advice from counsel."¹³²

The net result of these legislative and rulemaking efforts is that there has been no statutory or rule change that allows California attorneys to "blow the whistle" outside the narrow exception created by Section 6068(e)(2) and Rule 3-100 for disclosure of client secrets to prevent bodily injury or death.¹³³

C. The Crime-Fraud Exception to the Attorney-Client Privilege: Does It Authorize Unilateral Breach by an Attorney of the Duty of Confidentiality?

The Evidence Code imposes an independent statutory requirement on attorneys to claim the attorney-client privilege whenever disclosure of an attorney-client communication is sought to be disclosed.¹³⁴ This obligation, known as the attorney-client privilege, is susceptible to being conflated with an attorney's obligations under Section 6068(e).¹³⁵ The apparent similarity of these statutory obligations raises the question of whether the statutory exceptions to the attorney-client privilege should be applied to Section

128. Charles S. Duskow, *The Government Attorney and the Right to Blow the Whistle: The Cindy Ossiass Case and Its Aftermath (A Two Year Journey to Nowhere)*, 25 WHITTIER L. REV. 21, 37-38 (Fall 2003).

129. See Nancy McCarthy, *Rule Change Proposed to Protect Government Whistleblowers*, CAL. ST. B.J., March 2002, at 14.

130. See Assembly Floor Analysis (August 28, 2002), available at http://www.leginfo.ca.gov/pub/01-02/bill/asm/ab_0351-0400/ab_363_cfa_20021008_170624_asm_floor.html.

131. Press Release, Governor Gray Davis, AB 363 Veto Message (Oct. 1, 2002), available at http://www.governor.ca.gov/govsite/msdocs/press_release/L02_250_AB_363_veto_message.doc.

132. *Id.* A similar bill, AB 2713, was passed by the California legislature in 2004 and was also vetoed by Governor Arnold Schwarzenegger with a message that it "would condone violations of the attorney-client privilege, which is the cornerstone of our legal system." Press Release, *supra* note 104. It also raised concerns that the bill would dissuade government officials from obtaining legal advice. *Id.*

133. See generally Duskow, *supra* note 128, at 21.

134. CAL. EVID. CODE § 955 (West 2004).

135. Compare CAL. EVID. CODE §§ 955-62 (West 2004), with CAL. BUS. & PROF. CODE § 6068(e) (West 2003). See also *supra* note 127 and accompanying text.

6068(e) even though those exceptions are not mirrored in the Business and Professions Code.

The position that the statutory exceptions to the attorney-client privilege, including the so-called crime-fraud exception, apply to Section 6068(e) is supported by the obvious similarities between the attorney's obligation to assert the privilege and his or her duty to keep secret a client's secret. Case law also exists that can be interpreted to support that position.¹³⁶ However, that same case law may also be read in tandem with other developments in the law of California confidentiality to reject such an expansive view.¹³⁷

There is no question that the attorney-client privilege has much in common with the duties established by Section 6068(e). They share the same basic policy rationale: to ensure that every person is free to trust, confide in, and disclose all pertinent information to, an attorney and thereby obtain effective legal advice and representation.¹³⁸ By promoting the open and candid exchange of information, the attorney's duty under Section 6068(e) and the evidentiary privilege foster not only the proffering of sound legal advice and representation, but also compliance with the law as well. As the United States Supreme Court stated in *Upjohn Co. v. United States*, the evidentiary privilege "encourage[s] full and frank communication between attorneys and their clients and thereby promote[s] broader public interests in the observance of law and administration of justice."¹³⁹ For its part, the California Supreme Court has recognized that "the benefits derived [from the privilege] justify the risk that unjust decisions may sometimes result from the suppression of relevant evidence."¹⁴⁰ Thus, while the courts recognize the risks of potential injustice created by the mantle of confidentiality, they have repeatedly emphasized that the benefits derived – creation of an environment in which clients are forthright, the dispensation of useful advice, and increased observance of the law – outweigh those risks.¹⁴¹

Despite the similar policies supported by the duty to maintain client secrets and the evidentiary privilege, they are two distinct rules with important differences. These differences militate against any attempt to graft the statutory exceptions applicable to one onto the other.

First, these obligations are codified in different places. The statutory duty of confidentiality is established by the Business and Professions Code,

136. See *infra* notes 137-39 and accompanying text.

137. See *infra* notes 141-83 and accompanying text.

138. See *People ex rel Dep't of Corps. v. Speedee Oil Change Sys., Inc.*, 980 P.2d 371, 378-79 (Cal. Ct. App. 1999); California State Bar Ethics Opinion 2003-161, available at http://calbar.ca.gov/calbar/pdfs/ethics/OPN_2003_161.pdf.

139. *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981) (emphasis added).

140. *City & County of San Francisco v. Super. Ct.*, 231 P.2d 26, 30 (Cal. Ct. App. 1951).

141. See *supra* notes 99-100 and accompanying text.

while the attorney-client privilege is codified in the Evidence Code.¹⁴² It cannot be assumed that the Legislature intended for exceptions expressed in one statute to apply to entirely different statutes. Indeed, when the Legislature enacted AB 1101 in 2003 it created exceptions in both codes. The clear implication of this absence of parallelism between the two codes is that exceptions should not be carried inevitably from one code to the other.

Second, the attorney-client privilege is an evidentiary privilege that applies when a lawyer is legally compelled to speak, such as through subpoena. In contrast, the duty of confidentiality is a professional obligation that applies to the lawyer at all times, not just when the lawyer is testifying in court or pursuant to a subpoena.¹⁴³

Third, the scope of the attorney-client privilege is narrower than the duty of confidentiality. The attorney-client privilege applies only to “confidential communication[s] between client and lawyer,” which are defined to be:

[I]nformation transmitted between a client and his or her lawyer in the course of that relationship and in confidence by a means which, so far as the client is aware, discloses the information to no third persons other than those who are present to further the interest of the client in the consultation or those to whom disclosure is reasonably necessary for the transmission of the information or the accomplishment of the purpose for which the lawyer is consulted, and includes a legal opinion formed and the advice given by the lawyer in the course of that relationship.¹⁴⁴

The duty of confidentiality, by contrast, is substantially broader in its coverage. It protects from disclosure by the attorney any information gained in the course of the professional relationship, whether or not received from the client, that may be embarrassing or detrimental to the client or which the client has asked remain confidential.¹⁴⁵ For example, the California Supreme Court has disciplined an attorney for violating Section 6068(e) when he disclosed in a declaration his client’s concern that her husband had carried on an affair with her sister.¹⁴⁶

142. See CAL. EVID. CODE §§ 955 (West 2004); CAL. BUS. & PROF. CODE § 6068(e) (West 2003).

143. The discussion accompanying Rule 3-100 makes this distinction:

The attorney-client privilege and work-product doctrine apply in judicial and other proceedings in which a member may be called as a witness or be otherwise compelled to produce evidence concerning a client. A member’s ethical duty of confidentiality is *not so limited in its scope of protection* for the client-lawyer relationship of trust and prevents the member from revealing the client’s confidential information even when not confronted with such compulsion.

Cal. Sup. Ct. Order No. 125414 (June 24, 2004). See Mohr, *supra* note 96, at 319.

144. CAL. EVID. CODE § 952 (West 2003).

145. See, e.g., Cal. State Bar Formal Opinions 1993-133, 1988-96 & 1986-87, available at http://calbar.ca.gov/calbar/html_unclassified/ca93-133.html; http://calbar.ca.gov/calbar/html_unclassified/ca88-96.html; http://calbar.ca.gov/calbar/html_unclassified/ca86-87.html; see also Mohr, *supra* note 96, at 319.

146. Dixon v. State Bar, 653 P.2d 321, 325 (Cal. Ct. App. 1982).

Of course, the application of the privilege reduces the available pool of evidence and, thus, may interfere with the truth-seeking function of trial. Thus, the attorney-client privilege is not only narrowly construed,¹⁴⁷ but also over time it has been subject to numerous statutory exceptions that reflect a balancing between the policies of encouraging client candor and ensuring the integrity of the legal system.¹⁴⁸ For instance, there is no privilege concerning communications that were revealed to third parties or to communications relevant to an issue of breach, by lawyer or client, of a duty arising out of the attorney-client relationship.¹⁴⁹ Significantly, there is no privilege if the services of the lawyer were “sought or obtained to enable or aid anyone to commit or plan to commit a crime or a fraud.”¹⁵⁰ The existence of this exception to the privilege raises the issue that has confronted several courts: does the crime-fraud exception also constitute an exception to the duty of confidentiality, thus permitting attorneys unilaterally to disclose information about a client’s crime or fraud to third parties? The answer is unclear, but what is clear is that an attorney cannot assume that an exception to the attorney-client privilege will necessarily excuse the attorney from his or her obligations to keep his or her client’s secrets.

Evidence Code Section 956.5 had provided an exception to the attorney-client privilege permitting a lawyer to disclose confidential information as necessary to prevent the client from committing a criminal act that the lawyer believed would be likely to result in death or substantial bodily harm.¹⁵¹ This exception made little sense as an exception to the privilege, because rarely would a lawyer, faced with knowledge of a future criminal act by his or her client, happen to be testifying at a time when revelation of the potential future act could prevent injury to third parties. Thus, it might be supposed that the Legislature intended Section 956.5 to be an exception to the duty of confidentiality. The placement of the statutory language in the Evidence Code, however, meant that Section 6068(e) remained by its terms “absolute,” that is, subject to no express exception. That has caused confusion for both courts and commentators alike.¹⁵²

147. Mohr, *supra* note 96, at 341.

148. See CAL. EVID. CODE §§ 956–962 (2004).

149. *Id.* §§ 912(A), 958.

150. *Id.* § 956. This so-called “crime-fraud” exception is quite limited. A client who simply communicates a plan to commit a crime or fraud is still protected. The exception applies only when the client seeks legal assistance to plan or perpetrate a crime or fraud. *People v. Clark*, 789 P.2d 127, 152-54 (Cal. Ct. App. 1990).

151. CAL. EVID. CODE § 956.5 (2004). With the enactment of AB 1101, which permits a lawyer to disclose confidential information to prevent *any* criminal act (not just a client’s criminal act) likely to result in death or substantial bodily harm, § 956.5 has also been amended to apply to any criminal act. *Id.*

152. Commentators were split on the effect of Section 956.5. See Fred C. Zacharias, *Privilege and Confidentiality in California*, 28 U.C. DAVIS L. REV. 367 (1995) (concluding that a lawyer who

Recently, the Legislature resolved this confusion by enacting an express exception to Section 6068(e), similar to the exception in Section 956.5. The legislative history of AB 1101, the bill that accomplished this change, includes the following author's statement: "Evidence Code section 956.5 does not create an exception to an attorney's duty of confidentiality. Thus an attorney is still subject to State Bar discipline for disclosing a client's threats of death or serious bodily injury – even when the attorney believes that those threats will be acted on."¹⁵³ Thus, the bill's author appears to have recognized a need to clarify the law even though case law suggested that the exceptions to the attorney-client privilege could be applied to the duty of confidentiality.¹⁵⁴ The Legislature amended Business and Professions Code Section 6068(e) to provide an express exception to the duty of confidentiality in the face of a pre-existing and similar exception to privilege set forth in the Evidence Code. This action can be interpreted to suggest that exceptions to the privilege, including the "crime-fraud" exception, do *not* automatically apply to the duty of confidentiality.¹⁵⁵

Despite the inferences that can be drawn from the Legislature's enactment of AB 1101, some reported cases can be read to suggest that the courts have expanded exceptions to the attorney-client privilege so that they also constitute exceptions to the attorney's fiduciary duty of confidentiality. For example, in *General Dynamics Corp. v. Superior Court*, a corporation's in-house attorney sued his employer for, among other things, retaliatory discharge.¹⁵⁶ The employer contended that the lawsuit could not proceed due to the client's absolute right to discharge the attorney at any time for any reason and because allowing such suits to proceed would impair client confidentiality.¹⁵⁷ The court disagreed, reconciling the duties in-house attorneys owe to their employer/clients with the right of employees to sue for retaliatory discharge.¹⁵⁸ The court decided that an in-house attorney may sue for retaliatory discharge when (i) the "claims [are] founded on allegations that an in-house attorney was terminated for refusing to violate a *mandatory* ethical duty embodied in the Rules of Professional Conduct"¹⁵⁹ and (ii) "in-house counsel's *nonattorney* colleagues would be permitted to

disclosed confidential information in reliance on Section 956.5 would still be subject to discipline). *But see* Mohr, *supra* note 96, at 350 (concluding that attorneys simply could not be sure and arguing for a definitive statement from the California Supreme Court or the Legislature).

