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THE DUTY TO MONITOR: EMERGING OBLIGATIONS OF OUTSIDE  
LAWYERS AND AUDITORS TO DETECT AND REPORT CORPORATE  
WRONGDOING BEYOND THE FEDERAL SECURITIES LAWS

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# THE DUTY TO MONITOR: EMERGING OBLIGATIONS OF OUTSIDE LAWYERS AND AUDITORS TO DETECT AND REPORT CORPORATE WRONGDOING BEYOND THE FEDERAL SECURITIES LAWS

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## INTRODUCTION

As the twenty-first century opens, Americans are embracing monitoring as a matter of private ethics and state policy. Since the events of September 11, 2001,<sup>1</sup> Congress has focused considerable legislative efforts on the government's duty to monitor the public space. The USA Patriot Act of 2001<sup>2</sup> now provides the government with broad power to monitor people and organizations in the United States.<sup>3</sup> The government sought to create a single gateway for all information generated within the United States,<sup>4</sup> and criticism naturally followed.<sup>5</sup> In

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<sup>1</sup> When four domestic airplanes were hijacked, close to 3,000 people died after one plane crashed into the Pentagon, another plane crashed in central Pennsylvania, and the two remaining planes crashed into the World Trade Center, destroying both buildings. Some recently published books document the country's response to the events of 9/11. *See generally* STEVEN BRILL, *AFTER: HOW AMERICA CONFRONTED THE SEPTEMBER 12TH ERA* (2003) (discussing personal reactions and experiences of Americans on the days after September 11th); BOB WOODWARD, *BUSH AT WAR* (2002) (documenting President George Bush's response to September 11th in the 100 days after the attacks).

<sup>2</sup> Pub. L. No. 107-56, 115 Stat. 272.

<sup>3</sup> *See id.* §§ 201–202, 115 Stat. at 278 (broadening the government's authority intercept wire, oral or electronic communications relating to terrorism, computer fraud, and other abuse offenses). Section 207 increases the duration of government surveillance of non-United States persons serving as agents of foreign powers. *See id.* § 207, 115 Stat. at 282.

<sup>4</sup> Admiral John Poindexter was initially assigned to head the Information Awareness Office (IAO) aimed at gathering intelligence to preempt terrorist attacks, but Admiral Poindexter has since stepped down. *See* Bradley Graham, *Poindexter Resigns but Defends Programs; Anti-Terrorism, Data Scanning Efforts at Pentagon Called Victims of Ignorance*, WASH. POST, Aug. 13, 2003, at A2. The IAO was created after September 11th by the Pentagon's Defense Advanced Research Projects Agency (DARPA). DARPA is the Department of Defense's central research and development organization that centers on high risks with high payoffs, with the goal of creating various technologies that may help catch terrorists. The Total Information Awareness Project, which has since been renamed the Terrorist Information Awareness Program, is part of DARPA. Additionally, the Department of Homeland Security earlier in 2003 attempted to get legislation passed that would enable it to create a major database linking information from credit cards companies, medical insurers and motor vehicle agencies in hopes of snaring terrorists. *See* Report to Congress Regarding the Terrorism Information Awareness

addition, citizens themselves have been urged to greater vigilance to report suspicious activity or persons.<sup>6</sup> Once the province solely of totalitarian regimes, the apparatus of governmentally enforced and directed monitoring has assumed a substantial prominence within the free world.<sup>7</sup>

Monitoring has also assumed greater prominence in the regulation of business entities. Much of this focus on monitoring preceded the events of September 11, 2001, and it reflects years of governmental efforts to delegate responsibility for monitoring and reporting obligations to various groups within the private sector. For example, the war on gang and drug activity produced anti-money-laundering statutes through which banks and other financial intermediaries received substantial monitoring and reporting obligations with respect to large cash transactions.<sup>8</sup>

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Program: In Response to Consolidated Appropriations Resolution, Pub. L. No. 108-7, Div. M, § 111(b) (2003), <http://www.darpa.mil/body/tia/tia/TIA%20DI.pdf>. (last visited Sept. 30, 2003); Electronic Privacy Information Center, "Terrorism" Information Awareness (TIA), <http://www.epic.org/privacy/profiling/tia/> (last visited Sept. 11, 2003); Defense Advanced Research Projects Agency, <http://www.darpa.mil/index.html> (last visited Sept. 30, 2003).

<sup>5</sup> For example, Iowa Senator Chuck Grassley criticized the proposed legislation to link major databases, saying in a January 22, 2003 statement: "[T]his program could be used to invade the privacy of Americans by snooping around in our bank accounts, personal Internet computers, phone records and the like." *Cutting Edge*, PEORIA J. STAR, Feb. 4, 2003, at C10.

<sup>6</sup> See, e.g., Naftali Bendavid et al., *U.S. Officials Spread Calls for Vigilance*, CHI. TRIB., Oct. 9, 2001, at A3; Bill Rankin & Tasgola Karla Bruner, *Ashcroft Calls for Greater Vigilance*, ATLANTA J. CONST., Nov. 20, 2002, at A8.

<sup>7</sup> It is with some irony that one can access on the official website of the Marxist-Socialist government of Cuba the suggestion that the American government has attempted to create its own version of the revolutionary neighborhood committees for the defense of the revolution—*Comités de Defensa de la Revolución*. These committees were established by the Cuban government after 1959 to enlist citizens in the monitoring and reporting of their fellow citizens in the cause of the Cuban revolution, that is, against acts of counterrevolutionary terrorism. See Víctor Joaquín Ortega, *Comités de Defensa en USA...? En el Reino del Terrorismo*, LA CALLE, [http://www.lacalle.cubaweb.cu/latitudes/cdr\\_usa.htm](http://www.lacalle.cubaweb.cu/latitudes/cdr_usa.htm) (last visited Sept. 30, 2003).

<sup>8</sup> See Money Laundering and Financial Crimes Strategy Act of 1998, Pub. L. No. 105-310, 112 Stat. 2941 (1998). The Act began a five year initiative for the government to combat money laundering and related financial crimes through both detection and prevention. See *id.* § 5341, 112 Stat. at 2942. Money laundering statutes and the obligations of banks and others is beyond the scope of this article. For more information on this subject see, for example, Fernando L. Aenlle-Rocha, *Correspondent Banking after September 11: New Controls Will Combat Money Laundering and Money Transfers That Aid Illegal Acts*, L.A. LAW., Sept. 2002, at 27; Eduardo Aninat et al., *Combating Money Laundering and the Financing of Terrorism*, FIN. & DEV., Sept. 2002, at 44; Raymond W. Baker, *The Biggest Loophole*

The development of new prosecutorial strategies for charging corporations for unlawful activity resulted in an increased emphasis on the monitoring and disclosure obligations of corporations with respect to their internal operations.<sup>9</sup> These prosecutorial initiatives have been sharply criticized.<sup>10</sup> Such emphasis on monitoring and disclosure, however, was instrumental in shaping innovations to the nature and scope of state fiduciary duty of care principles, especially in the state of Delaware.<sup>11</sup> While academics<sup>12</sup> and others<sup>13</sup> criticized *Caremark*

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in the Free-Market System, WASH. Q., Autumn 1999, at 29.

<sup>9</sup> See Memorandum from the Deputy Attorney General, U.S. Dept. of Justice, to All Component Heads and U.S. Attorneys, Bringing Criminal Charges Against Corporations (June 16, 1999), [http://www.usdoj.gov/criminal/fraud/policy/Charging\\_corps.html](http://www.usdoj.gov/criminal/fraud/policy/Charging_corps.html) (last visited Sept. 30, 2003); Memorandum from Larry D. Thompson, Deputy Attorney General, U.S. Dep't of Justice, to Heads of Dep't Components, U.S. Attorneys, Principles of Federal Prosecution of Business Organizations (Jan. 20, 2003), [http://www.usdoj.gov/dag/cftf/corporate\\_guidelines.htm](http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm) (hereinafter New Guidelines) (last visited Sept. 30, 2003). The "existence and adequacy of the corporation's compliance program" is one of the factors prosecutors use to determine whether to charge a corporation. *Id.* at Part II.A.5.

<sup>10</sup> See American College of Trial Lawyers, *The Erosion of the Attorney-Client Privilege and Work Product Doctrine in Federal Criminal Investigations*, 41 DUQ. L. REV. 307, 321-23 (2003); see also Carl E. Person, *Criminal Prosecution Reform Website: The Worst Federal Prosecutorial Abuses and Misconduct with Suggested Remedies*, at <http://www.lawmall.com/abuse/> (last visited Sept. 30, 2003). The web site is devoted to criminal prosecution reform that lists "The Worst Federal Prosecutorial Abuses and Misconduct with Suggested Remedies." *Id.* The web site aims to give those accused of wrongdoing a chance to respond to the "wrongdoing, profit-making prosecutorial enterprise." *Id.* It asserts that those accused are victims of a biased and corrupt system that needs drastic changes to become more fair. See *id.*

<sup>11</sup> See *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 969 (Del. Ch. 1996); Cheryl L. Wade, *Racial Discrimination and the Relationship Between the Directorial Duty of Care and Corporate Disclosure*, 63 U. PITT. L. REV. 389, 403-20 (2002).

<sup>12</sup> See, e.g., Lawrence E. Mitchell, *Lessons from Enron, How did Corporate and Securities Law Fail? The Sarbanes-Oxley Act and the Reinvention of Corporate Governance?*, 48 VILL. L. REV. 1189, 1203 (2003); Stephen A. Radin, *Year 2000 Bank Director Liability Issues: State Law Breach of Fiduciary Duty and Mismanagement Claims*, in 1 YEAR 2000 LIAB. PREVENTION & LITIG. MANUAL, <http://www.weil.com/wgm/Cbyline.nsf/0/bd2a95f10865e4cd8525681700502f79?OpenDocument> (last visited Sept. 30, 2003). Radin argues that *Caremark* guidelines are insufficient because they may only apply when an action is taken, including a decision not to act, but that the guidelines do not apply when no decision or action is taken at all. See *id.* But see Eric A. Chiappinelli, *A Tribute to Chancellor William T. Allen: Bill Allen in Class*, 21 SEATTLE U.L. REV. 613, 619-20 (1998).

<sup>13</sup> See, e.g., Ronald Berenbeim, *How Effective Are Corporate Codes in Combating Corruption?*, International Anti-Corruption Conference (IACC) (1999), [http://www.transparency.org/iacc/9th\\_iacc/papers/day2/ws3/d2ws3\\_rberenbeim.html](http://www.transparency.org/iacc/9th_iacc/papers/day2/ws3/d2ws3_rberenbeim.html)

principles, the principles enunciated in the case are used by federal prosecutors to expand the importance of corporate internal monitoring in determining whether charging a corporation is appropriate.<sup>14</sup> Federal courts appear increasingly willing to impose personal liability on majority shareholders of closely-held corporations for the illegal activities of the corporate entity.<sup>15</sup>

Since 1995, corporate monitoring obligations expanded significantly to embrace non-corporate actors. These actors, principally auditors and outside counsel, appeared strategically placed to supplement the inside monitoring by corporate management and the outside institutional monitoring by agencies of the federal and state government.<sup>16</sup> In 1995, the federal government enacted the Private Securities Litigation

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(last visited Sept. 30, 2003). "Absent a system that encourages employees to expose inappropriate conduct, codes will never achieve their full potential to deter wrongdoing. . . . Companies need to strengthen code compliance verification procedures." *Id.*

<sup>14</sup> See New Guidelines, *supra* note 9, at Part VII.B.

For example, do the corporation's directors exercise independent review over proposed corporate actions rather than unquestioningly ratifying officers' recommendations; are the directors provided with information sufficient to enable the exercise of independent judgment, are internal audit functions conducted at a level sufficient to ensure their independence and accuracy and have the directors established an information and reporting system in the organization reasonable [sic] designed to provide management and the board of directors with timely and accurate information sufficient to allow them to reach an informed decision regarding the organization's compliance with the law.

*Id.* (citing *In re Caremark Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996)).

<sup>15</sup> This trend is most obvious in the area of environmental law under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), 42 U.S.C. § 9607 (2000). Recent cases, however, suggest a willingness of at least the appellate courts to find a basis for imposing monitoring obligations, and liability when monitoring fails, on majority shareholders where corporate discrimination is at issue. See *Holley v. Crank*, 258 F.3d 1127, 1132-36 (9th Cir. 2001), *vacated by Meyer v. Holley*, 530 U.S. 280 (2003).

<sup>16</sup> See, e.g., John C. Coffee, *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1414-20 (2002) (providing an academic articulation of this position and discussing the necessary role of auditors and lawyers as gatekeepers and approaches to correcting the problems leading to gatekeeper failure, like that of the Enron collapse). See generally H. Lowell Brown, *The Dilemma of Corporate Counsel Faced With Client Misconduct: Disclosure of Client Confidences or Constructive Discharge*, 44 BUFF. L. REV. 777 (1996) (discussing how inside counsel face different constraints and the options open to counsel who discover corporate misconduct and solutions for both the corporate client and the former counsel who dissociate because of disclosure of illegality).

Reform Act (PSLRA).<sup>17</sup> While the Act's principal thrust was against the plaintiffs' bar, section 301 created the new section 10A of the Securities Exchange Act of 1934.<sup>18</sup> This section imposed a duty on a reporting company's outside auditors to investigate and report to corporate management information indicating that an illegal act had taken place or might occur.<sup>19</sup> In 2002, the federal government enacted the Sarbanes-Oxley Act (SOA).<sup>20</sup> A number of the provisions of SOA amplify actual and potential monitoring obligations of auditors.<sup>21</sup> In addition, section 307 of SOA<sup>22</sup> seems to have the potential for imposing new ethical obligations on lawyers who practice before the SEC.<sup>23</sup> As amplified in the regulations of the SEC and other

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<sup>17</sup> Pub. L. No. 104-67, 109 Stat. 737.

<sup>18</sup> *Id.* § 301; 15 U.S.C. § 78j-1.

<sup>19</sup> *Id.* See generally Thomas Riesenber, *Trying to Hear the Whistle Blowing: The Widely Misunderstood "Illegal Act" Reporting Requirements of Exchange Act Section 10A*, 56 BUS. LAW. 1417 (2001) (providing a fairly partisan discussion of this provision and describing the statutory scheme, legislative history, and impact of the Private Securities Litigation Reform Act).

<sup>20</sup> Pub. L. No. 107-204, 116 Stat. 745. The statute is titled: "An Act [t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes." *Id.* It was adopted in response to the increase in restatements of corporate earnings following a spate of disclosures of possible large scale wrongdoing in some of the largest public companies in the United States. See 148 CONG. REC. H5462 (daily ed. July 25, 2002) (statement of Rep. Oxley.) The bill was signed by the President on July 30, 2002. See 148 CONG. REC. D866 (daily ed. July 31, 2002).

<sup>21</sup> See, e.g., Sarbanes-Oxley Act of 2002 §§ 201-209, 15 U.S.C.A. 78c(a)(58), 78j-1(g)-(k), 7231 (West Supp. 2003); see also Jeffrey N. Gordon, *Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley*, 35 CONN. L. REV. 1125, 1136 (2003) ("In this sense Sarbanes-Oxley can be seen as attempting to calibrate the mandatory disclosure system to a world in which the board of a public corporation will have insufficient incentives to undertake high-powered monitoring of corporate finance and, therefore, market monitoring must be strengthened."). Those acknowledging this focus have also criticized the new monitoring regime. See, e.g., Robert W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 40 HOUS. L. REV. 1, 50 (2003).

Post-Enron reforms, including Sarbanes-Oxley, rely on increased monitoring by independent directors, auditors, and regulators who have both weak incentives and low-level access to information. This monitoring has not been, and cannot be, an effective way to deal with fraud by highly motivated insiders. Moreover, the laws are likely to have significant costs, including perverse incentives of managers, increasing distrust and bureaucracy in firms, and impeding information flows.

*Id.*

<sup>22</sup> Sarbanes-Oxley Act of 2002 § 307, 15 U.S.C.A. § 7245.

<sup>23</sup> Section 307 provides that the Commission shall issue rules, including:

(1) requiring an attorney to report evidence of a material violation of

agencies, these obligations impose significant new monitoring and reporting requirements on lawyers with respect to corporate conduct.<sup>24</sup>

By the first years of the twenty-first century, the general trend in federal lawmaking became clear. Some of the obligations of lawyers and auditors were converging despite the very different natures of their primary societal roles. PSLRA section 10A and SOA section 307 represent parallel developments. Both focus on a shift of the primary duty of lawyers and accountants from their private clients to the government, the ultimate monitor, and the public at large. The resistance of the organized bar was broken with the enactment of SOA. Like auditors, at least to the extent required by statute, lawyers now have been burdened with a "public responsibility transcending any employment relationship with the client."<sup>25</sup> With SOA for lawyers and section 10A for accountants, federal law has begun to recognize "the similar economic function that both transactional lawyers and accountants play as reputational intermediaries for their corporate clients."<sup>26</sup>

While the government was increasing the monitoring obligations of corporate insiders and outside corporate gatekeepers, legislation was enacted to reduce the scope and power of shareholders to monitor corporate conduct through derivative litigation.<sup>27</sup> The PSLRA represented a significant

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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.

*Id.*, 15 U.S.C.A. § 7245.

<sup>24</sup> See Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 34-47276, 68 Fed. Reg. 6296 (Feb. 6, 2003) (to be codified at 17 C.F.R. pt. 205).

<sup>25</sup> *United States v. Arthur Young & Co.*, 465 U.S. 805, 818 (1984) (holding there is no work product privilege for accountant work). I suggest here, of course, a potential consequence of the Act in terms of its power to conflate lawyers' and accountants' roles with respect to corporate clients.

<sup>26</sup> Peter C. Kostant, *Paradigm Regained: How Competition From Accounting Firms May Help Corporate Attorneys to Recapture the Ethical High Ground*, 20 PACE L. REV. 43, 60 (1999).

<sup>27</sup> The value of shareholder litigation as a monitoring device has been

effort to reduce the scope of shareholder power exercised through derivative litigation.<sup>28</sup> In addition, the 1990s saw significant strengthening of the power of a board of directors to effect dismissal of derivative actions without breaching the obligations of the board under state fiduciary duty principles.<sup>29</sup> The rise in power and prominence of theoretically independent members of boards of directors is well-known.<sup>30</sup> The independent-director model of corporate governance, at least for publicly traded companies, had a significant effect outside the borders of the United States. The recent Higgs Commission report in the United Kingdom concluded that there was a need to move to an independent director model of corporate governance.<sup>31</sup>

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questioned. See, e.g., John C. Coffee, *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 5, 7 (1985) (discussing how the shift toward independent directors has decreased value of shareholder litigation as a monitoring device).

<sup>28</sup> See Joel Seligman, *The Private Securities Reform Act of 1995*, 38 ARIZ. L. REV. 717, 719-20 (1996).

<sup>29</sup> Cases involving judicial review of board decisions provide guidance. See *Scattered Corp. v. Chi. Stock Exch., Inc.*, 701 A.2d 70, 75-77 (Del. 1997) (reviewing a board decision not to bring suit after demand; *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788-89 (Del. 1981) (reviewing a board action when a special independent committee recommends termination). Special litigation committees, composed of a majority of disinterested directors may, after a good faith investigation, recommend termination of a derivative suit if the termination is in the best interests of the company. Commentary on internal corporate investigations is also helpful. See, e.g., Arthur F. Mathews, *Internal Corporate Investigations*, 45 OHIO ST. L.J. 655, 675-76 (1984); Thomas R. Mulroy & Eric J. Muñoz, *The Internal Corporate Investigation*, 1 DEPAUL BUS. & COM. L.J. 49, 49-50 (2002); James L. Rudolph & Gustavo A. del Puerto, *The Special Litigation Committee: Origin, Development, and Adoption Under Massachusetts Law*, 83 MASS. L. REV. 47, 47-48 (1998).

<sup>30</sup> An independent member of the board of directors is generally understood to mean a person with no financial, personal, or other connection with the company or officers of the company she serves. See *NYSE Approves Measures to Strengthen Corporate Accountability: New Standards Aim to Restore Investor Confidence*, EXCHANGE, Aug. 2002, at 1-2, <http://www.nyse.com/pdfs/xnlv9n08.pdf> (last visited Sept. 30, 2003) (stating a director must have no material relationship with the company to be deemed "independent"); see also Donald E. Pease, *Outside Directors: Their Importance to the Corporation and Protection from Liability*, 12 DEL. J. CORP. L. 25, 29-30 (1987).

<sup>31</sup> In April, 2002, "Secretary of State for Trade and Industry, Patricia Hewitt and the Chancellor, Gordon Brown, . . . appointed Derek Higgs to lead an independent Review into the role and effectiveness of non-executive directors." Press Release, U.K. Dep't of Trade and Industry, *Derek Higgs Appointed to Lead Review of Non-Executive Directors* (April 15, 2002), <http://www.nds.coi.gov.uk/coi/coipress.nsf/2b45e1e3ffe090ac802567350059d840/1256a817e7cec2e280256b9c004bb3e3?OpenDocument> (last visited Sept 30, 2003). The report of Derek Higgs on the role of non-executive directors in English companies

While a tremendous amount of time and effort has been spent on the need to create and enforce monitoring duties among corporate insiders and outsiders, relatively little time has been spent thinking through the nature of the duty created or the scope of activities to be monitored. The conventional, fairly thoughtless answer focuses on corporate misconduct based on violations of federal securities laws and state fiduciary duty law—that is, for violations of disclosure obligations and obligations of corporate fiduciaries to act with appropriate care and solely in the best interests of the corporation or its shareholders.

This conventional approach reflects a focus on the abuses of the shareholder derivative litigation process and its deleterious effects on corporate governance. It also represents a more forceful reaction to the corporate scandals of the late twentieth and early twenty-first centuries. These scandals profoundly influenced the relationship between law and American business. In 2000, at a time when the nation appeared to be heading into a mild recession after a hotly contested presidential election,<sup>32</sup> allegations surfaced of large-scale fraudulent transactions and accounting practices at Enron, one of the principal energy intermediary companies in the nation.<sup>33</sup> The company was eventually forced to seek bankruptcy protection,<sup>34</sup> and its top executives, many with access to the highest levels of the

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was recently published. See Derek Higgs, Review of the Role and Effectiveness of Non-Executive Directors (Jan. 2003), [http://www.dti.gov.uk/cld/non\\_exec\\_review/pdfs/higgsreport.pdf](http://www.dti.gov.uk/cld/non_exec_review/pdfs/higgsreport.pdf) (last visited Sept. 30, 2003). Many of the proposals would go into effect at the end of July, 2003. The Report recommended that at least one half of the directors, excluding the chairman, be independent. See *id.* at 9.5. The report also proposed that the roles of chairman and chief executive should be separated. See *id.* at 5.3. Higgs was well aware of developments in the U.S. The Report expressed concern regarding the American practice of concentrating authority in a single individual serving as both chairman of the board of directors and chief executive officer. See *id.* 2.8–10.