153. Assembly Committee on Judiciary, Committee Analysis re AB 1101 (Cal. July 1, 2003).

154. *Compare id.* (stating that "Evidence Code section 956.5 does not create an exception to an attorney's duty of confidentiality"), with *People v. Clark*, 789 P.2d 127, 153 (Cal. Ct. App. 1990) (holding that the attorney-client privilege does not apply "when a client seeks or obtains legal assistance 'to enable or aid' one to commit a crime or fraud").

155. The discussion to rule 3-100 is non-committal, stating, "Rule 3-100 is not intended to augment, diminish, or preclude reliance upon, any other exceptions to the duty to preserve the confidentiality of client information recognized under California law." CAL. RULES OF PROF'L CONDUCT R. 3-100 (2001).

156. 876 P.2d 487 (Cal. 1994).

157. *See generally id.*

158. *Id.* at 505.

159. *Id.* at 502 (emphasis added).

pursue a retaliatory discharge claim *and* governing professional rules or statutes expressly remove the requirement of attorney confidentiality.”¹⁶⁰

The California Supreme Court found more challenging a situation in which an in-house attorney had been subjected to retaliation based on the attorney’s decision to engage in conduct that was not ethically or legally mandated but was merely permissible.¹⁶¹ Under these circumstances, the Court ruled that:

[A] court must resolve *two* questions: First, whether the employer’s conduct is of the kind that would give rise to a retaliatory discharge action by a *nonattorney* employee under *Gantt v. Sentry Insurance* [citation omitted] and related cases; second, the court must determine whether some statute or ethical rule, such as the statutory exceptions to the attorney-client privilege codified in the Evidence Code [§§ 956–58] specifically permits the attorney to depart from the usual requirement of confidentiality with respect to the client-employer and engage in the “nonfiduciary” conduct for which he was terminated.¹⁶²

The court noted:

Although their revelation [of attorney-client communications] in the course of a retaliatory discharge suit may do lasting damage to the expectations of the corporate client (or, more likely, a corporate executive) that disclosures to counsel would remain inviolate, a concern for *protecting the fiduciary aspects of the relationship* in the case of a client who confides in counsel for the purpose of planning a crime or practicing a fraud is misplaced; *such disclosures do not violate the privilege.*¹⁶³

This broad statement, with its emphasis on the “misplaced” concern for protecting the attorney-client relationship when a client confides in a lawyer to plan a crime or fraud, could reasonably be read to represent a statement by the California Supreme Court that clients should not expect confidentiality when seeking to use their attorneys in their criminal or fraudulent plans.¹⁶⁴ It would follow from the court’s citation to statutory exceptions to the

160. *Id.* (emphasis in original).

161. *Id.* at 503.

162. *Id.* (emphasis in original).

163. *Id.* at 504 (emphasis added).

164. In fact, the California Supreme Court preceded that statement by noting:

Matters involving the commission of a crime or a fraud, or circumstances in which the attorney reasonably believes that disclosure is necessary to prevent the commission of a criminal act likely to result in death or substantial bodily harm, are statutory and well-recognized exceptions to the attorney-client privilege.

Id. (providing further support for such a broad reading).

privilege (Evidence Code Sections 956-58), that the court was signaling to lawyers that they could import the exceptions to the privilege into Business and Professions Code Section 6068(e)'s rule of confidentiality.

General Dynamics is, however, equally susceptible to a narrower reading that is arguably more consistent with the specific facts and circumstances of a retaliatory discharge action. First, the *General Dynamics* court emphasized the responsibility of the trial judge in a retaliatory discharge action to take "an aggressive managerial role" to protect the employer/client's "legitimate privilege interests" by employing sealing and protective orders, and the like.¹⁶⁵ Thus, the California Supreme Court may have envisioned a court's close management of the employee's testimony and evidence as an added layer of protection to legitimate client confidences that would not be present where an employee, believing the privilege's exceptions applied equally to Section 6068(e)'s duty of confidentiality, simply revealed the information to a third party, such as a government agency.

Second, and perhaps most telling, the court pointed out that if an in-house attorney's claim *fails* after he or she has revealed legitimately privileged communications in an attempt to prove a retaliating discharge claim, the attorney could be subject to discipline by the State Bar for violating Business and Professions Code Section 6068(e).¹⁶⁶ The Court's analysis appears to recognize the distinction discussed previously between the *privilege*, which governs an attorney's testimony, and the *duty of confidentiality*, which on its face governs an attorney's conduct in all circumstances. Information may be deemed unprivileged and admissible in court under the narrow attorney-client privilege, but at the same time be protected by the broader duty of confidentiality.¹⁶⁷ On the other hand, the court's statement may simply reflect a practical approach to the delicate balancing necessitated when an in-house attorney seeks to prove a claim against a former employer client. Presumably, if the in-house attorney fails to convince the court that the client employer's conduct fell outside the protection of the privilege, an in-house attorney will be deemed to have disclosed protected client information and be subject to discipline for violating Section 6068(e).¹⁶⁸ Such an outcome-determinative approach to the protection of confidences puts in-house attorneys on notice that they must be very sure of the rectitude of their actions before filing a retaliatory discharge action that would require disclosure of client confidence to be successful.¹⁶⁹ Further support for this interpretation can be found in the court's statement that

165. *Id.*

166. *Id.*

167. See *supra* notes 144-46 and accompanying text.

168. See *supra* note 125.

169. The limited scope of the *General Dynamics* decision arguably is also illustrated by the Court of Appeal's decision a few years later in *Solin v. O'Melveny & Meyers*. 107 Cal. Rptr. 2d 456 (Ct. App. 2001). In that case, the court upheld the dismissal of a malpractice lawsuit by one lawyer against another law firm because the defendant law firm could not defend the lawsuit without

the in-house attorney who publicly exposes the client's secrets will usually find no sanctuary in the courts. Except in those rare instances when disclosure is explicitly permitted or mandated by an ethics code provision or statute, it is never the business of the lawyer to disclose publicly the secrets of the client.¹⁷⁰

Before disclosing confidential information, the attorney contemplating such action must be quite certain of his or her claim.¹⁷¹

In sum, the precise facts and circumstances of *General Dynamics*, in conjunction with the Legislature's recent amendment of Business and Professions Code Section 6068(e) to provide an exception to the duty of confidentiality that had already existed for the privilege, leads to the conclusion that *General Dynamics* does not state a general rule that all exceptions to privilege apply equally to the duty of confidentiality and permit disclosures.

Another example of a case suggesting that exceptions to privilege can be read as exceptions to the duty of confidentiality is the California Court of Appeal's decision in *Fox Searchlight Pictures, Inc. v. Paladino*.¹⁷² In that case, the Court of Appeal addressed an employer's motion to disqualify the attorneys for plaintiff, a former in-house attorney who had sued the employer for sex discrimination.¹⁷³ The employer contended that the plaintiff had revealed the employer's confidential information to her

disclosing the secrets of the clients of the plaintiff-lawyer. See *id.* Still, other courts have expressly stated a belief that the exceptions to the privilege apply equally to Section 6068(e), presenting a confusing landscape to lawyers seeking to navigate attorney confidentiality in California. See, e.g., *People v. Dang*, 113 Cal. Rptr. 2d 763, 767-68 (Ct. App. 2002); *Fox Searchlight Pictures, Inc. v. Paladino*, 106 Cal. Rptr. 2d 906 (Ct. App. 2001). *Fox Searchlight* is discussed *infra* notes 172-83 and accompanying text.

170. *Gen. Dynamics Corp. v. Super. Ct.*, 876 P.2d 487, 503 (Cal. 1994).

171. The California Supreme Court in *General Dynamics* plainly struggled to find the right balance between in-house attorneys' rights as employees with the imperative of attorney-client confidentiality. In an earlier decision issued just months before *General Dynamics*, the court held that county attorneys did not violate their duty of loyalty to their client, the county, by suing their employer under a labor rights statute. See *Santa Clara County Counsel Attorneys Ass'n v. Woodside*, 869 P.2d 1142 (Cal. 1994). In *Woodside*, the court reasoned: "It is one thing to require an attorney, for the sake of client loyalty, to forgo a business opportunity or a potential client. It is another thing to require an attorney, for loyalty's sake, to forgo his or her statutory rights against a client to redress a legal injury." *Id.* at 1154. Applying the duty of loyalty to forbid such a suit would "represent not a compromise between collective bargaining rights and professional obligations, as the County contends, but a de facto judicial nullification of those rights." *Id.* at 1157. In like manner, the Court in *General Dynamics* looked for a compromise between the in-house attorney's right to be protected from retaliatory discharge and the employer's right to expect confidentiality, an essential attribute of the attorney-client relationship. See generally *Gen. Dynamics*, 876 P.2d at 491-505. To do that, the court permitted in-house attorneys to sue, but eschewed voluntary, public disclosures and left open the possibility that an unsuccessful retaliatory discharge case could subject the plaintiff-attorney to professional discipline. *Id.* at 492.

172. 106 Cal. Rptr. 2d 906 (Ct. App. 2001).

173. *Id.*

personal attorneys.¹⁷⁴ The court rejected that argument, and held that the disqualification motion lacked merit, because the end result would be that no attorney - not even the plaintiff herself - could assist plaintiff in vindicating her legal rights against her former employer.¹⁷⁵

The court reasoned that such a *de facto* bar would be inconsistent with the principles *General Dynamics* established.¹⁷⁶ Further, the court noted, Evidence Code Section 958 renders unprivileged information that is relevant to a case involving the alleged breach of duty by lawyer or client.¹⁷⁷ That exception to privilege comes into play most often when an attorney sues a client for unpaid fees and costs or a client sues a lawyer for malpractice.¹⁷⁸ However, the principle behind that exception to privilege applies equally to wrongful termination suits by in-house attorneys suing in their capacity as employees.¹⁷⁹ In the course of applying *General Dynamics* to the facts before it, the Court of Appeal stated, "Although the statute [Business and Professions Code Section 6068(e)] on its face brooks no exceptions, it must be read in conjunction with other statutes and ethical rules which specifically permit the attorney to depart from the usual rules of client confidentiality."¹⁸⁰ As with the language in *General Dynamics*, this broad statement can be taken to mean that *all* exceptions to privilege apply equally to the duty of confidentiality.¹⁸¹ As with the *General Dynamics* opinion, however, the *Fox Searchlight* opinion is susceptible to a different interpretation: the Court of Appeal was simply applying the general principle established by the *General Dynamics* and *Santa Clara County Counsel* cases that attorneys may sue their clients to vindicate rights held by the attorneys.¹⁸² In the course of such suits, it is well settled that attorneys must be able to reveal information necessary to prosecute the suit, but only with careful regard for the client's right to confidentiality.¹⁸³

These cases demonstrate that the issue of whether exceptions to the attorney-client privilege may be applied equally to the duty of confidentiality is a close one. The cases that have been cited to support that proposition are reasonably susceptible to diametrically opposed interpretations. California's history of strongly favoring confidentiality tilts the balance in favor of interpreting the relevant cases as having narrow and limited reach. Indeed, a prominent treatise on California legal ethics concludes that *General Dynamics* and *Fox Searchlight* do not establish any

174. *Id.* at 910.