<sup>32</sup> See Peter G. Gosselin, *Political Mess Raises Fears of Recession Economy*, L.A. TIMES, Nov. 15, 2000, at C1.

<sup>33</sup> See Daniel Fisher, *Shell Game: How Enron Concealed Losses, Inflated Earnings—and Hid Secret Deals from the Authorities: Are Criminal Charges Next?*, FORBES, Jan. 7, 2002, at 52 (describing Enron's use of a network of external partnerships to hide the declining value of its assets.); see also Allan Sloan et al., *Who Killed Enron*, NEWSWEEK, Jan. 21, 2002, at 18 (“[A] handful of executives and outsiders made millions by investing in off-balance-sheet deals with Enron that played a large role in destroying the company.”).

<sup>34</sup> See, e.g., Lanny J. Davis, *Enron? We're Missing the Point*, WASH. POST, Jan. 6, 2002, at B1 (providing an account from the popular press).

American government, were either prosecuted or ruined.<sup>35</sup> WorldCom, a worldwide telecommunications company, collapsed soon thereafter, following allegations of more simple-minded yet large-scale accounting fraud.<sup>36</sup> The founding family of Adelphia, a large cable broadcast company in the Northeast United States, ushered in a renewed media focus on the anti-celebrity of the white collar "perp-walk"<sup>37</sup> after the commencement of

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<sup>35</sup> See Carrie Johnson & Peter Behr, *Charges Near in Probe of Enron Officer; Former CFO Fastow is Task Force's Focus*, WASH. POST, Sept. 26, 2002, at E1 (discussing how investigators from the Justice Department's Enron task force and the Securities and Exchange Commission attempt to prove that former executives knew, or should have known, that Enron was dependent on sham asset sales and inflated financial deals.); see also Alexei Barrionuevo et al., *Enron's Fastow Charged With Fraud*, WALL ST. J., Oct. 3, 2002, at A3 (describing charges against former Enron chief financial officer, Andrew Fastow).

Kenneth Lay, the CEO who was the friend of the current President and Vice-President, was forced to resign and seek the protection of obscurity but has to date managed to avoid indictment. See Jonathan Weil & Alexei Barrionuevo, *Justice Department Finds Building Criminal Case Against Lay Tough*, WALL ST. J., Aug. 26, 2002, at A3.

A significant aspect of the Enron meltdown is that officers, such as Kenneth Lay, and, more generally, the other members of the Enron board of directors, likely did not steal directly from the cash register. Instead, they relied upon assurances of technical compliance to insulate them from the consequences of improper behavior as they inflated the price of Enron stock for their own gain.

William H. Widen, *Enron at the Margin*, 58 BUS. LAW. 961, 967 (2003).

<sup>36</sup> See, e.g., Shawn Young et al., *WorldCom Files for Bankruptcy*, WALL ST. J., July 22, 2002, at A3 (revealing WorldCom filed for bankruptcy protection after accumulating \$41 billion of debt due to, in part, misstating \$3.8 billion in expenses for five quarters); see also *The Lessons of WorldCom*, WASH. POST, July 23, 2002, at A16 ("WorldCom's accounts were spectacularly misleading: Nearly \$4 billion in expenses were misreported, creating a huge overrepresentation of the firm's profits."); Jon Van, *Ex-WorldCom Execs Charged with Fraud; 3 Others Likely to Plead Guilty*, CHI. TRIB., Aug. 29, 2002, at 1 (noting that accounting irregularities at Worldcom were reported as high as \$7.1 billion, nearly twice the amount originally disclosed).

<sup>37</sup> See Andrew E. Taslitz, *Racial Auditors and the Fourth Amendment: Data with the Power to Inspire Political Action*, 66 LAW & CONTEMP. PROBS. 221 (2003) (providing a more nuanced insight on the perp-walk in the broader context of "racialized" criminality). In particular, he notes that

[f]urthermore, entertainment value means that juicy, atypical crime stories that either meet audiences' pre-existing expectations or are novel only in their severity crowd out coverage of more typical crimes. Several structural factors skew the media's presentation of the role of race in the criminal justice system. Television coverage, for example, reflects an inadvertent class bias: Middle-and-upper-income persons, a group that is disproportionately white, have the skills and resources to afford bail, get good legal representation, and get advice on handling the press. In short, they look good on television. Police are also more likely to protect their

investigations related to allegations of large-scale misuse of corporate funds for unsuccessful family ventures.<sup>38</sup> Tyco, a large conglomerate, suffered severe losses after revelations of the use of corporate funds to support the lavish life styles of select corporate executives and allegations of questionable financial reporting.<sup>39</sup> Many other companies quietly reviewed and restated their financial reports to avoid scandal and potential prosecution.

The focus on one set of scandals affecting corporations at the end of the twentieth century should not blind us to other scandals that plagued corporations during that time. Enron-type financial and securities laws violations were not the only significant corporate scandals of the early twenty-first century. For example, while Enron was collapsing, Texaco faced a massive racial discrimination lawsuit.<sup>40</sup> The evidence in that litigation demonstrated significant passive evasion and cover up at all levels of the corporation.<sup>41</sup> Texaco was not the only large

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privacy. But poor, low-status offenders, a group that is disproportionately comprised of racial or ethnic minorities, often do not make bail, and are more likely to appear disheveled, poorly dressed, and threatening on the news, when reporters cover their "perp-walks" to the station, frequently having been alerted by the police.

*Id.* at 261.

<sup>38</sup> See Christopher Stern, *Members of Rigas Family Indicted; 3 Ex-Adelphia Officials Accused of Conspiracy*, WASH. POST, Sept. 24, 2002, at E1 ("[T]he Rigases . . . allegedly] used Adelphia funds to cover more than \$250 million in personal stock losses."); see also Bill Bergstrom, *Adelphia Boss Took in \$67 Million; Agents Document Hefty Advances From Cable Firm*, CHI. TRIB., July 29, 2002, at 6 (stating that bills from family owned companies, including the Buffalo Sabres professional hockey team, a furniture and interior design company, a car dealership, and a number of partnerships, were allegedly paid out of Adelphia bank accounts); Geraldine Fabrikant, *Indictments for Founder of Adelphia and Two Sons*, N.Y. TIMES, Sept. 24, 2002, at C1 (revealing the charges of conspiracy, securities fraud, wire fraud, and bank fraud against the three in connection with their economic activities involving Adelphia).

<sup>39</sup> See, e.g., Kevin McCoy, *Authorities Widen Tyco Case, Look at Other Officials' Actions*, USA TODAY, Aug. 13, 2002, at 1A; Floyd Norris, *Now Will Come the Sorting Out of the Chief Executive's Legacy*, N.Y. TIMES, June 4, 2002, at C1.

<sup>40</sup> See *Roberts v. Texaco, Inc.*, 979 F. Supp. 185 (S.D.N.Y. 1997). In settling the case, Texaco agreed to increase the salaries of all members of the complaining class by 11.34%, implement programs to eradicate prejudice throughout their company, and establish diversity and equal opportunity for all employees. *Id.* at 191-92.

<sup>41</sup> See *id.* at 190. The named plaintiff in the case, Bari-Ellen Roberts, a Finance Department employee, alleged that she was denied a promotion for which she claimed she was qualified after she requested and the company rejected her request that Texaco implement an equal opportunity program. *Id.* at 202-03. Evidence showed that Texaco directors rejected Robert's suggestion and one director said,

corporation subject to charges of large-scale discrimination. Coca-Cola,<sup>42</sup> Xerox,<sup>43</sup> and others<sup>44</sup> also faced such charges. Discrimination actions against large public companies do not appear to be a temporary phenomenon.<sup>45</sup>

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"before you know it, we will have Black Panthers in the Texaco parking lot." *Id.* at 202 n.27. Roberts also complained that Texaco directors rejected her formal complaints and retaliated against her because of her complaints. *See id.* at 202. After Roberts filed suit, she said that Texaco's EEO officer told her and another plaintiff "not to show [their] faces at Texaco for a while" and another Texaco supervisor threatened her with physical violence. *Id.* at 203. Another plaintiff, Sil Chambers, challenged the Performance Management Process, a Texaco management monitoring system, as discriminatory against women and minorities. A Texaco director offered Chambers an increase in salary if Chambers withdrew his complaint. Chambers refused, and Texaco managers embarked on a campaign to embarrass Chambers in front of directors. *Id.* at 204.

<sup>42</sup> *See Abdallah v. Coca-Cola Co.*, 133 F. Supp. 2d 1364 (N.D. Ga. 2001). In this suit, plaintiffs' alleged that Coca-Cola's employment policies, including promotions, compensation, and performance evaluations, discriminated against African Americans. *Id.* at 1366. Coca-Cola reached a settlement agreement with the class action representatives and the Court confirmed the settlement agreement. *Id.* at 1364-65. Coca-Cola agreed to make substantial programmatic changes, including the establishment of a task force to oversee the changes, throughout the entire company. *Id.* at 1368.

<sup>43</sup> *See Reed Abelson, Black Sales Agents File Discrimination Suit Against Xerox*, N.Y. TIMES, May 10, 2001, at C4. In this case, African-American employees filed a class action suit against Xerox corporation on May 9, 2001, alleging that Xerox's sales organization was a "boys club" and a "buddy-buddy system." *Id.* White managers excluded black employees from sales opportunities that offered higher commissions and greater chance at promotion. Alicia Dean-Hall alleged the promotion was given to a white male who was less qualified and less experienced than her. *Id.* Kenneth Jimmerson alleged that following a reorganization, managers allocated his lucrative sales opportunities to white employees with less experience than him. *Id.* Dora Miller alleged that managers gave attractive sales territories to white employees over her and had asked if another black sales representative was "too black" to handle major accounts. *Id.* Another racial discrimination suit against Xerox was filed in 2002. *See Duncan Campbell, Workers Take Xerox to Court for 'Blacks in a Noose' Discrimination*, GUARDIAN (London), Aug. 9, 2002, at 11.

<sup>44</sup> *See, e.g., Bloomberg News, Avis to Pay \$3.3M in Discrimination Case*, SUN-SENTINEL (Ft. Lauderdale, Fla.), Dec. 23, 1997, at 2D (discussing settlement payment by Avis over discriminatory denial of rental cars to customers); Dave L'Heureux, *Eight Sue SCE&G for Discrimination*, STATE (Columbia, S.C.), at B6 (listing a number of charges of discrimination against large public companies); Lisa Miller, *Justice Department Probes Allegations That Avis Practiced Discrimination*, WALL ST. J., Oct. 17, 1997, at B6; *Year-End Review of Markets & Finance 2001—Review of What Was News—One Year, Two Worlds: What Was News in 2001*, WALL ST. J., Jan. 2, 2002, at 12 ("Morgan Stanley is sued by the EEOC, which charges sexual discrimination against a former saleswoman who earned \$1 million a year. The government says its class-action suit on behalf of up to 100 women in the firm's institutional-stock department is the first major case charging sexual bias against a large brokerage house.").

<sup>45</sup> *See Alison Grant, Complaints to EEOC Increasing Nationally*, PLAIN DEALER

This Article focuses specifically on the scope of activities covered by and the nature of the duties imposed by the new monitoring statutes on outside gatekeepers, outside counsel, and auditors in publicly-held corporations. The Article makes three points. In Part I, I argue that the recent amendments to the federal securities laws impose a duty on outside auditors and counsel to seek out and report on an issuer's violation of any law, rule or obligation which might have material effect on the issuer. Part I reviews the nature of the monitoring burdens imposed by recent legislation and case law on these actors under professional accounting standards. The duty to report is not limited to violations of federal securities laws, failures to disclose, or acts of financial misconduct. Instead, the statutes are written broadly, extending the duty to report to a wide range of corporate misconduct, including violations of the anti-discrimination, environmental, and other laws. For purposes of this Article, I focus on the effect of the new monitoring obligations on a corporation's compliance with anti-discrimination laws.

I argue in Part II of this Article that the duty to monitor and report is active rather than passive; it imposes an active duty to develop and implement monitoring systems that can detect materially significant violations. I demonstrate how the relevant statutes can be reasonably interpreted to impose positive responsibilities on corporate counsel and auditors to uncover corporate wrongdoing over a very broad range of activity. Both auditors and outside counsel have affirmative duties to inquire. Both have affirmative duties to be suspicious. Both have the duty to implement systems of gathering information designed to collect the sort of data that could trigger suspicion. Consequently, neither lawyers nor accountants can narrowly tailor their review to minimize the likelihood of detecting evidence of wrongdoing. These active obligations may be limited only by the scope of the gatekeeper's engagement with the corporate client.

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(Cleveland, Ohio), May 16, 2003, at C3 (providing a sample of the description of this trend from the popular press). *But see* Mark Diana, *Beginning of the End of Money Damage Class Actions? The Future of Big Money Employment Discrimination Class Actions, on the Rise Since the 1991 Civil Rights Act Was Passed, Is Unsettled*. 167 N.J. L.J.1270 (Mar. 25, 2002) (suggesting that limitations on class actions lawsuits seeking money damages may slow the proliferation of such actions).

Finally, in Part III of this Article, I assert that though governmentally imposed monitoring obligations also protect outside auditors and counsel against private actions for a failure to comply with the duty to monitor and report, both auditors and counsel risk liability as principals. I conclude by proposing that while these new obligations present tremendous risk for outside counsel and auditors, they may well present a significant opportunity for litigants looking for deep pockets. In particular, I demonstrate how the new monitoring obligations of corporate counsel and auditors possibly gave rise to an obligation on their parts to discover and report racial, ethnic, religious, gender, and other forms of discrimination in the workplace. In addition, I demonstrate how the failure to discover and to take appropriate measures in the face of evidence of potential discrimination within a corporation might leave corporations open to liability in discrimination actions.

### I. THE SCOPE OF THE DUTY TO MONITOR

Congress has imposed obligations to report violations of law to their clients on both lawyers and auditors. The main objective of these reporting requirements was to provide information to corporate management, primarily the board of directors, about potential legal violations.<sup>46</sup> By making information available to the board of directors, Congress intended to reduce the occurrence and severity of corporate misconduct.<sup>47</sup> But the

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<sup>46</sup> 148 CONG. REC. S6552 (daily ed. July 10, 2002) (statement of Sen. Edwards) ("This amendment is about making sure those lawyers, in addition to the accountants and executives in the company, don't violate the law and, in fact, more importantly, ensure that the law is being followed."). This is reflected in the understanding of some SEC Commissioners. See, e.g., Cynthia A. Glassman, *Sarbanes-Oxley and the Idea of "Good" Governance*, Address Before the American Society of Corporate Secretaries (Sept. 27, 2002), at <http://www.sec.gov/news/speech/spch586.htm> (last visited Sept. 30, 2003) ("Recognizing that awareness must precede action, Sarbanes-Oxley and the Commission's rules require the CEO and Board to make certain that procedures are in place to ensure that they hear bad news.").

<sup>47</sup> See, for example, Harvey Pitt, then-SEC Chairman, commenting on Sarbanes-Oxley Section 307, and stating that "[i]t's difficult, and often impossible, for government to discover frauds perpetrated with management collusion in the early stages. This makes the need even stronger for people of integrity in accounting, law and business who detect fraud early, or avert it." Harvey L. Pitt, *Remarks Before the Annual Meeting of the American Bar Association's Business Law Section* (August 12, 2002), <http://www.sec.gov/news/speech/spch579.htm> (last visited Sept. 30, 2003); see also *Implementation of Standards of Professional*

provisions were also meant to provide governmental regulators, primarily the Securities and Exchange Commission, with information about violations of law.<sup>48</sup> Armed with this information, the government could enforce applicable laws more effectively.<sup>49</sup>

The focus of the reporting requirements for lawyers was on corporate financial improprieties of the type that caused the collapse of Enron, WorldCom, and the other corporations caught

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Conduct for Attorneys, Exchange Act Release No. 34-46868, 67 Fed. Reg. 71,670, 71,671-73 (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. pt. 205) (describing earlier efforts to discipline lawyers leading up to enactment of Sarbanes-Oxley Act, Section 307). In the proposed rule, the SEC also referred to evidence from the floor debate regarding section 307 between Senators Edwards, Enzi, and Corzine indicating "that they believed that an issuer's directors, once notified of the evidence of a material violation could be counted on to remedy it." *Id.* at 71,687 n.55. This result would parallel the results after enactment of Section 10A. *Id.* (citing in part Riesenber, *supra* note 19, at 1444-45).

<sup>48</sup> In this regard there was something of a contrast between section PSLRA 10A and SOA section 307. The SEC, however, in proposing that lawyers, under certain circumstances, report to the SEC, attempted to finesse the difference in language between section 10A and SOA section 307. As the SEC explained in its commentary to the regulations proposed under SOA section 307:

Senator Enzi stated in the floor debate over Section 307 of the Act that "[t]he amendment [he] support[ed] 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." 148 Cong. Rec. S6555 (July 10, 2002). He was, however, contrasting the reporting requirement in what would be Section 205.3(b) of the proposed rule with the reporting requirement in Section 10A(3) of the Exchange Act. As Senator Enzi explained, requiring an attorney to report evidence of a material violation first to senior officers of an issuer, and then, if they do not rectify the violation, to the board of directors, as Section 205.3(b) would, is "less onerous" than Section 10A's requirement that an accountant must, as the Senator put it, "report, both to the client's directors and simultaneously to the SEC, an[] illegal act if management fails to take remedial action." *Id.* (emphasis added). Senator Enzi nowhere suggested that an attorney representing an issuer should not be required (1) to withdraw in the unlikely and extreme event that the issuer's board of directors failed to prevent an ongoing material violation and (2) to notify the Commission that he had withdrawn for "professional considerations.

Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. at 71,689 n.57; see also *Financial Fraud Detection: Hearings on H.R. 574 Before the Subcomm. on Telecommunications and Fin. of the Comm. on Energy and Commerce*, 103d Cong. 84 (1993) (statement of Rep. Markey) ("[T]here needs to be direct reporting by the auditor to the SEC, within 1 day after notifying the board of directors of the client firm, of the fraud which has been identified. . . . That's a big change. That gives an earlier warning. The flag is going up.").

<sup>49</sup> This notion was especially important in the passage of section 10A. See Thomas L. Riesenber, *supra* note 19, at 1426-27 (providing helpful citations to legislative history).

up in the scandals of 2000 through 2002.<sup>50</sup> However, the statutes were broadly written and broadly construed in the regulations implementing them. A close reading of the new gatekeeper provisions suggests that any form of corporate illegal conduct, including conduct constituting violations of state and federal anti-discrimination laws, is subject to the reporting requirements imposed on accountants under section 10A of the Exchange Act of 1934 and on lawyers under section 307 of the Sarbanes-Oxley Act and the regulations promulgated thereunder. While the provisions can be read narrowly,<sup>51</sup> a broad reading more likely accords with the sentiments of Congress in enacting this requirement.

#### A. *The Scope of Monitoring Burdens: Auditors*

The Private Securities Litigation Reform Act<sup>52</sup> added a new section 10A to the Securities Exchange Act of 1934.<sup>53</sup> Under this provision, accountants performing audits for registered companies are required to build procedures into their audits that are designed to provide reasonable assurance of detecting illegal acts that would have a direct material effect on the issuer's financial statements, identify related party transactions, and evaluate the issuer's ability to continue as a going concern.<sup>54</sup> If

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<sup>50</sup> Some of the relevant legislative history is quoted in John C. Coffee, Jr., *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293, 1293-94 n.1 (2003).

<sup>51</sup> Indeed, this has been suggested by some academic commentators. See, e.g., Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, 35 CONN. L. REV. 915, 966-68 (2003); Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 32 (2002); Riesenber, *supra* note 19, at 1433-34.

<sup>52</sup> Pub. L. No. 104-67, 109 Stat. 737 (1995).

<sup>53</sup> See *id.* § 301, 15 U.S.C. § 78j-1 (2000).

<sup>54</sup> See 15 U.S.C. § 78j-1(a) (2000). Section 10A(a)(1) creates the requirement that all auditors of 1934 Act reporting companies include "procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts." *Id.* at § 78j-1(a)(1). Should an auditor "detect[] or otherwise become[] aware of information," *id.* at § 78j-1(b)(1), during the course of an audit, the auditor is required to determine "whether it is likely that an illegal act has occurred [] and if so, determine and consider the possible effect of the illegal act on the financial statements of the insurer." *Id.* at § 78j-1(b)(1)(A)(i)-(ii).

In addition, the auditor is required to "inform the appropriate level of management . . . and assure that the [board's] audit committee . . . or the board of directors . . . is adequately informed with respect to illegal acts that have been

there is a determination that an illegal act has or may have occurred, the auditor is required under section 10A to make an additional determination as to the effect of the illegal act on the financial statements of the issuer.<sup>55</sup> This reporting requirement applies to all “illegal act[s] (whether or not perceived to have a material effect on the financial statements of the issuer)”<sup>56</sup> if the auditor determines that “it is likely that an illegal act has occurred.”<sup>57</sup>

If the effect is determined to be other than inconsequential, section 10A(b) imposes on auditors the duty to report detected illegal acts to management and to the audit committee.<sup>58</sup> If the reported breach of law is not corrected in a timely manner and the failure to take remedial action will warrant a departure from the standard report of the auditor, the auditor is required formally to report to the board of directors.<sup>59</sup> If the company fails to inform the SEC of the receipt of this report, the auditor is required to resign or to furnish the SEC with a copy of the report.<sup>60</sup>

The term “illegal act” in section 10A(f) is defined in the statute as “an act or omission that violates any law, or any rule or regulation having the force of law.”<sup>61</sup> The actual meaning of the term, however, has been the subject of some debate. The black letter of the statute suggests that Congress intended a

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detected.” *Id.* at § 78j-1(b)(1)(B) (emphasis added). The auditor is required to “directly report its conclusions to the board of directors.” *Id.* at § 78j-1(b)(2)(C). In the event the auditor concludes that the illegal act has a material effect on the issuer’s financial statements, management has not taken or has not been caused to take “timely and appropriate remedial actions,” and the failure to take such measures will prevent the auditor from issuing a standard audit report. *Id.* at § 78j-1(b)(2)(A)–(C).

The auditor is also required to resign from its engagement or furnish the SEC with a description of its report to the board, should the board, itself, fail to furnish such a report to the SEC with a copy to the auditor. *Id.* at § 78j-1(b)(3)(A)–(B). Should the auditor resign, it must furnish a copy of its report to the SEC. *See id.* at § 78j-1(b)(4). Should the SEC determine that the auditor “willfully violated” its obligations, the SEC can impose civil penalties. *Id.* at § 78j-1(d). However, auditors are protected against civil liability “in a private action for any finding, conclusion, or statement expressed in a report made” pursuant to Section 10A. *Id.* at § 78j-1(c).