175. *Id.* at 919-21.

176. *Id.* at 919.

177. *Id.* at 922.

178. *See id.* n.54 (pointing out that Evidence Code Section 958 applies beyond the usual cases of "lawyer's fees or malpractice").

179. *Id.*

180. *Id.*

181. *See supra* note 164 and accompanying text.

182. *See Fox Searchlight Pictures, Inc. v. Paladino*, 106 Cal. Rptr. 2d 906 (Ct. App. 2001).

183. *See id.*

general principle that exceptions to attorney-client privilege necessarily permit attorneys to make unilateral disclosures of client confidences.¹⁸⁴

D. The Attorney's Responsibilities in the Case of Organizational Misconduct

The duty of confidentiality and the attorney-client evidentiary privilege both apply with full force and effect when the client is an organization.¹⁸⁵ With respect to the obligations of lawyers representing corporations, Rule 3-600(A) states: "In representing an organization, a member 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."¹⁸⁶ The lawyer's duty is therefore owed to the organization, and not to its constituents such as directors, officers, employees, members, or shareholders.¹⁸⁷

Under the Evidence Code, the holder of the privilege is generally the client – not the attorney.¹⁸⁸ The "client" is "a person who, directly or

184. PAUL W. VAPNEK ET AL., CALIFORNIA PRACTICE GUIDE: PROF'L RESPONSIBILITY ¶ 7:87-88 (2003).

185. *Goldstein v. Lees*, 120 Cal. Rptr. 253, 257 (Ct. App. 1975). See also *Brooklyn Navy Yard Cogeneration Partners, L.P. v. Super. Ct.*, 70 Cal. Rptr. 2d 419, 422-23 (Ct. App. 1997) (acknowledging that the interest of the corporation, as counsel's client, can be adverse to those of its shareholders); *Nat'l Football League Props., Inc. v. Super. Ct.*, 75 Cal. Rptr. 2d 895, 897 (Ct. App. Dist. 1998) (stating that an attorney representing a corporation does not become the representative of its shareholders); and *Skarbrevik v. Cohen, England & Whitfield*, 282 Cal. Rptr. 627, 634 (Ct. App. 1991).

186. CAL. RULES OF PROF'L CONDUCT R. 3-600(A) (2001).

187. The Proposing Release provided that an attorney shall act in the best interest of the corporation and its shareholders. See *Implementation of Standards of Prof'l Conduct for Attorneys, Securities Act Release No. 33-8150*, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,802 (86,513 *et. seq.*) (Nov. 21, 2002). The Corporations Committee and others commented that this formulation was inconsistent with state law. In adopting the final Part 205 Rules, the SEC acknowledged this concern:

[T]he courts have recognized that counsel to an issuer does not generally owe a legal obligation to the constituents of an issuer—including shareholders. The Commission does not want the final rule to suggest it is creating a fiduciary duty to shareholders that does not currently exist. Accordingly, we have deleted from the final rule the reference to the attorney being obligated to act in the best interest of shareholders.

Implementation of Standards of Prof'l Conduct for Attorneys, Securities Act Release No. 33-8185, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 87,069, at 87084 (Jan. 29, 2003).

However, attorneys should recognize that a move away from the traditional "corporation as client" model is implicit in the SEC's proposals with respect to "noisy withdrawal." See *PLI Speech*, *supra* note 59 (stating that "[t]hese proposals go beyond the 'corporation as client' principle and stand for the important idea that some violations of law provide such risk of financial injury that the public interest requires attorneys or their clients to make the Commission aware of the attorney's resignation for professional reasons"). Moreover, it is unclear under the Rules which issuer is referred to in Section 205.3(a) when an attorney represents a subsidiary, but not the parent corporation. An interpretation that makes the attorney's obligations run to the non-client parent would be at odds with California law.

188. CAL. EVID. CODE § 953 (West 2004).

through an authorized representative, consults a lawyer for the purpose of retaining the lawyer or securing legal service or advice from him in his professional capacity.”¹⁸⁹ Because the term “person” includes corporations, the attorney-client privilege is held by corporations.¹⁹⁰ Indeed, the shareholders of a corporation cannot force a waiver of the attorney-client privilege by bringing a derivative lawsuit for malpractice against the corporation’s counsel.¹⁹¹

The California Rules of Conduct spell out the attorney’s duties in the event of wrongdoing by an agent of the corporation. The attorney cannot recommend a violation of the law or otherwise assist in it unless he or she believes in good faith that the law is invalid.¹⁹² Further, an attorney “shall not knowingly assist in, solicit, or induce any violation of these rules or the State Bar Act.”¹⁹³

However, the attorney’s recourse under the California Rules of Conduct is limited. When he or she knows that an agent of the organization is acting or refusing to act in a manner that may be a violation of the law (such as a material violation of the securities laws) or in a manner likely to result in substantial injury to the organization, Rule 3-600(B) states that the attorney *may* take such actions as appear to the lawyer to be “in the best lawful interest of the organization.”¹⁹⁴ Among the available options are: “(1) Urging reconsideration of the matter while explaining its likely consequences to the organization; or (2) Referring the matter to the next higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest internal authority that can act on behalf of the organization.”¹⁹⁵

Typically this “highest internal authority” will be the corporation’s board of directors.¹⁹⁶ Whichever option is chosen, however, Rule 3-600

189. *Id.* § 951.

190. *Id.* § 175. See *State Comp. Ins. Fund v. Super. Ct.*, 111 Cal. Rptr. 2d 288 (Ct. App. 2001).

191. *McDermott, Will & Emery v. Super. Ct.*, 83 Cal. App. 4th 378 (Ct. App. 2000).

192. CAL. RULES OF PROF’L CONDUCT R. 3-210 (2001) (applying also to regulations and rulings). The exception for invalid laws, rules and rulings is essential to our constitutional system in which laws, rules and rulings are often successfully challenged with the assistance of counsel. The Part 205 Rules contain no such exception. See generally 17 C.F.R. § 205 (2004)

193. CAL. RULES OF PROF’L CONDUCT R. 1-120 (2001).

194. CAL. RULES OF PROF’L CONDUCT R. 3-600(B) (2001). Note that the California Rules of Conduct are *permissive* while the Part 205 Rules, discussed above, *require* an attorney to report up the ladder. See *supra* notes 41-53 and accompanying text.

195. CAL. RULES OF PROF’L CONDUCT R. 3-600(B)(1), (2) (2001).

196. Subject to certain limitations, the business and affairs of the corporation shall be managed and all corporate powers exercised by or under the direction of the board of Directors. CAL. CORP. CODE §300(a) (West 2004). See also H. MARSH ET. AL., MARSH’S CALIFORNIA CORPORATIONS LAW §10.01 (“[T]he board of directors is the governing body of the corporation and ultimately responsible for all decisions taken.”). The corresponding provisions of the California Nonprofit Corporation Law essentially mirror those of General Corporation Law. CAL. CORP. CODE §§ 5210, 7210 (West 2004). However, in the case of a religious corporation, the applicable section was modified to permit the corporation to be governed in accordance with the applicable tenets of the religious organization. *Id.* § 9210. Similar provisions exist in the corporate laws of other states. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) (2004) (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.”); NEV.

expressly states that the lawyer “shall not violate his or her duty of protecting all confidential information as provided in Business and Professions Code section 6068, subdivision (e).”¹⁹⁷ While the attorney may discuss the matter with constituents within the corporation, all the way up to the board of directors, the attorney is not permitted to disclose information protected under Section 6068(e) outside the corporation.¹⁹⁸

If the company’s highest authority nevertheless persists in illegal conduct that is likely to result in substantial injury to the entity, Rule 3-600(C) provides that the attorney has the right, and in some cases the duty, to resign.¹⁹⁹ Withdrawal from employment is *permissive* if the client:

[S]eeks to pursue an illegal course of conduct, or . . . insists that the member pursue a course of conduct that is illegal or that is prohibited under these rules or the State Bar Act, or . . . [t]he continued employment is *likely* to result in a violation of these rules or of the State Bar Act.²⁰⁰

Withdrawal is *mandatory* if “[t]he member knows or should know that continued employment *will* result in violation of these rules or of the State Bar Act.”²⁰¹ Withdrawal is, however, still subject to Section 6068(e)(1) and the lawyer is prohibited from disclosing client confidential information upon or after withdrawal.

REV. STAT. 78.120(1) (2004) (“Subject only to such limitations as may be provided by this chapter, or the articles of incorporation of the corporation, the board of directors has full control over the affairs of the corporation.”).

197. CAL. RULES OF PROF’L CONDUCT R. 3-600(B) (2001).

198. The “legislative history” of rule 3-600 expressly states that “[t]he proposed rule would make clear that an attorney should not play the role of whistle blower: he or she may not go outside the organization in order to rectify a perceived or prospective wrong.” Office of Professional Standards, State Bar of California, *Request that the Supreme Court of California Approve Amendments to the Rules of Professional Conduct of the State Bar of California, and Memorandum and Supporting Documents in Explanation* 39 (December 1987). In explaining the purpose of the proposed rule, the request noted: “An attorney who represents an organization must maintain a confidential relationship with it. This confidential relationship includes *only* the organization, not other parties who have some kind of stake in the organization’s activities.” *Id.* at 38 (emphasis added). In addition, when the State Bar sought to amend rule 3-600 in 2002 to permit an attorney representing a governmental agency to report governmental misconduct to an oversight or law enforcement agency, the California Supreme Court stated, in its order declining to approve the rule amendment, that “[t]he State Bar Board of Governors’ request to adopt amendments to the Rules of Professional Conduct, rule 3-600, is denied because the proposed modifications conflict with [B]usiness and Professions Code Section 6068, subdivision (e).” Cal. S. Ct. Order No. 46 (2004). (Supreme Court Order, En Banc, filed May 10, 2002, *In the Matter of the Adoption of Amendments to Rule 3-600 of the Rules of Professional Conduct*, Bar Misc. S104682.).

199. CAL. RULES OF PROF’L CONDUCT R. 3-600(c) (2001).

200. CAL. RULES OF PROF’L CONDUCT R. 3-700(C)(1),(2) (2001) (emphasis added).

201. CAL. RULES OF PROF’L CONDUCT R. 3-700(B)(2) (2001) (emphasis added).

E. Perspectives on California's Requirements

It is apparent that the State Bar Act, the California Rules of Professional Conduct, and the decisions of California courts consistently confirm the societal importance of fostering and maintaining the confidential nature of the attorney-client relationship. However, as in other areas of the law, the issues are more gray than black and white. Other public policy considerations can take precedence over the evidentiary privilege or the duty of confidentiality. In that regard, the courts and the State Bar appear to be willing, in very fact-specific circumstances, to exercise discretion not to discipline attorneys who have made limited disclosures of client confidences and secrets where (a) the legislature has declared the importance of countervailing policy considerations, as in exceptions to the attorney-client privilege or under the Whistle-Blower Protection Act,²⁰² (b) the attorney making the disclosure has used discretion (or court direction in the event of the evidentiary privilege) to limit the disclosure as much as possible,²⁰³ and (c) the attorney has correctly determined that the countervailing policy justified the limited disclosure in the context in which the disclosure was made and in light of the actual result obtained.²⁰⁴

Nevertheless, California attorneys must be mindful that state law does not include an exception to the statutory duty to maintain client secrets that would allow the lawyer to blow the whistle on a client who is violating federal or state securities laws.²⁰⁵ In the absence of any such exception, a California attorney disclosing client confidences outside of the corporate hierarchy in an attempt to rectify or mitigate the effects of the client's potentially criminal or fraudulent conduct would be acting at his or her peril, facing the risk of both malpractice exposure and discipline for violating Business and Professions Code Section 6068(e).

III. ANALYSIS OF THE SEC'S AUTHORITY

As discussed above, the Part 205 Rules permit, and the SEC has actively encouraged, attorney conduct that is inconsistent with the obligations of California lawyers and potentially of lawyers in other states.²⁰⁶ As also noted above, the SEC takes the position that its Rules preempt conflicting state laws and rules mandating attorney-client confidentiality.²⁰⁷ However,

202. See *supra* notes 104, 119-25 and accompanying text.

203. See *supra* note 165 and accompanying text.

204. See *supra* notes 169-71 and accompanying text.

205. See *supra* note 133 and accompanying text.

206. This article does not address whether the Part 205 Rules may also be inconsistent with the provisions of the ABA Model Rules, which California does not follow. The Committee notes, however, that one state bar association which does follow the ABA Model Rules (the Washington State Bar Association) has concluded that there is sufficient uncertainty on that point as to prevent any member of it from acting "in good faith" in relying on the permissive disclosure provisions of the Part 205 Rules. See *supra* notes 76-78 and accompanying text. See also *supra* note 15 regarding conflict between the ABA Model Rules (and the rules of Oklahoma which follow it) and the Part 205 Rules.

207. See *supra* notes 70-82 and accompanying text.

the mere assertion of preemption does not make it so. Further, the SEC's position has yet to be tested in court. To sustain its claim, the SEC must first show that its Rules were adopted within the scope of its authority and, if so, then demonstrate that well-established standards for federal preemption of state law have been met.²⁰⁸

The question of authority is variously addressed in the context of constitutional law principles regarding delegation of legislative authority²⁰⁹ or with reference to corresponding provisions of the Administrative Procedure Act.²¹⁰ In the case of preemption, regulations adopted by federal agencies may only preempt state law if (i) there is a constitutional basis for Congress to authorize the agency to preempt state law, (ii) Congress authorized the agency to preempt state law, and (iii) the Congressional authority grants the agency the power to adopt preemptive rules in the area covered by the regulation.²¹¹ This Part examines each of these requirements and concludes that the SEC does not have the authority to preempt state confidentiality requirements.²¹² Courts may elect to stop short of addressing preemption issues if they can find absence of authority. For that reason, the latter topic is an inherent part of any examination of the preemption asserted by the SEC.

A. *The Debate Leading to Adoption of the Rules*

Several bar associations questioned the SEC's authority to preempt state laws or rules governing attorney-client confidentiality.²¹³ In adopting the

208. See *infra* notes 232-246 and 249-265 and accompanying text.

209. See, e.g., *Whitman v. Am. Trucking Ass'ns.*, 531 U.S. 457 (2001); *Panama Ref. Co. v. Ryan*, 293 U.S. 388 (1935).

210. 5 U.S.C.A. §§ 701-06 (West 2004). The "Administrative Procedure Act" as originally enacted was repealed by Pub. L. No. 89-554 and incorporated into those provisions of 5 U.S.C., which continue to be known popularly as the "Administrative Procedure Act." The portions of it specifically relevant to the issues presented in this article are found in 5 U.S.C. § 706.

211. BASIL J. MEZINES ET AL., *ADMINISTRATIVE LAW* § 3.03[5] (1995). See also *Whitman v. American Trucking Ass'ns.*, 531 U.S. 457, 572 (2001).

212. This article does not address the situation in which any state law or bar regulations would prevent an attorney from reporting "up the ladder" as is specifically provided in Section 307 of the Sarbanes-Oxley Act. The Committee is unaware of any state where that might be the case and notes that reporting "up the ladder" within the organizational structure of a client has long been permitted under the California Rules of Practice (Rule 3-600(B)) and is consistent with provisions of the California Corporations Code § 300(a) (specifying that the corporation is managed by and under the direction of the board of directors). However, if the Rules are interpreted so as to require an attorney to report "up the ladder" to a parent corporation, that interpretation would clearly conflict with Section 6068(e) and the principle under California law that an attorney does not by virtue of his or her representation of a corporation also represent its shareholders. See *supra* notes 34-40, 63, and 194-96 and accompanying text.

213. See, e.g., Letter from Alfred P. Carlton, Jr., President, Am. Bar Ass'n, to the Sec. & Exch. Comm'n (Dec. 18, 2002), at <http://www.sec.gov/rules/proposed/s74502/apcarlton1.htm> ("The Commission cannot itself establish its authority to preempt state privilege rules."); Letter from Jeff Bleich, President, Bar Ass'n of San Francisco, to Jonathan G. Katz, Secretary, Sec. & Exch.

Part 205 Rules, the SEC cited a plethora of statutory provisions in support of its authority to adopt the attorney conduct rules.²¹⁴ However, none of the statutes cited by the SEC expressly empowers the SEC with specific authority to permit counsel to disclose client secrets or to immunize attorneys from state laws and rules prohibiting such disclosure. The Proposing Release and the Adopting Release both discuss the public policy considerations relevant to the adoption of the Rules, specifically addressing whether they should preempt state law. Both Releases are surprisingly sparse, however, in their discussion of the basic question of whether the SEC actually has authority to adopt preemptive rules in this area.²¹⁵

The Proposing Release itself raised the question of a conflict with state rules forbidding disclosure of client confidences. It did so in the context of observing that the attorney rules for some states require attorney disclosure of client confidences in certain circumstances involving the criminal, illegal or fraudulent acts.²¹⁶ It acknowledges, however, that the rules of other states prohibit the disclosure of client confidences without exception.²¹⁷ In addressing these conflicting state law approaches, the Proposing Release accepts that it is possible for an attorney to comply with both state law and the proposed rules: (i) in states for which disclosure is prohibited, the attorney could be in compliance with the Rules by electing not to do so, and (ii) in states that require disclosure of criminal, illegal or fraudulent acts, the attorney could be in compliance by electing to disclose that information to the SEC.²¹⁸ At the same time, however, the Proposing Release states:

[P]ermitting disclosure would appear to preempt a state's rule forbidding disclosure. Accordingly, an attorney appearing and practicing before the [SEC] who is admitted in a jurisdiction that forbids disclosure of confidential information under circumstances where the proposed rule would permit disclosure, may disclose the information to the [SEC] notwithstanding the contrary state rule.²¹⁹

At a later point in the Proposing Release, the SEC does acknowledge the risk that an attorney might be subject to simultaneous disciplinary

Comm'n (April 3, 2003), at <http://www.sec.gov/rules/proposed/s74502/jbleich1.htm> ("The SEC, with its adoption of 17 CFR Part 205 . . . has met, and in the view of many commentators, has gone beyond Congress' mandate under Section 307 of the Sarbanes-Oxley Act.")

214. The SEC cited, as authority for the adoption of Part 205, "Sections 3, 307 and 404 of the Sarbanes-Oxley Act of 2002, Section 19 of the Securities Act of 1933, Sections 3(b), 4C, 13, and 23 of the Exchange Act, Sections 38 and 39 of the Investment Company Act of 1940, and Section 211 of the Investment Advisers Act of 1940." Implementation of Standards of Prof'l Conduct for Attorneys, Securities Act Release No. 33-8185, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,823 (87,069 *et. seq.*) (Jan. 29, 2003) (citations omitted).

215. See *infra* notes 216-28 and accompanying text.

216. The SEC cited New Jersey, Wisconsin and Florida. Implementation of Standards of Prof'l Conduct for Attorneys, Securities Act Release No. 33-8185, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,802, at 86,547 (Nov. 21, 2002).

217. See *id.*

218. *Id.*

219. *Id.* at 86,548.

proceedings both by the SEC and by state authorities, raising the question, according to the Proposing Release, of the impact of the proposed Part 205 Rules upon state ethical rules and regulations.²²⁰ The Proposing Release goes on to state that “[d]ue to the breadth and specificity of the Congressional mandate to the [SEC] to implement an ‘up the ladder’ reporting system . . . the [SEC] is considering whether Congress intended for the [SEC’s] rule to ‘occupy the field’ on this issue, and whether Part 205 would preempt any [conflicting] state rules.”²²¹ Thus, despite its *post hoc* assertions to the contrary, the SEC has itself acknowledged that its authority to preempt state law was questionable.

The Proposing Release then further discusses the potential benefit of preemption from the standpoint of providing a single, uniform rule of conduct for attorneys, particularly including attorneys who practice in multiple jurisdictions.²²² However, neither the Proposing Release nor the Adopting Release contains any further discussion about whether Congress did in fact intend to “occupy the field” and, if so, whether it was on the limited topic of reporting “up-the-ladder” (which is specifically addressed in Section 307 of the Sarbanes-Oxley Act) or more generally on the topic of client confidentiality (which is not addressed in that Section at all).²²³ In addition, neither of the SEC releases addressed whether Congress intended to confer specific authority on the SEC to adopt rules preempting state law in the area of attorney-client communications or related attorney ethical requirements.²²⁴

The Adopting Release acknowledges that “a number of commenters [had] questioned the [SEC’s] authority to preempt state [attorney] ethics rules, at least without being explicitly authorized and directed to do so by Congress.”²²⁵ The Adopting Release then states that:

220. *Id.*

221. *Id.* at 86,544.

222. *Id.*

223. As noted below, the issue under federal preemption case law is whether Congress intended that the provision contained in Section 307 of the Sarbanes-Oxley Act “occupied the field,” not whether the SEC intended to do so when it adopted the Rules. See *supra* notes 298-313 and accompanying text. As an administrative agency, the SEC does not have the power to preempt by assertion.

224. See Implementation of Standards of Prof’l Conduct for Attorneys, Securities Act Release No. 33-8185, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,823 (87,069 *et. seq.*) (Jan. 29, 2003) (citations omitted); Implementation of Standards of Prof’l Conduct for Attorneys, Securities Act Release No. 33-8185, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,802, at 86,547 (Nov. 21, 2002).

225. Implementation of Standards of Prof’l Conduct for Attorneys, Securities Act Release No. 33-8185, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,823 (87,069 *et. seq.*) (Jan. 29, 2003). See, e.g., Ass’n of the Bar of the City of New York, at 28 (“There is nothing in Section 307 to suggest that Congress authorized the Commission to preempt state law and rules governing attorney conduct.”).

Another comment letter noted that the Constitution's Commerce Clause grants the federal government the power to regulate the securities industry, that the Sarbanes-Oxley Act requires the [SEC] to establish rules setting forth minimum standards of conduct for attorneys appearing and practicing before [the SEC], and that, under the Supremacy Clause, [the adopted Part 205 rules] will preempt conflicting state rules.²²⁶

The Adopting Release also notes that "several commenters questioned why the [SEC] would seek to supplant state ethical rules which impose a higher [disclosure] obligation upon attorneys."²²⁷

The Adopting Release further states that the Part 205 Rules do not "preempt ethical rules in United States jurisdictions that establish more rigorous obligations than those imposed by [the SEC's rules]."²²⁸ It specifically notes in contrast, however, that the SEC "reaffirms that its rules shall prevail over any conflicting or inconsistent laws of a state or other United States jurisdiction in which an attorney is admitted or practices."²²⁹ With specific reference to Rule 205.3(d)(2), the Adopting Release notes that the SEC had received comments "that this provision would preempt state law ethics rules that do not permit disclosure of information concerning such [client] acts," as well as concerns expressed by "commenters at the other end of the spectrum that this [rule] could be misread to supplant state ethics rules that require rather than permit [such] disclosure."²³⁰ The Adopting Release does not directly address those issues. Instead, it simply refers to the text quoted above dealing with the general proposition that the Part 205 Rules supplement more restrictive state rules and supersede those that are less restrictive, without further discussion or explanation of the SEC's basis for its position that it has preemptive authority in this area.²³¹

B. Did the SEC Act in Excess of the Authority Granted by Congress?

Any judicial examination of the extent of the SEC's authority to adopt the Part 205 Rules is likely to begin with Section 706 of the Administrative Procedures Act, which sets forth the scope of review by federal courts of the actions of federal agencies.²³² Under Section 706(2)(C), a reviewing court is required to hold unlawful and to set aside rules or other actions that are found to be "in excess of statutory jurisdiction, authority, or limitations, or

226. Implementation of Standards of Prof'l Conduct for Attorneys, Securities Act Release No. 33-8185, [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,823 (87,069 *et. seq.*) (Jan. 29, 2003). The SEC cited the Comments of Professor Susan P. Koniak, Boston University School of Law. *Id.*

227. *Id.* at 87,071.