<sup>55</sup> *Id.* § 78j-1(b)(1).

<sup>56</sup> *Id.*

<sup>57</sup> *Id.* § 78j-1(b)(1)(A)(i).

<sup>58</sup> *Id.* § 78j-1(b)(1).

<sup>59</sup> *Id.* § 78j-1(b)(2).

<sup>60</sup> *Id.* § 78j-1(b)(3).

<sup>61</sup> *Id.* § 78j-1(f).

broad meaning of "illegal act." Under this view, auditors would have to report all acts or omissions "that violate[] any law, or any rule or regulation having the force of law,"<sup>62</sup> unless the likely "illegal act" discovered by the auditor is "clearly inconsequential."<sup>63</sup> This view is the position echoed by the SEC in promulgating regulations under section 10A.<sup>64</sup> This broad reading is also consistent with the language of the Statement on Auditing Standards No. 54, which defines illegal acts as "violations of laws or governmental regulations."<sup>65</sup> Moreover, the SEC staff has taken a position with respect to materiality under section 10A that also suggests a very broad interpretation of illegal acts for purposes of section 10A.<sup>66</sup>

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<sup>62</sup> *Id.*

<sup>63</sup> *Id.* § 78j-1(b)(1)(B).

<sup>64</sup> See Implementation of Section 10A of the Securities and Exchange Act of 1934, Exchange Act Release No. 34-38387, 62 Fed. Reg. 12,743, 12,744 n.2 (Mar. 18, 1997) (to be codified at 14 C.F.R. pt. 71) (implementing Section 10A of the Securities Exchange Act of 1934).

<sup>65</sup> CODIFICATION OF STATEMENTS ON AUDITING STANDARDS AU § 317.02 (Am. Inst. of Certified Pub. Accountants 1989) (citing Statement on Auditing Standards No. 54) [hereinafter SAS 54]. SAS 54 includes within its definition of illegal acts, both illegal acts that have a "direct and material effect on the determination of financial statement amounts" and those which have "material but indirect effects." *Id.* §§ 317.05, 317.07. With respect to the latter, AU Section 317.06 explains that "Entities may be affected by many other laws or regulations, including those related to securities trading, occupational safety and health, food and drug administration, environmental protection, equal employment and price-fixing or other antitrust violations." *Id.* § 317.06. Illegal acts with material but indirect effects "are normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality." *Id.*

Of course, what might make this broad reading plausible within the auditing standards is the related understanding that an auditor's obligations with respect to uncovering illegal acts with indirect effects is significantly lower than with respect to the discovery of illegal acts with direct effects on the financial statements. With respect to material indirect illegal acts, an auditor may not be expected to learn facts leading to their discovery "unless he is informed by the client, or there is evidence of a governmental agency investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements." *Id.* § 317.06. But this understanding does not, as a consequence, narrow the meaning of illegal acts for purposes of SAS 54. See discussion *infra* Part II (discussing the nature of the detection and reporting requirements).

<sup>66</sup> See Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150, 45,154-55 (Aug. 19, 1999) (to be codified at 17 C.F.R. pt. 211) [hereinafter SAB 99]. An SAB does not have the same force or effect as a regulation. It represents the views of the SEC staff, and not necessarily those of the Commission itself. *Id.* at 45,150. The staff rejected the idea that an issuer could either net the financial effects of misstatements to determine the scope of its reporting obligation or rely on quantitative thresholds to trigger disclosure. See *id.* They also took the position that

Indeed, the structure of section 10A(b) lends itself most plausibly to a broad reading of the term illegal acts as defined in section 10A(f). Section 10A(a) imposes an obligation on auditors to develop procedures for detecting illegal acts “that would have a direct and material effect on the determination of financial statement amounts,”<sup>67</sup> identify related party transactions “that are material to the financial statements,”<sup>68</sup> and conduct “an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern.”<sup>69</sup> This obligation would seem to limit the reach of the procedures to acts with a direct connection to the financial statements. However, the auditor’s obligation to report to management, set forth in section 10A(b), makes it clear that there was no intent to create such a limitation. The auditor’s obligation to report to management extends to any circumstance in which the auditor “detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred.”<sup>70</sup> The only exception provided by section 10A is for illegal acts which have clearly inconsequential effects “on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties and damages.”<sup>71</sup> As a result, illegal acts, including acts which might result in damages that are not clearly inconsequential, are included within the auditor’s duty to report, whether or not those illegal acts are directly related to financial disclosure. These illegal acts could include race, sex, or other forms of prohibited employment discrimination, systematic sexual harassment, violations of health and safety regulations, and acts contrary to law which could result in either public or private actions against the issuer. Put another way, the procedures required to be implemented under section 10A(a) are intended to detect illegal acts, including

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illegal acts “include personal misconduct by the entity’s personnel unrelated to their business activities.” *Id.* at 45,154 n.41.

<sup>67</sup> 15 U.S.C. § 78j-1(a)(1) (2000).

<sup>68</sup> *Id.* § 78j-1(a)(2).

<sup>69</sup> *Id.* § 78j-1(a)(3).

<sup>70</sup> *Id.* § 78j-1(b)(1). Reporting is mandatory only after the auditor is satisfied that the illegal act has occurred, and has determined the possible effect of the illegal act on the financial statements. *See id.* § 78j-1(b)(1)(A)(i)–(ii).

<sup>71</sup> *Id.* § 78j-1(b)(1)(A)(ii).

those that might produce "contingent monetary effects" as understood pursuant to section 10A(b).<sup>72</sup>

On the other hand, auditors and their counsel have argued for a narrow definition of illegal acts, centering on financial fraud.<sup>73</sup> They assert that a narrow reading of the term is consistent with what is viewed as the most plausible reading of the legislative history of the provision and other indicia of Congressional intent at the time of the provision's enactment.<sup>74</sup> Even those taking this narrow view, however, concede that "there might also be unusual cases in which other types of misconduct are discovered, such as significant violations of the tax, environmental, antitrust, or other laws which could materially impact the financial statements and, if not properly disclosed, could also constitute fraud."<sup>75</sup> Thus, even some proponents of a narrow reading concede the broad scope of the obligation to discover and report. Their arguments, however,

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<sup>72</sup> *Id.*; see also SAB 99, *supra* note 66, 64 Fed. Reg. at 45,154 ("The statute specifies that these [reporting] obligations are triggered 'whether or not [the illegal acts are] perceived to have a material effect on financial statements of the issuer . . . [sic]'"). Moreover, the auditing standards in effect since 1976 have provided auditors with substantial guidance on procedures to be used for obtaining evidence and otherwise testing management's representations regarding litigation or claim contingencies. See CODIFICATION OF STATEMENTS ON AUDITING STANDARDS AU §§ 337.01-.05 (Am. Inst. of Certified Pub. Accountants 2000) (citing Statement on Auditing Standards No. 12).

<sup>73</sup> See Riesenberg, *supra* note 19, at 1434-36. Mr. Riesenberg was associate general counsel of Ernst & Young LLP at the time he wrote the article. See *id.* at 1417. Cf. Richard W. Painter, *Lawyers' Rules, Auditors' Rules and the Psychology of Concealment*, 84 MINN. L. REV. 1399, 1411 (2000) ("Section 10A . . . specifies procedures that auditors must follow to detect and disclose fraud and other illegal acts (including violations of the securities laws) by a registered company.").

<sup>74</sup> See Riesenberg, *supra* note 19, at 1436 ("Here, the title of the law, the numbering of the statute, and most importantly the legislative history all point to the law's reach as being limited to fraud.") (citation omitted). Mr. Riesenberg argues that the legislative history of section 10A never suggested a broad understanding of the meaning of the term illegal acts. See *id.* at 1434-35. The Congressional hearings on the bills centered only on issues of financial fraud. See *id.* at 1435. Moreover, he suggests, a legislative intent to limit the meaning of the term could be discerned from the title of the bills which set forth the various versions of what became section 10A because each of these bills was contained the word "fraud" in its title. See *id.* at 1436, 1436 n.106. Section 10A(f) defines an "illegal acts" as "an act or omission that violates any law, or any rule or regulation having the force of law." 15 U.S.C. § 78j-1(f)(2000). Riesenberg, however, suggests that the "striking inconsistency between the statutory intent and the statutory language" creates an ambiguity which in analogous contexts has been resolved by the courts in light of legislative history. Riesenberg, *supra* note 19, at 1435-36.

<sup>75</sup> Riesenberg, *supra* note 19, at 1438.

tend to center on the issue of the nature rather than on the scope of the obligation, that is, on the scope of measures that an auditor must take to discover and report,<sup>76</sup> rather than on the nature of the misconduct itself. This argument is taken up in the section that follows.<sup>77</sup>

*B. The Scope of the Monitoring Burdens: Lawyers.*

In addition to widely publicized criminal enforcement actions, the federal government responded to the corporate fraud scandals after 2000 by enacting the Sarbanes-Oxley Act in 2002.<sup>78</sup> SOA amended federal securities law in many respects. Among the most important changes was the addition of certification requirements for chief executive and chief financial officers in connection with the company's periodic reports that must be filed under the Exchange Act.<sup>79</sup> Additionally, SOA now requires that the annual report contain a report and evaluation of management's internal controls<sup>80</sup> and requires "[r]eal [t]ime" disclosure of material changes in the financial condition of the reporting company or results of operation.<sup>81</sup> It changes the reporting rules for purposes of section 16 of the Exchange Act<sup>82</sup> and amends section 10A of the Exchange Act to require exchanges to adopt listing standards requiring every member of a company's audit committee to be independent and carry out

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<sup>76</sup> See *id.* at 1418.

<sup>77</sup> See discussion *infra* Part II.A.

<sup>78</sup> Pub. L. No. 107-204, 116 Stat. 745. The statute, titled "An Act [t]o protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes." *Id.* The statute was adopted in response to the increase in restatements of corporate earnings following a spate of disclosures of possible large scale wrongdoing in some of the largest public companies in the United States. See 148 CONG. REC. H5462 (daily ed. July 25, 2002) (statement of Rep. Oxley). The bill was signed by the President on July 30, 2002. See 148 CONG. REC. D866 (daily ed. July 31, 2002).

<sup>79</sup> Section 302 requires the company's principal officers to certify each annual and quarterly report with respect to their review of the report and certain internal controls now mandated by the Act. See Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C.A. § 7241 (West Supp. 2003). Section 906(a) of the Sarbanes-Oxley Act requires CEO and CFO certification of each periodic report that contains financial statements, with criminal penalties for failure to comply. See *id.* § 906(a), 18 U.S.C.A. § 1350 (a).

<sup>80</sup> *Id.* § 404, 15 U.S.C.A. § 7262.

<sup>81</sup> *Id.* § 409, 15 U.S.C.A. § 78m(l).

<sup>82</sup> See *id.* § 403, 15 U.S.C.A. § 78p (requiring reports of changes in beneficial ownership within two days, rather than monthly as previously permitted through the use of Form 4 and Form 5).

specific responsibilities.<sup>83</sup> SOA also requires every reporting company to disclose whether its audit committee has at least one financial expert and, if not, the reasons why it does not.<sup>84</sup> The law also requires public companies to disclose whether they have adopted a code of financial ethics or the reasons they have not,<sup>85</sup> prohibits public companies from extending or arranging loans to their directors and officers,<sup>86</sup> and imposes certain blackout periods for trading shares acquired in connection with employment as an officer or director.<sup>87</sup>

SOA focused on areas of traditional concern in the regulation of securities disclosure, accountability, and information equality—the so-called *level-playing field*. It broadened federal governmental involvement in the regulation of corporate agents, primarily with respect to accountants,<sup>88</sup> but also with respect to lawyers.<sup>89</sup> Most importantly for purposes of this Article, it also significantly increased the role of the federal government in the monitoring of activity within the corporation. In addition to the certification requirements imposed on corporate principal officers,<sup>90</sup> SOA imposed significant

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<sup>83</sup> *Id.* § 301, 15 U.S.C.A. § 78j-1(m). These duties include the appointment and oversight of outside auditors, the determination of the compensation of outside auditors, and the resolution of conflicts between management and the auditors. *See id.* In addition, section 202 of the Act requires the SEC to adopt rules requiring the audit committee to pre-approve all auditing and non-auditing services. *Id.* § 202, 15 U.S.C.A. § 78j-1(i).

<sup>84</sup> *Id.* § 407, 15 U.S.C.A. § 7265.

<sup>85</sup> *Id.* § 406, 15 U.S.C.A. § 7264.

<sup>86</sup> *Id.* § 402, 15 U.S.C.A. § 78m(k).

<sup>87</sup> *Id.* § 306, 15 U.S.C.A. § 7244. These provisions will operate in a manner analogous to the short swing trading rules of Exchange Act section 16.

<sup>88</sup> The Sarbanes-Oxley Act establishes a regulatory agency to oversee the work of accountants performing auditing services for companies subject to registration under the Securities Acts, the Public Company Accounting Oversight Board (PCAOB). *See id.* § 101, 15 U.S.C.A. § 7211. The PCAOB is empowered: (1) to register firms that perform auditing services for public companies; (2) to adopt auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports; (3) to inspect registered auditing firms; and (4) to conduct investigations and disciplinary hearings involving registered auditing firms. *Id.* § 101(c), 15 U.S.C.A. § 7211(c). Only auditing firms registered with the PCAOB can perform or participate in audits of companies subject to registration under the Securities Acts. *Id.* § 102(a), 15 U.S.C.A. § 7212(a).

<sup>89</sup> The Sarbanes-Oxley Act imposes new ethical obligations on lawyers who practice before the SEC. *See id.* § 307, 15 U.S.C.A. § 7245.

<sup>90</sup> *See id.* § 906, 18 U.S.C.A. § 1350 (requiring CEO and CFO certification of each periodic report that contains financial statements); *id.* § 302, 15 U.S.C.A. § 7241) (mandating that principal officers to certify each annual and quarterly report

monitoring responsibilities on corporate audit committees,<sup>91</sup> as well as on management in general.<sup>92</sup>

SOA's focus on monitoring was not revolutionary. For at least a decade before its enactment, the government had been increasing its focus on corporate monitoring as a means of curbing illegal or unethical behavior. Especially in the decade before passage of SOA, federal prosecutors had started to use evidence of corporate monitoring as a factor for determining the extent and character of corporate prosecution.<sup>93</sup> The Delaware courts arguably incorporated a duty to monitor under some circumstances as part of the general fiduciary duty of care.<sup>94</sup>

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with respect to their review of the report and certain internal controls now required by the SOA).

<sup>91</sup> The Audit Committee is defined in the Sarbanes-Oxley Act as "a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer." *Id.* § 2(a)(3)(A), 15 U.S.C.A. § 7201(a)(3)(A). A company is not required to appoint an audit committee. In the event none is appointed, however, then the entire board of directors is treated as the audit committee for purposes of the Act. *See id.* § 2(a)(3)(B), 15 U.S.C.A. § 7201(a)(3)(B). SOA creates disclosure incentives for appointing a financial expert, as defined by the Securities Exchange Commission in accordance with framework of the Act, to the audit committee. *See id.* § 407(a), 15 U.S.C.A. § 7265(a). The Act imposes responsibility on the audit committee

for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee.

*Id.* § 301, 15 U.S.C.A. § 78j-1(m)(2).

The audit committee is also responsible for creating and maintaining systems for "(A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters." *Id.* § 301, 15 U.S.C.A. § 78j-1(m)(4).

<sup>92</sup> SOA section 404 will require management to prepare an "internal control report" in their Form 10-K reports. *Id.* § 404(a) (to be codified at 15 U.S.C. § 7262(a)). The report must "state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting." *Id.* § 404(a)(1), 15 U.S.C.A. § 7262(a)(1). The report must also "contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting." *Id.* § 404(a)(2), 15 U.S.C.A. § 7262(a)(2).

<sup>93</sup> *See supra* note 9 and accompanying text.

<sup>94</sup> *See In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 968-69 (Del. Ch. 1996); *see also infra* notes 219-25 and accompanying text.

Thus, at least in this respect, SOA represents evidence of a broad and growing embrace by the government of monitoring as an important weapon in its regulation of corporate conduct.

Section 307 of SOA introduced a very controversial provision affecting lawyers.<sup>95</sup> That section directed the SEC to adopt new rules of professional conduct applicable to attorneys practicing before it who represent issuers.<sup>96</sup> The purpose of section 307 was to impose on lawyers a gatekeeper obligation similar to that imposed on accountants in 1995 under section 10A.<sup>97</sup> This imposition was meant to provide a partial remedy to the institutional failures raised by academics, who had suggested that the Enron collapse could have been averted, or at least made less spectacular, had the company's natural gatekeepers, lawyers and accountants, fulfilled their duties.<sup>98</sup>

The SEC regulations<sup>99</sup> took an expansive view of the regulatory objective of section 307. The regulations require an attorney subject to its provisions<sup>100</sup> who "becomes aware of

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<sup>95</sup> See Sarbanes-Oxley Act of 2002 § 307, 15 U.S.C.A. § 7245.

<sup>96</sup> Section 307 requires the promulgation of rules

(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.

*Id.*

<sup>97</sup> The need to align lawyers' and accountants' duties was emphasized by Senator Edwards before the enactment of the Act. See 148 CONG. REC. S6552 (daily ed. July 10, 2002) (statement of Sen. Edwards).

<sup>98</sup> See Coffee, *supra* note 16, at 1403-05. See generally Painter, *supra* note 73 (discussing lawyers' and auditors' rules and the psychology of fraud concealment in the representation of clients).

<sup>99</sup> Standard of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of the Issuer, 17 C.F.R. § 205 (2003).

<sup>100</sup> *Id.* § 205.1-2. This portion of the regulations remains both controversial and unsettled. While the SEC initially proposed a very broad definition, it substantially narrowed its definition of attorneys appearing and practicing before the Commission. According to the final regulations, appearing and practicing before the commission means

(i) [t]ransacting any business with the Commission, including communications in any form; (ii) Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena; (iii) Providing

evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, [to] report such evidence to the issuer's chief legal officer . . . or to both the issuer's chief legal officer and its chief executive officer . . . forthwith."<sup>101</sup> If the attorney does not believe that the initial response is appropriate,<sup>102</sup> or if the attorney reasonably believes that reporting to the chief legal officer would be futile,<sup>103</sup> then the attorney is obligated to report the evidence of material violation to the audit committee of the board, another board committee designated to receive such disclosure, or the board as a whole.<sup>104</sup>

The regulations define a "material violation" as a "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 a similar material violation of any United States federal or state law."<sup>105</sup> It is also evident from the sweep of this provision that both Congress and the SEC meant to paint with a broad brush. The securities laws are defined to include the provisions of SOA itself.<sup>106</sup> As such, among those activities that lawyers must bring to the attention of the company are failures by company lawyers and others to comply with their reporting obligations under section 307.<sup>107</sup> Lawyers now have a duty to report, if they fall within the ambit of section 307, and they must report "evidence" of a "material violation" of the

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advice in respect of the United States securities laws or the Commission'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 Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or (iv) Advising an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the Commission's rules or regulations thereunder to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission.

*Id.* § 205.2(a)(1); *see also* Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 34-47276, 68 Fed. Reg. 6296, 6297-98 (Feb. 6, 2003) (to be codified at 17 C.F.R. pt. 205) (discussing of the SEC's rationale).

<sup>101</sup> 17 C.F.R. § 205.3(b)(1).

<sup>102</sup> *Id.* § 205.3(b)(3).

<sup>103</sup> *Id.* § 205.3(b)(4).

<sup>104</sup> *Id.* § 205.3(b)(3).

<sup>105</sup> *Id.* § 205.2(i).

<sup>106</sup> *See* 15 U.S.C.A. § 78(c)(47) (West Supp. 2003).

<sup>107</sup> *See* Sarbanes-Oxley Act of 2002 § 307, 15 U.S.C.A. § 7245 (West Supp. 2003).

reporting obligations of other lawyers under section 307.<sup>108</sup> The regulations define "breach of fiduciary duty" 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."<sup>109</sup> On the other hand, the phrase "a similar violation" is not further defined.<sup>110</sup> However, it appears from the context in which it is used in section 307 that the term is intended to extend beyond a breach of fiduciary duty or a violation of the securities laws.<sup>111</sup>

The literal language of the regulation thus suggests a broad scope of reportable activity. The *primary focus* of the reporting required by the regulation is on material violations by corporate agents of their obligations under the federal securities laws and state fiduciary duty laws, including SOA itself.<sup>112</sup> But lawyers' obligations extend beyond violations of those sorts of provisions to cover similar material violations of *any United States or state law*.<sup>113</sup> These similar material violations must include illegal acts that have a direct effect on the corporation and its financial condition.<sup>114</sup> They may, however, include violations of any law with a direct, indirect, or contingent effect on the company.<sup>115</sup> Among these could be violations of discrimination, environmental, and other laws.<sup>116</sup>

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<sup>108</sup> *See id.*

<sup>109</sup> 17 C.F.R. § 205.2(d).

<sup>110</sup> *Id.* § 205.2(i).

<sup>111</sup> Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 34-46868, 67 Fed. Reg. 71,670, 71,679 (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. pt. 205).

<sup>112</sup> *See* 17 C.F.R. § 205.3(b)(1).

<sup>113</sup> *See id.* § 205.2(i).

<sup>114</sup> *See* Management's Discussion and Analysis of Financial Condition and Results of Operations (Item 303), 17 C.F.R. § 229.303(a) (2002).

<sup>115</sup> *See* Susan P. Koniak, *Corporate Fraud: See, Lawyers*, 26 HARV. J.L. & PUB. POL'Y 195, 201-10 (2003).