228. *Id.*

229. *Id.*

230. *Id.*

231. *Id.*

232. 5 U.S.C. § 706 (2004).

short of statutory right.”²³³ As explained by Justice Powell in *Ernst & Ernst v. Hochfelder*: “The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is ‘the power to adopt regulations to carry into effect the will of Congress as expressed by the statute.’”²³⁴ The question, then, is whether Congress has given the SEC statutory authority, either in the Sarbanes-Oxley Act or in the previously existing provisions of the federal securities laws, to adopt attorney conduct rules of the scope set forth in the Part 205 Rules.

When Congress has “explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation.”²³⁵ The resulting regulations are ordinarily given controlling weight, but this rule does not apply if they are “procedurally defective, arbitrary or capricious in substance, or manifestly contrary to the statute” pursuant to which they have been adopted.²³⁶

In *Business Roundtable v. SEC*,²³⁷ the District of Columbia Circuit Court of Appeals held that the SEC had acted in excess of its authority when it adopted Rule 19c-4 under the Exchange Act.²³⁸ Rule 19c-4 would have barred national securities exchanges from listing stock of a corporation that takes any action to nullify, restrict or disparately reduce the per share voting rights of existing common stockholders.²³⁹ The Court of Appeals carefully examined the authority granted by Congress to the SEC under the Exchange Act.²⁴⁰ The SEC argued that it had broad authority to adopt regulations in furtherance of the purposes of the Exchange Act.²⁴¹ The Court of Appeals, however, concluded that “the Exchange Act cannot be understood to include regulation of an issue that is so far beyond matters of disclosure [which the court treated as a principal purpose of the Exchange Act] . . . and of the management and practices of self-regulatory organizations, and that is concededly a part of corporate governance traditionally left to the states.”²⁴²

The Rules regarding the disclosure of confidential information in a manner that is inconsistent with state law appear to exceed the grant of authority from Congress to the Commission in Section 307. If a court so

233. *Id.* § 706(2)(c).

234. 425 U.S. 185, 213-14 (1976) (quoting *Dixon v. United States*, 381 U.S. 68, 74 (1965)). In *Hochfelder*, the United States Supreme Court held that a private cause of action for damages will not lie under Section 10(b) and Rule 10b-5 in the absence of an allegation of scienter. *Id.* at 193.

235. *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843-44 (1984).

236. *United States v. Mead Corp.*, 533 U.S. 218, 227 (2001).

237. 905 F.2d 406 (D.C. Cir. 1990).

238. *Id.* at 407.

239. *Id.*

240. *See id.* at 408-16.

241. *Id.* at 410-11.

242. *Id.* at 408 (emphasis added).

concluded, the Rules would be set aside.²⁴³ Furthermore, the SEC's interpretation of its expansive authority to promulgate such rules, and to preempt state law, is not entitled to deference.²⁴⁴ The regulation of attorneys has traditionally been the responsibility of the states, not the federal government. As the Supreme Court noted:

Since the founding of the Republic, the licensing and regulation of lawyers has been left exclusively to the States and the District of Columbia within their respective jurisdictions. The States prescribe the qualifications for admission to practice and the standards of professional conduct. They are also responsible for the discipline of lawyers.²⁴⁵

A more difficult and novel issue is raised by the fact that the SEC has in effect preempted the rules of the federal courts. Attorneys appearing in federal district court in California are subject to the California State Bar Act and Rules of Professional Conduct.²⁴⁶ Thus, the SEC's action raises the question of whether an administrative agency may in effect overturn the rules of the federal courts. While an analysis of this issue is beyond the scope of this article, there is no indication in the legislative history that Congress intended to, or could, authorize the SEC to override rules of conduct adopted by the federal district courts.

243. 5 U.S.C. § 706(2)(C) (2004) ("The reviewing court shall . . . hold unlawful and set aside agency action . . . found to be . . . in excess of statutory jurisdiction, authority, or limitations.")

244. See *United States v. Mead Corp.*, 533 U.S. 218, 228 (2001):

The fair measure of deference to an agency administering its own statute has been understood to vary with circumstances, and courts have looked to the degree of the agency's care, its consistency, formality, and relative expertness, and to the persuasiveness of the agency's position The approach has produced a spectrum of judicial responses, from great respect at one end . . . to near indifference at the other. . . .

Id. (footnotes and citations omitted).

245. *Leis v. Flynt*, 439 U.S. 438, 442 (1979).

246. U.S. Dist. Ct. (C.D. Cal.) Local Rule No. 83-3.1.2; U.S. Dist. Ct. (E.D. Cal.) Local Rule No. 83-180(e); U.S. Dist. Ct. (N.D. Cal.) Local Rule No. 11-4(a)(1); U.S. Dist. Ct. (S.D. Cal.) Local Rule No. 83-4(b). See *Image Technical Serv. Inc. v. Eastman Kodak Co.*, 136 F.3d 1354, 1357 (9th Cir. 1998) ("California law controls whether an ethical violation occurred."); *Visa U.S.A., Inc. v. First Data Corp.*, 241 F. Supp. 2d 1100, 1103 (N.D. Cal. 2003) ("The Northern District of California has adopted the California Rules of Professional Conduct at Civ. L.R. 11-4, and attorneys practicing in this court are required to adhere to those standards, as articulated in the rules and any court decisions interpreting them."); *Miller v. Alagna*, 138 F. Supp. 2d 1252, 1255 (C.D. Cal. 2000) ("Pursuant to Local Rule 2.5.1, the United States District Court for the Central District of California . . . adopts the California Rules of Professional Conduct and the decisions of any applicable court."); *Terrebonne, Ltd. of Cal. v. Murray*, 1 F. Supp. 2d 1050, 1054-55 (E.D. Cal. 1998); *In re Grand Jury Investigation of Targets*, 918 F. Supp. 1374, 1377 (S.D. Cal. 1996) ("Attorneys admitted to practice in the Southern District of California must adhere to the California Rules of Professional Conduct as well as the American Bar Association Model Rules of Professional Conduct."). Rule 1-100(d)(2) of the California Rules of Professional Conduct also states, with respect to "lawyers from other jurisdictions who are not members" of the State Bar of California, that "[t]hese rules shall also govern the activities of lawyers while engaged in the performance of lawyer functions in this state; but nothing contained in these rules shall be deemed to authorize the performance of such functions by such persons in this state except as otherwise permitted by law." CAL. RULES OF PROF'L CONDUCT R. 1-100(d)(2) (2004).

C. Section 307 of the Sarbanes-Oxley Act

As cited above, Section 307 addresses the reporting by an attorney of evidence of a material violation first to the issuer's chief legal counsel or chief executive officer, and then, if the officers to whom the report is made do not "appropriately respond," the reporting by the attorney up-the-ladder to the "audit committee" of the board of directors or to the board of directors itself.²⁴⁷ Nothing in this language mandates, or suggests, that an attorney should "report out" evidence of a material violation to the SEC or any other third party.

The source of the SEC's authority to require reporting out, therefore, must come from Congress' grant of authority to the SEC to adopt rules implementing the specific mandates of Section 307. This general mandate directs the SEC, "in the public interest and for the protection of investors," to adopt "minimum standards of professional conduct for attorneys appearing and practicing before the [SEC]," including a rule incorporating the above two specific mandates of Section 307.²⁴⁸

D. Federal Preemption Doctrine

Any judicial proceeding that weighs the Part 205 Rules against conflicting California law must examine the prevailing body of law governing federal preemption. The Supremacy Clause of the U.S. Constitution, Art. VI, cl. 2, provides: "This Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding."²⁴⁹ As noted by Justice Stevens, since *McCulloch v. Maryland* "it has been settled that state law that conflicts with federal law is 'without effect.'"²⁵⁰ "Consideration of issues arising under the Supremacy Clause starts with the assumption that the historic police powers of the states are 'not to be superseded by . . . [f]ederal [a]ct unless that is the clear and manifest purpose of Congress.'"²⁵¹ This presumption against the preemption

247. 15 U.S.C. § 7245 (West Supp. 2004).

248. *Id.*

249. U.S. CONST. art. VI, cl. 2. At least one commentator has observed that "preemption" actually has virtually nothing to do with the Supremacy Clause but instead is a straight-forward examination of what Congress actually did in approving a law being examined for such preemption. See Stephen A. Gardbaum, *The Nature of Preemption*, 79 CORNELL L. REV. 767 (1994). While the analysis presented in that article is thought-provoking, the fact remains that courts continue to "start from the top" with a reference to the Supremacy Clause" when opining on issues of federal preemption of state laws. See *id.* at 769.

250. *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 516 (1992) (quoting *Maryland v. Louisiana*, 451 U.S. 725, 746 (1981)).

251. *Id.* (quoting *Rice v. Sante Fe Flower Corp.*, 331 U.S. 218, 230 (1947)). See also *Cipollone*, 505 U.S. at 505 ("This conclusion is required by . . . the strong presumption against pre-emption of

of state police power regulations requires a narrow reading of the conflicting federal act.²⁵²

“The purpose of Congress is the ultimate touchstone’ of preemption analysis.”²⁵³ Congressional intent may be “explicitly stated in a statute’s language or implicitly contained in its structure and purpose.”²⁵⁴ Federal law can preempt state law through express preemption or implied preemption.²⁵⁵ Express preemption exists where Congress enacts an explicit statutory command that state law be displaced, as in the Employee Retirement Income Security Act of 1974 (“ERISA”),²⁵⁶ which states that it “shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan.”²⁵⁷

In the absence of express statement of preemption in the text of a federal law, preemption can be implied on either of two theories which require a court to examine the intent of Congress from the statute’s structure: field preemption or conflict preemption.²⁵⁸ Field preemption exists when “[t]he scheme of federal regulation may be so pervasive as to make reasonable the inference that Congress left no room for the States to supplant it.”²⁵⁹ Conflict preemption exists when compliance with both federal and state law is impossible,²⁶⁰ or when state law “stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.”²⁶¹

When the federal statute “does not speak directly to [an] issue,” the court looks to the “goals and policies” of the federal law in question “in determining whether it in fact pre-empt[s].”²⁶² “[C]ourts should not lightly infer pre-emption.”²⁶³ The court’s ultimate task is to determine whether state regulation is consistent with the structure and purpose of the statute as a

state police power regulations. . . .”); *California v. ARC America*, 490 U.S. 93, 101 (1989) (“In this case, in addition, appellees must overcome the presumption against finding pre-emption of state law in areas traditionally regulated by the States.”); *Santa Fe Indus. v. Green*, 430 U.S. 462, 479 (1977) (“Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden.”); *Rice*, 331 U.S. at 230 (“So we start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress.”); *accord Dowhal v. SmithKline Beecham Consumer Healthcare*, 88 P.3d 1 (Cal. 2004).

252. *Cipollone*, 505 U.S. at 518; *see also* *Bronco Wine Co. v. Jolly*, 95 P.3d 422 (Cal. 2004).

253. *Cipollone*, 505 U.S. at 516 (quoting *Retail Clerks v. Schermerhorn*, 375 U.S. 96, 103 (1963)).

254. *Jones v. Rath Packing Co.*, 430 U.S. 519, 525 (1977).

255. *Ting v. AT&T*, 319 F.3d 1126, 1135 (9th Cir. 2003).

256. 29 U.S.C. § 1144(a) (2004).

257. *Id.*

258. *Ting*, 319 F.3d at 1135.

259. *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1942) (citing *Cloverleaf Butter Co. v. Patterson*, 315 U.S. 148 (1942)); *Pennsylvania R. Co. v. Pub. Serv. Comm’n*, 250 U.S. 566, 569 (1919)).

260. *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142-43 (1963).

261. *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941).

262. *Int’l Paper Co. v. Ouellette*, 479 U.S. 481, 493 (1987).

263. *Id.* at 491.

whole.²⁶⁴ When a federal agency asserts that regulations adopted by it preempt state laws on an implied basis, it bears the burden of proving that Congress intended that the law passed by it under which the regulation was adopted would, in fact, preempt state law.²⁶⁵

E. Express Preemption

The Sarbanes-Oxley Act does not contain any express provisions governing disclosure by any attorney of client confidences, nor does it expressly preempt inconsistent state law. Instead, Section 307 of the Act²⁶⁶ sets forth a very precise Congressional directive to the SEC to 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 requiring attorneys to report evidence of violations of the securities laws or breach of fiduciary duty up the ladder in the corporation.²⁶⁷

The standard required for a court to find express preemption is quite straight-forward: the text of the statute must indicate that Congress has “unmistakably . . . ordained”²⁶⁸ that “its enactments alone are to regulate”²⁶⁹ the subject matter. That occurs when “Congress’ command [of preemption] is explicitly stated in the statute’s language.”²⁷⁰ Even when it is so stated with respect to one aspect of a federal statute, it will not be extended to another aspect if it is unnecessary to do so.²⁷¹ The Corporations Committee is unaware of any assertion by the SEC that Section 307 of the Sarbanes-Oxley Act expressly preempts state requirements regarding the attorney-client relationship, or expressly authorizes the SEC to adopt regulations which do so.²⁷² Section 307 of the Act is, in fact, completely devoid of text which suggests either.²⁷³

264. *Gade v. Nat’l Solid Wastes Mgmt. Ass’n*, 505 U.S. 88, 98 (1992).

265. See RONALD D. ROTUNDA & JOHN E. NOVAK, *TREATISE ON CONSTITUTIONAL LAW*, § 12.4 (3d ed., 1999) (synthesizing the holdings of and citing *New York State Dep’t of Soc. Servs. v. Dublino*, 413 U.S. 405 (1973); *Exxon Corp. v. Governor of Md.*, 437 U.S. 117 (1978); *Fort Halifax Packing Co., Inc. v. Coyne*, 482 U.S. 1 (1987); and *Silkwood v. Kerr-McGee Corp.*, 464 U.S. 238 (1984)). See also *supra* note 251 and accompanying text.

266. 15 U.S.C. § 7245 (2004).

267. *Id.*

268. *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142 (1963).

269. *Jones v. Rath Packing Co.*, 430 U.S. 519, 525 (1977).

270. *Id.*

271. See generally *Silkwood v. Kerr-McGee Corp.*, 464 U.S. 238 (1984).

272. The Public Statement specifically asserted both categories of implied preemption: field preemption and conflict preemption. See *supra* notes 72, 76-89 and accompanying text.

273. 15 U.S.C. § 7245 (2004). Indeed, proponents of SEC preemption have acknowledged that there is no express preemption. Cramton et al., *supra* note 27, at 792 (conceding that “the statute makes no explicit reference to preemption”).

F. Legislative Intent—Implied Preemption

A court reviewing an administrative regulation must first examine whether Congress has spoken to the precise question at issue, using “traditional tools of statutory interpretation – text, structure, purpose and legislative history.”²⁷⁴ If the statute is ambiguous or silent on the issue, the court must next determine what kind of deference should be accorded to the agency’s interpretation. The deference accorded will depend on the thoroughness evident in the agency’s consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control.²⁷⁵

An agency’s interpretation “is not entitled to deference when it goes beyond the meaning the statute can bear.”²⁷⁶ The implausibility of Congress leaving a highly significant issue unaddressed and thus delegating it to the agency is reason to hesitate before concluding that Congress intended the agency to fill in the statutory gaps.²⁷⁷ As Justice Scalia has noted, “Congress . . . does not . . . hide elephants in mouseholes.”²⁷⁸

As previously noted, the Sarbanes-Oxley Act itself does not contain any provisions authorizing attorney disclosure of client confidences. Instead, Section 307 directs the SEC to issue rules setting forth “minimum standards” for professional conduct for attorneys, “including a rule” that requires attorneys to report evidence of wrongdoing to higher-ups within the corporation.²⁷⁹ Such “reporting up” requirement is consistent with a California attorney’s duties to a corporate client under Rule 3-600 of the Rules of Professional Conduct and Business and Professions Code Section 6068(e).²⁸⁰ None of these provisions entails “reporting out,” or disclosing confidential client information outside the company. The conflict with California’s duty of confidentiality, therefore, is created not by the Sarbanes-Oxley Act, but by the Part 205 Rules that would permit, and possibly even require,²⁸¹ disclosure without the client’s consent.

274. *Citizens Coal Council v. Norton*, 330 F.3d 478, 481 (D.C. Cir. 2003) (citation & quotations omitted).

275. *United States v. Mead Corp.*, 533 U.S. 218, 228 (2001) (citing *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944)).

276. *MCI Telecomms. Corp. v. AT&T Co.*, 512 U.S. 218, 229 (1994); see also *Jones v. Rath Packing Co.*, 430 U.S. 519, 525 (1977).

277. *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 146-47, 159-60 (2000).

278. *Whitman v. Am. Trucking Ass’ns, Inc.*, 531 U.S. 457, 468 (2001). What no doubt will become an oft-quoted phrase was in essence a summary of a finding in *MCI Telecomms. v. AT&T Co.*, 512 U.S. 218, 231 (1994) (“It is highly unlikely that Congress would leave the determination of whether an industry will be entirely, or even substantially, rate-regulated to agency discretion—and even more unlikely that it would achieve that through such a subtle device as permission to ‘modify’ rate-filing requirements.”).

279. 15 U.S.C. § 7245 (2004). The contrast between Section 307 and the Part 205 Rules is noteworthy: the former focuses on conduct by the attorney while the latter focus on conduct by the client which would trigger a safe harbor for disclosure of the conduct of the client.

280. CAL. RULES OF PROF’L CONDUCT R. 3-600 (2001); CAL. BUS. & PROF. CODE § 6068(e) (West 2003).

281. See *supra* notes 43, 73, & 196 and accompanying text.

G. *The Legislative History*

The SEC has contended in public statements that the Part 205 Rules are consistent with Congress' mandate to establish minimum standards for attorney conduct, and that Congress specificity regarding "reporting up" the corporate ladder was not intended to be exclusive.²⁸² The relevant questions, then, are (i) did Congress intend to authorize the SEC to promulgate standards permitting lawyers to "report out" confidential client information without the client's consent,²⁸³ and (ii) did Congress intend such rules to preempt state law that prohibits such disclosures?²⁸⁴

The Sarbanes-Oxley Act was notable for its "swift" passage, which left little time for extended floor debate by Congress.²⁸⁵ There is, in fact, no evidence in the legislative history that Congress desired to include any sort of "reporting out" requirement. The focus was on reinforcing the lawyer's duty to his client, defined as the corporation and the board of directors who represent the shareholders. During the Senate debate, Senator Edwards of North Carolina, a sponsor of the amendment to add Section 307 to the Act, summarized the amendment succinctly:

Let me be a little more specific about what this amendment does and what the responsibility of a lawyer is and should be. If you are a lawyer for a corporation, your client is the corporation and you work for the corporation and you work for the shareholders, the investors in that corporation; that is to whom you owe your responsibility and loyalty. . . .

If you find out that the managers are breaking the law, you must tell them to stop. If they won't stop, you go to the board of directors, which represents the shareholders, and tell them what is going on. If they won't act responsibly and in compliance with the law, then you go to the board and say something has to be done; there is a violation of the law occurring. **It is basically going up the ladder, up the chain of command. . . .**

The time has come for Congress to act. This amendment acts in a very simple way. It basically instructs the SEC to start doing

282. See Prezioso, *supra* note 92.

283. See *supra* notes 63-68 and accompanying text.

284. See *supra* note 251 and accompanying text.

285. See, e.g., Julie Hirschfeld Davis, *For Sarbanes, the Grumbling Was Expected*, BALTIMORE SUN, July 29, 2003, at 1D (describing the efforts of Senator Sarbanes and Rep. Oxley to push the legislation "to swift enactment"); Andrew Parker & Tony Tassell, *US Corporate Reform Efforts Come Under Attack in Britain*, FIN. TIMES, Jan. 21, 2003, at 1 (referencing the "swift approval" of the legislation).

exactly what they were doing 20 years ago, to start enforcing this up-the-ladder principle.²⁸⁶

Senator Enzi of Wyoming, a co-sponsor, added:

This amendment [Section 307] is designed to assure that attorneys are responsible for fully informing their corporate client of evidence of material violations of Federal securities law. . .

When their counsel and advice is sought, attorneys should have an explicit, not just an implied, duty to advise the primary officer and then, if necessary, the auditing committee or the board of directors of any serious legal violation of the law by a corporate agent. Currently, there is no explicit mandate requiring this standard of conduct.²⁸⁷

This amendment instructs the Commission to establish rules that require an attorney, with evidence of material legal violation by the corporation or its agent, to notify the chief legal counsel or the chief executive officer of such evidence and the appropriate response to correct it. If these officers do not promptly take action in response, the Commission is instructed to establish a rule that the attorney then has a duty, to take further appropriate action, including notifying the audit committee of the board of directors or the board of directors themselves, of such evidence and the actions of the attorney and others regarding this evidence. **It is all within the corporation.**²⁸⁸

Senator Enzi compared the proposed rule to the IRS regulation, 31 CFR part 10.21, which requires tax attorneys to advise their clients if they learn the client has not complied with the revenue laws, and he contrasted the proposed rule with the more onerous disclosure requirement for accountants, which requires auditors to report violations both to the client's directors and simultaneously to the SEC.²⁸⁹

286. 148 CONG. REC. S6551-52 (daily ed. July 10, 2002) (emphasis added).

287. As to an attorney's responsibilities under the California Rules of Conduct, *see supra* note 185 and accompanying text.

288. 148 CONG. REC. S6554-55 (daily ed. July 10, 2002) (emphasis added).

289. *Id.* The Corporations Committee published a "Public Commentary" dated November 18, 2003, pointing out (among other things) that the roles and duties of attorneys and independent public auditors are fundamentally different. The Public Commentary specifically noted "the regulations of the California Board of Accountancy make numerous exceptions to an accountant's duty to maintain client confidences, including disclosures made in response to an official inquiry from a federal or state government regulatory agency." Keith Paul Bishop, et al., *A Public Commentary from the Corporations Committee: "At Ever Peril." New Pressures on the Attorney-Client Relationship*, 23 BUS. L. NEWS 5, 21 (2003). The text of the Public Commentary is available on the Corporations Committee's website at http://www.calbar.ca.gov/calbar/pdfs/sections/buslaw/corporations/2003-11-18_public-commentary.pdf.