<sup>116</sup> As lawyers for public companies are well aware, significant legal contingencies of actual or threatened lawsuits, or other legal action, can have a significant effect on financial statement amounts. To the extent that legal action is unresolved, or not filed, auditors may be required under GAAP to disclose loss contingencies. *See* FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 5: ACCOUNTING FOR CONTINGENCIES 6-7 (1975). As the Coca Cola, Texaco, and other recent discrimination suits demonstrate, discrimination suits can have a significant effect not only on financial statement amounts but also on the corporation itself. *See supra* notes 40-45. In that respect, management may be under a separate obligation to disclose contingent

This approach would be consistent with the broad range of company activities that usually involve review by lawyers. The SEC's treatment of disclosure of contingent liabilities<sup>117</sup> and the development of the required disclosures under Management's Discussion and Analysis of Financial Condition (MD&A)<sup>118</sup> provide two examples of the breadth of issues requiring lawyer involvement; such issues are likely to expose the lawyer to potential evidence of material violations far more extensive than mere direct violation of the securities laws. Regulation S-K, section 103, requires disclosure of any material pending legal proceedings.<sup>119</sup> Environmental litigation is subject to special instructions designed to induce disclosure.<sup>120</sup> Lawyers involved in the preparation of disclosure under Item 103 would necessarily be exposed to information that might reasonably be believed to constitute evidence of a material violation. Even where disclosure is not required under Item 103, the sweep of disclosure required by MD&A and Item 303 may expose the prudent lawyer to information requiring disclosure under the SOA section 307 regulations.<sup>121</sup> The Instructions to Item 303 specify that MD&A disclosure "shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition."<sup>122</sup> To the extent that lawyers are involved in the due diligence necessary for appropriate disclosure, evidence of a

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liability arising out of actual or threatened legal action. *See, e.g.*, Standard Instructions for Filing Forms under the Securities Act of 1933, Reg. S-K, (Item 103) Legal Proceedings, 17 C.F.R. § 229.103.

<sup>117</sup> *See* 17 C.F.R. § 229.103.

<sup>118</sup> Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Exchange Act Release No. 34-26831, 54 Fed. Reg. 22,427 (May 24, 1989) (to be codified at 17 C.F.R. pts. 211, 231, 241, 271).

<sup>119</sup> *See* 17 C.F.R. § 229.103.

<sup>120</sup> *See id.* n.5. Administrative or judicial proceedings involving violation of the environmental laws are subject to disclosure if the proceedings or litigation are either material to the business or financial condition of the company, involve claims exceeding 10 percent of the current assets of the company, or the government is a party to the proceedings and the claim will result sanctions of less than \$100,000. *Id.*

<sup>121</sup> *See* Management's Discussion and Analysis of Financial Condition and Results of Operations (Item 303), 17 C.F.R. § 229.303; Sarbanes Oxley Act of 2002 § 307, 15 U.S.C.A. § 7245 (West Supp. 2003).

<sup>122</sup> 17 C.F.R. § 229.303(a), Instructions to Paragraph 303(a) no.3.

material violation of a contingent nature would likely come to the attention of counsel.<sup>123</sup> The evidence might well be of wrongs potentially far a field of mere technical securities laws compliance issues; that is, it might relate to underlying wrongs that might have a material effect on the financial statements and thus on the company's disclosure obligations. Because "[a] disclosure duty exists where a trend, demand, commitment, event or uncertainty is both presently known to management and reasonably likely to have material effects on the registrant's financial condition or results of operation,"<sup>124</sup> it seems that the scope of the lawyer's obligation under section 307 would extend to the preparation of those disclosures as well as to the underlying events or uncertainties comprising the subjects of that disclosure. Read together with company disclosure obligations under the securities laws, the scope of material violations subject to reporting under the regulations to SOA section 307 would logically have to include disclosures of violations of any law that might have a material effect on the company.

Proper disclosure, however, would do more. SOA section 307 affects the auditor's parallel obligations under section 10A and management's parallel obligations under SOA section 404. In particular, the new lawyer detect-and-report provisions will substantially affect the reporting of legal contingencies, both to management and to the company's auditors.<sup>125</sup> It is possible to take the position that SOA section 307 and section 10A, either separately or taken together, have upset the carefully-crafted compromise between auditors and lawyers with respect to lawyers' responses to auditors' inquiry letters,<sup>126</sup> which is

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<sup>123</sup> As Professor Koniak reminds us, in reviewing the web of transactions leading to the Enron disaster, lawyers were heavily involved in all of the transactions on behalf of all of the parties and their accountants. See Koniak, *supra* note 115, at 201-10.

<sup>124</sup> Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Exchange Act Release No. 34-26831, 54 Fed. Reg. 22,427, 22,429 (interpretive release May 24, 1989) (to be codified at 17 C.F.R. pts. 211, 231, 241, 271).

<sup>125</sup> I thank Lance Cole, Pennsylvania State University, for this insight.

<sup>126</sup> Matthew Barrett recently well described the pre-SOA conflict between auditors and lawyers with respect to disclosure:

The enterprise's auditors generally want to encourage as much disclosure as possible, or even adequate accruals, to ensure that the financial statements do not understate or overlook material liabilities. In the

reflected in the ABA's "Auditor's Letter Handbook" monograph.<sup>127</sup> In particular, the agreement with respect to loss contingencies involving "unasserted possible claims"<sup>128</sup> that a lawyer currently must reveal to an auditor only when the client has authorized/requested in writing that the lawyer do so violates both the letter and spirit of both provisions in a post-Enron/WorldCom world. The policy behind the ABA's Auditor's Letter Handbook rested on the now discredited view of an expansive duty of counsel to keep a client's secrets.<sup>129</sup> That broad interpretation of confidentiality was substantially narrowed by the requirements of SOA section 307 on outside counsel, the requirements of SOA section 404 on management, and the requirements of SOA section 404 and section 10A on auditors. Material unasserted claims may well constitute evidence of a "material violation" which must be reported to management<sup>130</sup> and on which management must act.<sup>131</sup> Such claims may also be subject to the internal controls procedures required by SOA section 404,<sup>132</sup> to an auditor's obligation to detect and report illegal acts, and to ensure that such illegal acts do not have a material effect on financial statement amounts.<sup>133</sup>

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absence of an accrual, the auditor wants the financial statements to disclose as much information as possible about a material contingent liability to communicate all relevant information to the users of financial statements. In addition, the auditor wants to gather as much information as possible to support the enterprise's treatment of contingent liabilities. Disclosure and documentation help to protect the auditor from liability if the client experiences future financial problems. Lawyers, on the other hand, strive to protect the attorney-client privilege. These goals conflict, because a lawyer's disclosure of information to auditors can waive the attorney-client privilege.

Matthew J. Barrett, *Opportunities for Obtaining and Using Litigation Reserves and Disclosures*, 63 OHIO ST. L.J. 1017, 1051 (2002).

<sup>127</sup> See A.B.A., AUDITOR'S LETTER HANDBOOK 11 (1990).

<sup>128</sup> *Id.* at 12.

<sup>129</sup> Official commentary on lawyer-client confidentiality in relations to auditors is available. See, e.g., A.B.A., *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information*, 31 BUS. LAW. 1709, 1709-10 (1976); Subcomm. on Audit Inquiry Responses, A.B.A., *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretation AU Section 337*, 45 BUS. LAW. 2245, 2245-46 (1990); James J. Fuld, *Lawyers' Responses to Auditors—Some Practical Aspects*, 44 BUS. LAW. 159, 164-65 (1988).

<sup>130</sup> See Sarbanes-Oxley Act of 2002 § 307(1), 15 U.S.C.A. § 7245 (West Supp. 2003).

<sup>131</sup> See *id.*, 15 U.S.C.A. § 7245.

<sup>132</sup> See *id.* § 404, 15 U.S.C.A. § 7262.

<sup>133</sup> See Private Securities Litigation Reform Act of 1995 § 301, 15 U.S.C. § 78j-

Lawyers will likely no longer be able to hide behind the ABA Auditor's Letter Handbook to avoid disclosure of material unasserted contingencies or to avoid liability either under SOA section 307<sup>134</sup> or the securities laws.<sup>135</sup> SOA section 307, in particular, will therefore substantially affect the scope and nature of the reporting of assertions of violation, especially of violations of laws that do not directly affect the financial statements, like discrimination, environmental, and health and safety laws, both up the ladder and to the auditors. A secondary but significant effect might well be that some of these disclosures will more readily and rapidly find their way into at least the footnotes of a company's financial statements. To the extent that such disclosure in the financial statements affects share price, it may increase management's motivation to investigate and resolve *rather than resist* the object of the complaint or allegation. Also, to the extent the old compromise between auditors and lawyers was undermined by the requirements of recent securities legislation, the likelihood grows for greater discovery opportunities, at the expense of traditional and now displaced rules of attorney-client confidentiality.

The comments to the language of the proposed regulation under SOA section 307 demonstrate the legal community's broad understanding of the scope of the term "material violation"<sup>136</sup> and its primary focus. Interestingly, the most telling comments about the scope of material violations were received in reaction to 17 C.F.R. § 205.3(d)(2).<sup>137</sup> As originally proposed, disclosure

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1(b)(1) (2000).

<sup>134</sup> This is an obligation owed to and policed by the government, but with the potential for spilling over into private litigation. *See infra* Part III.

<sup>135</sup> To some extent the ABA manual, like GAAP and GAAS for auditors, will not provide much of a shield against liability where it can be shown that a gatekeeper became aware of misconduct and failed to act on it in some reasonable way. *See infra* Part III.B.2.

<sup>136</sup> Sarbanes-Oxley Act of 2002 § 307(1), 15 U.S.C.A. § 7245.

<sup>137</sup> 17 C.F.R. § 205.3(d)(2)(i) (2003) (permitting lawyers to disclose, without the consent of the client, otherwise privileged information of a material violation where injury to property or to the financial interests of investors are at stake).

Substantially similar rules were added to the ABA Model Rules of Professional Conduct by vote of the ABA House of Delegates at its August, 2003 meeting. *See Client Confidentiality*, CHRISTIAN SCI. MONITOR, Aug. 13, 2003, at 8.

The ABA, at its annual meeting in San Francisco, voted to modify its rules regarding the fiercely protected attorney-client privilege. When actions by a client harm the financial interests of others, the ABA says, a lawyer has an obligation to the public good to report the wrongdoing. . . . The ABA

was required with respect to “illegal acts,” the term similar to the one used in section 10A.<sup>138</sup> Some argued that it should not be a lawyer’s duty to correct or report illegal activities, “or even to prevent wrong-doing.”<sup>139</sup> Others suggested that the obligation be “limited to illegal acts that are likely to have a material impact on the market for the issuer’s securities.”<sup>140</sup> Still others argued that the duty to disclose should be limited to those instances where there existed a risk of bodily harm but not where mere monetary interests were at stake.<sup>141</sup> In response, the SEC chose to substitute the term “material violation” for “illegal act,” in order to “conform to the statutory language in section 307.”<sup>142</sup> However, the SEC did not suggest that the change of language meant to change the intent or scope of the provision as finally adopted. It would seem then, that this action is strong evidence of intent by the SEC to conflate the scope of “illegal acts” under section 10A<sup>143</sup> and “material violations” under SOA section 307.<sup>144</sup>

A reasonable construction of the scope of the reporting obligation under the regulations to SOA section 307 is necessarily broad. The regulation is written that way. The scope of lawyers’ involvement in the disclosure and due diligence obligations of companies under the Securities Acts makes it

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acted in the face of a Securities and Exchange Commission threat to force the issue of attorneys cooperating with its investigations of corporate malfeasance. The SEC already had enacted new rules that require lawyers for public companies to tip regulators to clients when they believe clients are committing fraud.

*Id.* It remains to be seen, however, whether and to what extent state regulators will adopt the rule. My suspicion is that eventually a majority of them will, as states have increasingly as a matter of course, follow the federal lead.

<sup>138</sup> See Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 34-47276, 68 Fed. Reg. 6296, 6310 (Feb. 6, 2003) (to be codified at 17 C.F.R. pt. 205).

<sup>139</sup> *Id.* (quoting Comments of the Law Society of England and Wales, at 12).