Furthermore, the legislative history indicates that Congress did not intend that Section 307 would abrogate the traditional confidentiality of communications between corporate lawyers and their clients by requiring attorneys to report outside the corporation. Senator Enzi stated:

The amendment I am supporting would not require the attorneys to report violations to the SEC, only to corporate legal counsel or the CEO, and ultimately, to the board of directors.

Some argue that the amendment will cause a breach of client/attorney privilege, which is ludicrous. The attorney owes a duty to its client which is the corporation and the shareholders. By reporting a legal violation to management and then the board of directors, no breach of the privilege occurs, because it is all internal – within the corporation and not to an outside party, such as the SEC.

This amendment also does not empower the SEC to cause attorneys to breach their attorney/client privilege.²⁹⁰

This intent was confirmed by Senator Edwards in the following exchange with Senator Sarbanes of Maryland, one of principal authors of the Act:

Mr. SARBANES. It is my understanding that this amendment, which places responsibility on the lawyer for the corporation to report up the ladder, only involves going up within the corporate structure. He doesn't go outside of the corporate structure. So the lawyer would first go to the chief legal officer, or the chief executive officer, and if he didn't get an appropriate response, he would go to the board of directors. Is that correct?

Mr. EDWARDS. Mr. President, my response to the question is the only obligation that this amendment creates is the obligation to report to the client, which begins with the chief legal officer, and, if that is unsuccessful, then to the board of the corporation. **There is no obligation to report anything outside the client – the corporation.**

290. 148 CONG. REC. S6554-55 (daily ed. July 10, 2002). Authors of a recent article in support of the SEC's preemptive authority overlooked this statement by Senator Enzi. See Crampton et al., *supra* note 27. While Senator Enzi's statement could be read narrowly to say that Section 307 does not empower the SEC to force breaches of the privilege, it could also be understood to say that the SEC cannot "cause" breaches by offering immunity to attorneys for doing so.

Mr. SARBANES. **I think that is an important point.** I simply asked the question in order to stress the fact that that is the way this amendment works. This has been a very carefully worked out amendment.²⁹¹

Based on the legislative history of Section 307, it appears clear that Congress was concerned about the impact that new standards of professional conduct might have on the confidentiality of attorney-client communications. There is no indication that Congress intended to abrogate the privilege and duty that exists under the law of every state. At a minimum, it is at least doubtful that Congress intended to authorize the SEC to include a rule that would encourage attorneys to report evidence of wrongdoing outside the corporation.

The SEC may argue that Section 205.3(d)(2) is merely permissive, and does not require an attorney to report to the SEC, which was the concern that Senator Edwards and Senator Enzi expressed. The distinction is a fine one, however, and is not reflected in the floor debate. Moreover, there is no indication that any such “permission” could be granted under the Sarbanes-Oxley Act by the SEC other than with respect to any of its own rules of conduct which might otherwise be interpreted as inhibiting disclosure of client confidences. There is no suggestion that Congress intended to invite (or empower the SEC to invite), but not require, reporting outside the corporation, as a means of strengthening the lawyer’s duty to the corporate client.

The SEC also may seek to ascribe significance to the extensive criticism in the legislative history of the purported failure of attorneys to police their peers who fail to place the interests of the corporation ahead of management. Senator Edwards stated, “With Enron and Worldcom, and all the other corporate misconduct we have seen, it is again clear that corporate lawyers should not be left to regulate themselves no more than accountants should be left to regulate themselves.”²⁹² Senator Enzi added:

I am usually in the camp that believes States should regulate professionals within their jurisdiction. However, in this case, the State bars as a whole have failed. They have provided no specific ethical rule of conduct to remedy this kind of situation. Even if they do have a general rule that applies, it often goes unenforced. Most States also do not have the ability to investigate attorney violations involved with the complex circumstances of audit procedures within giant corporations.²⁹³

However, by limiting its solution to “up-the-ladder reporting,” and forswearing any alteration of the attorney-client privilege, Congress did not demonstrate any discernible intent to occupy the entire field of lawyer

291. 148 CONG. REC. S6557 (daily ed. July 10, 2002) (emphasis added).

292. 148 CONG. REC. S6552 (daily ed. July 10, 2002).

293. 148 CONG. REC. S6555 (daily ed. July 10, 2002).

regulation, or to preempt state laws that would prohibit disclosure of confidential client information outside the corporation. “[W]hen Congress remains silent regarding the preemptive effect of its legislation on state laws it knows to be in existence at the time of such legislation’s passing, Congress has failed to evince the requisite clear and manifest purpose to supersede those state laws.”²⁹⁴

The Congressional debate demonstrated recognition of, and adherence to, the qualitative distinction between reporting up the ladder within the corporation and reporting out. The debate shows that Congress regarded the former as fulfilling the attorney’s duty to the corporate client. The Senators acknowledged that the latter was limited by the attorney-client privilege that exists under the law of every state. Therefore, there is no actual conflict between Section 307 and the duty of lawyer-client confidentiality, and California law governing the duty of confidentiality is not an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.²⁹⁵

There is no indication in the legislative record that Congress intended for rules adopted under Section 307 to preempt any state’s law governing attorney conduct. Indeed the absence of specific text in the Sarbanes-Oxley Act itself is a marked contrast with the manner in which Congress has addressed the obligations of independent accountants. Section 10A(b) of the Exchange Act imposes specific obligations on independent accountants to report directly to the SEC in specified circumstances.²⁹⁶ Thus, it is quite clear that Congress knows how to craft a reporting out statute had it intended to do so.²⁹⁷

294. *Pennsylvania Med. Soc’y v. Marconis*, 942 F.2d 842, 850 (3d Cir. 1991) (citing *California Fed. Sav. & Loan Ass’n v. Guerra*, 479 U.S. 272, 287-88 (1987)).

295. *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941); *Geier v. Am. Honda Motor Co.*, 529 U.S. 861 (2000).

296. See 15 U.S.C. § 78j-1 (2004).

297. See *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504, 517 (1992) (“Congress’ enactment of a provision defining the pre-emptive reach of a statute implies that matters beyond that reach are not pre-empted.”). In that context, it is similarly worth noting that Congress actually *did* assert preemption over certain state laws and regulations relating to the accounting profession in Section 101 of the Sarbanes-Oxley Act:

(f) Powers of the board. In addition to any authority granted to the Board otherwise in this Act, the Board shall have the power, subject to section 107 [15 U.S.C. §7217] . . .

(2) to conduct its operations and maintain offices, and to exercise all other rights and powers authorized by this Act, in any State, without regard to any qualification, licensing, or other provision of law in effect in such State (or a political subdivision thereof);

15 U.S.C. § 7211(f)(2) (2004). The Court in the *Cipollone* case identified its conclusion as a “variant of the familiar principle of expression unius est exclusio alterius.” *Cipollone*, 505 U.S. at 517.

H. Field Preemption

The Part 205 Rules would effect a significant change in California's traditional regulation of attorneys and the standards of their professional conduct. It is implausible that Congress intended to delegate authority to the SEC to make such a fundamental change, especially in the absence of a clear expression by Congress of any intent to permit disclosure of confidential client information.²⁹⁸ In an analogous case, *Oregon v. Ashcroft*, the Ninth Circuit invalidated the Attorney General's regulation prohibiting physician-assisted suicide because the regulation encroached on the state's authority to regulate medical practice without a clear statement by Congress authorizing such intrusion.²⁹⁹ The opinion of the Court of Appeals is particularly relevant to the analysis of preemption with respect to the Part 205 Rules. It states, "Unless Congress' authorization is 'unmistakably clear,' the Attorney General may not exercise control over an area of law traditionally reserved for state authority . . . 'This concern is heightened where an administrative interpretation alters the federal-state framework by permitting federal encroachment upon a traditional state power.'"³⁰⁰

In several recent examples, Congress and the courts have respected the right of states to regulate the ethical conduct of attorneys who practice in their jurisdictions. Thus, in the McDade Amendment, Congress confirmed that federal prosecutors are subject to state and local rules governing attorney conduct.³⁰¹ Similarly, Congress did not intend the sweeping privacy provisions of the Gramm-Leach-Bliley Act to apply to attorneys, an area of regulation traditionally reserved to the states. A recent U.S. District Court ruling to that effect is relevant to the analysis of preemption with respect to the Part 205 Rules: "[T]he delegation of authority to the FTC by Congress to regulate the ethical conduct of attorneys in the face of approximately two hundred years of exclusive state regulation in such subtle way would be, in the words of Justice Scalia, like 'hid[ing an] elephant[] in a mousehole.'"³⁰² Most recently, the Ninth Circuit Court of Appeals held that federal law does not preempt California's authority to discipline or disbar attorneys admitted to practice in California who practice immigration law exclusively in federal court.³⁰³

Some recent cases might suggest that the SEC's comprehensive scheme of regulation of the securities industry may preempt California law, even where the goals are similar. In *Mayo v. Dean Witter Reynolds, Inc.*, the

298. See *FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120, 146-47 (2000); *Whitman v. Am. Trucking Ass'ns, Inc.*, 531 U.S. 457, 468 (2001).

299. 368 F.3d 1118 (9th Cir. 2004).

300. *Id.*, at 1125 (quoting *Solid Waste Agency of N. Cook County v. U.S. Army Corps of Eng'rs*, 531 U.S. 159, 173 (2001)).

301. 28 U.S.C. § 530B (2004); see also *United States v. McDonnell Douglas Corp.*, 132 F.3d 1252 (8th Cir. 1998); *United States v. Lopez*, 765 F. Supp. 1433 (N.D. Cal. 1991), *vacated on other grounds*, 4 F.3d 1455 (9th Cir. 1993).

302. *New York State Bar Ass'n v. FTC*, 276 F. Supp. 2d 110, 136 (D.D.C. 2003). See *supra* note 276 and accompanying text.

303. *Gadda v. Ashcroft*, 363 F.3d 861 (9th Cir. 2004).

district court held that California's new ethics standards for non-judicial arbitrators in Division VI of the Appendix to the California Rules of Court were preempted by the Exchange Act and the comprehensive system of federal regulation of the securities industry, and the Federal Arbitration Act.³⁰⁴ The distinguishing feature of these cases, however, was that California was purporting to introduce new rules in a field long regulated by the federal government.

The case relied on by the SEC concerning "field preemption" appears inapposite and distinguishable.³⁰⁵ In *Sperry v. Florida*, the Supreme Court overruled the state's requirement that all patent agents be admitted attorneys.³⁰⁶ However, the Constitution and history had long established the supremacy of the federal government in regulating practice in the patent office. The power of Congress to establish the patent office is set forth in the Constitution, and it had expressly granted authority to the Commissioner of Patents to prescribe regulations which permitted non-lawyer agents.³⁰⁷ Notwithstanding this broad grant of authority to the federal government, the authority of states to discipline patent lawyers is not preempted.³⁰⁸

The prerequisites for a finding of "field preemption" are well-summarized in *Pacific Gas & Elec. Co. v. State Energy Res. Conservation & Dev. Comm'n*:

Absent explicit pre-emptive language, Congress' intent to supercede state law altogether may be found from a "scheme of federal regulation . . . so pervasive as to make reasonable the inference that Congress left no room for the States to supplement it,' because 'the Act of Congress may touch a field in which the federal interest is so dominant that the federal system will be assumed to preclude enforcement of state laws on the same subject,' or because 'the object sought to be obtained by the federal law and the character of obligations imposed by it . . . [evidence that purpose of dominance].'³⁰⁹

Put another way, "field preemption"³¹⁰ occurs where Congress has "left no

304. 258 F. Supp. 2d 1097 (N.D. Cal. 2003); *accord* *Wilmot v. McNabb*, 269 F. Supp. 2d 1203 (N.D. Cal. 2003); *Jevne v. Super. Ct.*, 113 Cal. App. 4th 486 (2003).

305. See the Public Statement, *supra*, note 79; see also *infra* notes 316-19 and accompanying text for a discussion of the other case cited by the SEC in support of Part 205 having preempted state regulation of the attorney-client relationship.

306. 373 U.S. 379 (1963).

307. *Id.* at 384.

308. *Kroll v. Finnerty*, 242 F.3d 1359 (Fed. Cir. 2001).

309. 461 U.S. 190, 203-04 (1983) (quoting *Fidelity Fed. Sav. & Loan Ass'n v. De la Cuesta*, 458 U.S. 141, 153 (1982)).

310. The term appears to have its origin in the first decision by the U.S. Supreme Court applying the concept, in which it held that Congress had "taken possession of the field" by regulating railroad rates when it adopted the Interstate Commerce Act, even while not actually using the term

room”³¹¹ for any form of regulation (parallel, supplemental, or implementing) by the states. It is important to note that the test is not whether a particular regulation “occupies the field” or seeks to do so, but whether that results from a law passed by Congress under which that regulation is adopted or from the cumulative effect of multiple laws including the one under which that regulation is adopted.³¹²

Again, it is significant that “field preemption” is an implied preemption. Applying the standards from the *Pacific Gas* case,³¹³ the SEC would bear the burden of proof³¹⁴ in demonstrating that

Congress intended with the passage of Section 307 of the Sarbanes-Oxley Act to create a regulatory scheme so pervasive that there would be no room for the states to adopt any law at all on the topic of attorney obligations to honor and protect client confidentiality;

the federal interest in regulating the attorney-client relationship is so dominant that the states have no cognizable interest in that topic; and

Congress intended in adopting Section 307 to demonstrate its purpose of exclusive control over the attorney-client relationship.

None of that is evident in the legislative history of Section 307. Accordingly, a court should decline to find that “field preemption” exists in the context of the Part 205 Rules.

I. Conflict Preemption

The second line of analysis in questions of implied preemption relates to situations in which a federal law conflicts with a state law or regulation such that it is not possible to comply with both. It is important to note that this analysis *does not* focus on such conflict as between state law and a federal regulation ostensibly adopted under that federal law but rather on the law itself.³¹⁵

Such conflict might exist if Section 307 of the Sarbanes-Oxley Act had forbidden lawyers to “report up” within the corporation. Various state provisions (including those of California)³¹⁶ specifically authorize an

“preemption.” *S. Ry. Co. v. Reid*, 222 U.S. 424, 442 (1912).

311. *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218 (1947).

312. See *supra* notes 251-59 and accompanying text.

313. *Pacific Gas*, 461 U.S. at 203-04.

314. See *supra* notes 260-63 and accompanying text.

315. *Jones v. Rath Packing Co.*, 430 U.S. 519, 525 (1977) (“The first inquiry is whether Congress, pursuant to its power to regulate commerce, U.S. Const., Art. I, § 8, has prohibited state regulation of the particular aspects of commerce involved in this case.”). See also *supra* notes 251 and 263 and accompanying text.

316. CAL RULES OF PROF’L CONDUCT R. 3-600(B)(2) (2001).

attorney to do so. Similarly, a conflict would exist (at least with respect to California provisions) if Section 307 of the Act had specifically required that attorneys practicing before the SEC “report out” of the corporation to the SEC. Neither situation is present here. Indeed, there is nothing in the text of Section 307 which an attorney would be prevented by California law or regulations from doing. The letter from the WSBA President dated August 11, 2003, to the General Counsel of the SEC specifically made that point with respect to the State of Washington’s laws.³¹⁷

The other case cited by the SEC in support of preemption,³¹⁸ *Fidelity Federal Savings & Loan Association v. de la Cuesta*, held that a federal regulation promulgated by the Federal Home Loan Bank Board under the Home Owners Loan Act of 1933 (“HOLA”) preempted inconsistent California law.³¹⁹ However, the HOLA was enacted by Congress to establish a uniform system of savings and loan associations where none previously had existed.³²⁰ The regulation was issued pursuant to a Congressional grant of “plenary authority” and only after Congress expressly approved the Board’s promulgation of regulations superseding state law.³²¹

The U.S. Supreme Court has recognized several prerequisites for a finding of “conflict preemption”: 1) preemption is a matter of degree and is applicable only to the extent that there is an actual conflict with the federal law,³²² 2) such actual conflict results in it being impossible to comply both with the federal law and the conflicting state provisions,³²³ and 3) implementation of the conflicting state law would create an insurmountable obstacle to compliance with the federal law.³²⁴ As with field preemption, this is an implied preemption theory. The SEC would thus have the burden of proving that these prerequisites have been met.³²⁵ It would have a particularly difficult time doing so because: (i) it has already conceded attorneys could comply with both the Part 205 Rules and state restrictions on divulging client confidences simply by electing not to do so,³²⁶ and (ii) there is no evidence in the legislative history of Section 307, as shown above, that any of those prerequisites have been met, much less all of them.³²⁷

317. See *supra* notes 75-89 and accompanying text.

318. See the Public Statement, *supra* note 79 and accompanying text. See *supra* notes 305-307 and accompanying text for a discussion of the other case cited by the SEC in support of the Part 205 Rules having preempted state regulation of the attorney-client relationship.

319. 458 U.S. 141 (1982).

320. *Id.* at 166.

321. *Id.*

322. *Dalton v. Little Rock Family Planning Servs.*, 516 U.S. 474, 476 (1996).

323. *California Fed. Sav. & Loan Ass’n v. Guerra*, 479 U.S. 272, 281 (1987).

324. *Gade v. Nat’l Solid Wastes Mgmt. Ass’n*, 505 U.S. 88, 98 (1992).

325. See *supra* notes 260-63 and accompanying text.

326. See *supra* note 218 and accompanying text.

327. See *supra* notes 288-90 and accompanying text.

J. Summary Perspective on the SEC's Authority and its Preemption Claim

Section 307 of the Sarbanes-Oxley Act is very clear in granting authority to the SEC to promulgate regulations "setting forth minimum standards of professional conduct for attorneys appearing and practicing before" the SEC.³²⁸ It is far less clear whether the specific example of reporting "up the ladder" is sufficient authority to promulgate rules changing long-standing state regulation of the obligation of attorneys to preserve confidential information of clients as the Part 205 Rules do. Even if it did, however, there is a complete paucity of evidence that it intended any such regulation of the attorney-client relationship to be exclusive and to supersede state regulation. The analysis set forth in this part demonstrates that a court could reasonably conclude that the Part 205 Rules did not satisfy the "authority" requirements of case law or the Administrative Procedures Act. It further shows that a court should conclude that neither Section 307 of the Sarbanes-Oxley Act nor the Part 205 Rules preempt state regulation of the attorney-client relationship and the prohibition of an attorney disclosing confidential information of a client without its consent.³²⁹

IV. CONCLUSION

When an attorney subject to the California Rules of Conduct is acting on behalf of an organization and he or she knows that an agent of the organization acts in a manner that is or may be a violation of law or in a manner which is likely to result in substantial injury to the organization,³³⁰ that attorney "shall not violate his or her duty of protecting all confidential information as provided in"³³¹ Section 6068(e). Such attorney may, however, "take such actions as appear to . . . [him or her] to be in the best lawful interest of the organization"³³² which actions include, similar to the SEC's Part 205 Rules, reporting "up-the-ladder" to prevent the unlawful conduct. Where an attorney is unsuccessful in obtaining redress within the organization, then Rule 3-600(C) mandates that the "member's response is *limited* to the member's right, and, where appropriate, duty to resign in accordance with rule 3-700."³³³

The SEC's Part 205 Rules state that an attorney appearing and practicing before the SEC in the representation of an issuer may reveal to the SEC, without the consent of the "issuer", confidential information to the

328. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784.

329. The Corporations Committee has raised similar concerns regarding preemption of state law in its comments on the SEC's proposed rules regarding "Security Holder Director Nominations." Letter from Corp. Comm. to Jonathan G. Katz, Secretary, Sec. & Exch. Comm'n (Dec. 19, 2003), available at <http://www.sec.gov/rules/proposed/s71903/calbar121903.htm>.

330. See *supra* notes 194-201 and accompanying text for a discussion of CAL RULES OF PROF'L CONDUCT R. 3-600 (2001).

331. CAL RULES OF PROF'L CONDUCT R. 3-600(B) (2001).

332. *Id.*

333. *Id.* R. 3-600(C) (emphasis added); see also *supra* notes 198-99 and accompanying text (discussing R. 3-700).

extent that the attorney believes such disclosure is reasonably necessary to prevent specified harms or to “rectify” the consequences of past violations.³³⁴ As discussed in this article, doing so would, in almost all cases, result in a conflict with obligations imposed under Business and Professions Code Section 6068(e).

An attorney relying upon the SEC’s safe harbor in disclosing client confidences to the SEC would be doing so at his or her own peril. The attorney would have to be confident that:

- the attorney is “appearing and practicing” before the SEC in the representation of the issuer and the confidential information was related to that representation, as determined by the interlocking and confusing component provisions of the Part 205 Rules;³³⁵
- disclosure was reasonably necessary to prevent or rectify a “material violation” likely to cause “substantial” injury to the financial interests or property of the client or investors, or other violations specifically covered by the Part 205 Rules, thereby falling within the threshold provisions of the safe harbor;
- he or she could satisfactorily demonstrate that such disclosure would be a “good faith” reliance on the safe harbor; and
- the SEC’s claim of federal preemption with respect to the Part 205 Rules being relied upon as justification for disclosure would be upheld despite the lack of case law and legislative history clearly and unambiguously supporting the SEC’s claim of preemption.

This analysis may be tested in a variety of contexts for which the controlling issues might not be the same, including the following: (a) a State Bar disciplinary proceeding, or (b) a malpractice/breach of fiduciary duty action by the attorney’s client.

Notwithstanding the SEC’s invitation that attorneys disclose client confidences to the SEC, prudence dictates that an attorney subject to Business and Professions Code Section 6068(e) involved with a client

334. See *supra* note 34 (discussing the use of the defined term “issuer” instead of client); see also *supra* notes 63-68 and accompanying text (discussing the SEC’s permissive disclosure rule).

335. See *supra* notes 63-68 and accompanying text.

engaged in unlawful practices follow the Rules of Professional Conduct 3-600 and 3-700 unless and until the validity of the SEC's permissive disclosure rule is resolved by an appellate court in the SEC's favor.**

** Note about the Corporations Committee:

The Corporations Committee is one of 15 Standing Committees of the Business Law Section (the "Section") of the State Bar of California (the "State Bar"). The Section is one of 16 sections of the State Bar created as advisory organizations of it under Article XIII of the Rules and Regulations of the State Bar. Membership in the Section, and on the Committee, is voluntary and funding for activities of them, including all legislative activities, is obtained entirely from voluntary sources and not from mandatory dues of the State Bar. There are currently more than 9,500 members of the State Bar who are members of the Section. The official website of the Section at the date of publication is located at <http://www.calbar.org/buslaw>. The official website of the Corporations Committee at the date of publication is located at <http://www.calbar.org/buslaw/corporations>.

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Not all of the Members of the Corporations Committee necessarily endorse each and every conclusion or view expressed in this article and it should not be construed to be the position of any one of them specifically. Taken as a whole, however, this article reflects the overwhelming consensus of the Members on the date of approval and constitutes the formal position of the Corporations Committee as an institution pursuant to vote of the Members.

Publication of this article in the name of the Corporations Committee was approved by vote of the 2003-04 Section Executive Committee, Charles L. Crouch, III, Chair. This article does not, however, represent the formal position of the Section, the Section Executive Committee, or the members of the Section on any of the matters addressed in it. It similarly does not represent the formal position of the State Bar itself or its members.