<sup>140</sup> *Id.* (citing Comments of the Los Angeles County Bar Association, at 2; Comments of Edward C. Brewer III at 8; Comments of the Association of the Bar of the City of New York, at 5).

<sup>141</sup> See *id.* at 6310–11 (citing Comments of the American College of Trial Lawyers, at 6).

<sup>142</sup> *Id.* at 6311 (commenting on 17 C.F.R. § 205.3(d)(2)). Subparagraph (iii) was also modified to clarify that the “material violation must be one that has ‘caused, or may cause, substantial injury to the financial interest or property of the issuer or investors.’” *Id.* (quoting 17 C.F.R. § 205.3(d)(2)(iii)).

<sup>143</sup> 15 U.S.C. § 78j-1(f) (2000).

<sup>144</sup> Sarbanes-Oxley Act of 2002 § 307(1), 15 U.S.C.A. § 7245 (West Supp. 2003).

almost impossible to conceive of a definition of a scope of reporting smaller than the scope of a lawyer's activities for its client. In its own way, it provides a sweep analogous to section 10A(f) as applied to the reporting obligations of auditors.

## II. THE POSITIVE NATURE OF THE DUTY TO MONITOR.

It is one thing to impose a reporting requirement on lawyers and accountants. It is quite another to determine the nature and extent of the duties of these new gatekeepers. The imposition of an obligation to report does not necessarily include an obligation to investigate, or at least to put oneself in a position that increases the likelihood that relevant information will be encountered. On the one hand, it is possible to argue that the gatekeeper provisions do not impose any positive duty to act on lawyers and accountants. Information that comes to the attention of such gatekeepers in the normal course of their representation is the only sort of information with respect to which these gatekeepers have a duty to act. On the other hand, the statutes could be interpreted to impose a positive obligation on accountants and lawyers to implement information-gathering systems designed to discover facts relating to their respective reporting obligations.

Neither section 10A of the 1934 Act nor section 307 of SOA clearly describes the approach to monitoring which is required under either provision. It is not difficult to suggest that, with the possible exception of misconduct directly related to the federal securities laws, the detection obligation is passive. I suggest, however, that this reading neither accords with the general intent of Congress in creating the gatekeeper roles for auditors and lawyers, nor with a fair reading of the provisions in context. Reasonably read, both provisions appear to create positive obligations to discover and report corporate illegal conduct of every sort. With respect to auditors, the positive obligation suggests a rejection of a division between the way auditors approach illegal acts that have an indirect rather than a direct and material effect on the financial statements.<sup>145</sup> With respect to lawyers, that positive obligation accords with developments in Delaware duty of care law<sup>146</sup> and changes the

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<sup>145</sup> See SAS 54, *supra* note 65, at AU § 317.06.

<sup>146</sup> See *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. Ch.

way in which federal prosecutors approach the determination of corporate culpability for purposes of charging corporations with crimes.<sup>147</sup>

A. *The Auditor's Positive Monitoring Obligations.*

It is generally undisputed that auditors have some sort of obligation to detect and report unlawful activities. The scope of that obligation might be quite broad.<sup>148</sup> The nature of the obligation may also be quite broad, especially after the enactments of sections 10A and SOA. The auditing profession's obligations to detect and report unlawful conduct have three primary sources: accounting standards developed by the profession itself, case law, and statutory enactments. These sources, when read together, evidence an intention to broadly define the nature and scope of the detection obligation.

The most relevant accounting standards are the Statement on Auditing Standards (SAS) 54<sup>149</sup> and 99.<sup>150</sup> SAS 54 is particularly ambiguous about the nature of the obligation to detect illegal activities, given the distinction made in that standard between acts that cause direct and material effects and those that have a material but indirect effects on the financial statements.<sup>151</sup> It is fairly clear that under the standard, auditors have a positive obligation to detect illegal acts that have a direct and material effect on the financial statements.<sup>152</sup> These acts

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1996) (listing the elements of the Delaware duty of care as it is applied to directors).

<sup>147</sup> See Memorandum from Larry D. Thompson, Deputy Attorney General, U.S. Dept. of Justice, to Heads of Dept. Components, U.S. Attorneys, Principles of Federal Prosecution of Business Organizations (Jan. 20, 2003), [http://www.usdoj.gov/dag/cftf/corporate\\_guidelines.htm](http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm).

<sup>148</sup> See *supra* Part I.A.

<sup>149</sup> See SAS 54, *supra* note 65, at AU § 317.

<sup>150</sup> Statement on Auditing Standards No. 99, Consideration of Fraud in a Financial Statement Audit (American Inst. of Certified Pub. Accountants 2002) [hereinafter SAS 99]. SAS 99, effective December 15, 2002, supercedes SAS 82. *Id.* at para. 84. SAS 82, effective starting December 17, 1997, is the successor to SAS No. 53. See Statement on Auditing Standards No. 82, Consideration of Fraud in a Financial Statement Audit, para. 41 (American Inst. of Certified Pub. Accountants 1997) [hereinafter SAS 82]; CODIFICATION OF STATEMENTS ON AUDITING STANDARDS AU § 316 (American Inst. of Certified Pub. Accountants 2000) (citing Statement on Auditing Standards No. 82); Steven Burkholder, *New Fraud Reporting Rules are Not Mere Clarifications, ASB Chairman Warns*, 28 SEC. REG. & L. REP. 1528, 1529 (1996).

<sup>151</sup> See SAS 54, *supra* note 65, at AU § 317.05-07.

<sup>152</sup> See *id.* § 317.05.

are understood to primarily encompass acts of fraud.<sup>153</sup> "The auditor's responsibility to detect and report misstatements resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for misstatements caused by error or fraud . . . ."<sup>154</sup>

The obligation to detect and report financial statement fraud is treated specifically in SAS 99.<sup>155</sup> Under this standard, the "auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."<sup>156</sup> SAS 99 focuses only on a subset of illegal acts governed by SAS 54<sup>157</sup>, such as internal falsification of financial statement amounts and theft.<sup>158</sup> With respect to these acts, SAS 99 provides rules relating to the construction of appropriate audit procedures for detecting fraud.<sup>159</sup> Included among the risk factors for financial statement fraud is an assessment of management's actions with respect to internal controls.<sup>160</sup> When a draft of SAS 82, the predecessor of SAS 99, was circulating, an official of the AICPA was quoted as saying that the aim of the new standard was to induce "auditors to focus more on suspicious situations and carry a healthy skepticism with them when they do their job."<sup>161</sup>

With respect to illegal acts that may have an indirect but material effect, however, SAS 99 is silent and SAS 54 suggests that the auditor may not become aware of these acts "unless he is informed by the client, or there is evidence of a governmental agency investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements."<sup>162</sup> Echoing this notion, commentators have expressed the view that because "[United States]

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<sup>153</sup> See generally SAS 99, *supra* note 150 (entitled "Consideration of Fraud in a Financial Statement Audit").

<sup>154</sup> SAS 54, *supra* note 63, at AU § 317.05.

<sup>155</sup> See SAS 99, *supra* note 150, at para. 1.

<sup>156</sup> *Id.* (citing in part prior section 110, Responsibilities and Functions of the Independent Auditor).

<sup>157</sup> See SAS 54, *supra* note 65, at AU § 317.02.

<sup>158</sup> Compare *id.*, with SAS 99, *supra* note 151, at para. 5-12.

<sup>159</sup> See SAS 99, *supra* note 150, at para.19-27.

<sup>160</sup> See *id.*

<sup>161</sup> Lee Berton, *Auditors Face Stiffer Rules for Finding, Reporting Fraud at Client Companies*, WALL ST. J., Feb. 5, 1996, at A2.

<sup>162</sup> SAS 54, *supra* note 65, at AU § 317.06.

businesses are subject to so many laws and regulations that, if violated, could lead to material consequences, it is questionable whether an audit can be designed to provide reasonable assurance of detecting all illegal acts that may have a material effect on financial statements."<sup>163</sup> However, the SAS 54 description is not meant to serve as a shield to justify a passive approach to illegal acts. SAS 54 provides that:

Normally, an audit in accordance with generally accepted auditing standards does not include audit procedures specifically designed to detect illegal acts. However, procedures applied for the purpose of forming an opinion on the financial statements may bring possible illegal acts to the auditor's attention. For example, such procedures include reading minutes; inquiring of the client's management and legal counsel concerning litigation, claims, and assessments; performing substantive tests of details of transactions or balances. The auditor should make inquiries of management concerning the client's compliance with laws and regulations.<sup>164</sup>

Thus, while there appears to be no *obligation* under the standard to include procedures that *directly* detect illegal acts with indirect material effects on the financial statements, the standard appears to raise an *expectation* that illegal acts will be detected. The accounting profession has long established standards and procedures for verifying management's assertions with respect to certain contingencies, litigation, claims, and assessments.<sup>165</sup> Indeed, AU section 337.07 reminds auditors that an "audit normally includes certain other procedures undertaken for different purposes that might also disclose litigation, claims, and assessments."<sup>166</sup> These include reviews of corporate minutes, contracts, loan agreements, leases, correspondence

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<sup>163</sup> Jeanne Calderon & Rachel Kowal, *Auditors Whistle an Unhappy Tune*, 75 DENV. U. L. REV. 419, 438 (1998) (relying, in part, on Jane Mancino, *The Auditor and Fraud*, J. ACCT., April 1997, at 32, 36).

<sup>164</sup> SAS 54, *supra* note 65, at AU § 317.08.

<sup>165</sup> Auditors are instructed first to obtain information from management and counsel regarding litigation. See CODIFICATION OF STATEMENTS ON AUDITING STANDARDS, Inquiry of a Client's Lawyer Concerning Litig., Claims, and Assessments, AU § 337.05 (American Inst. of Certified Pub. Accountants 1976) (citing Statement on Auditing Standards No. 12) In addition, the auditor is to "[e]xamine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers." *Id.* at AU § 337.05(c).

<sup>166</sup> *Id.* at AU § 337.07.

from governmental agencies, and similar documents.<sup>167</sup> With such a broad sweep, it is more likely than not that these procedures will also potentially uncover illegal acts other than those referenced by management and the focus of the audit inquiry. With respect to those acts, auditing standards and section 10A now require auditors to take action.

On the other hand, the *expectation* appears to be greater in the context of fraud, and this is especially true of fraud with a direct material effect on financial statement amounts. In those cases, the auditor has a positive obligation to plan and perform the audit in order to obtain reasonable assurance that the financial statements are free of material misstatements caused by fraud or error.<sup>168</sup> But this expectation appears to run to other illegal acts defined in SAS 54 as well: "For those illegal acts that are defined in [section 317] as having a direct and material effect on the determination of financial statement amounts, the auditor's responsibility to detect misstatements resulting from such illegal acts is the same as that for errors or fraud."<sup>169</sup> Thus, "when fraud is detected, the auditor should consider the implications for the integrity of management or employees and the possible effect on other aspects of the audit."<sup>170</sup> Auditing standards thus appear to cut more heavily in favor of a contextually limited, but nonetheless positive, duty to detect illegal acts.

This positive obligation has been amplified in judicial opinions. Courts have recognized that auditors serve not only the management of the company being audited but investors as well. In an often-quoted passage, the Supreme Court described the duty of an accountant, independent of additional statutory requirements, as "a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders . . . ."<sup>171</sup> Thus, it is almost a truism that "[a]ccountants do have a duty to take reasonable steps to correct misstatements they have

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<sup>167</sup> See *id.* at AU § 337.07(b).

<sup>168</sup> See SAS 99, *supra* note 150, at para. 3.

<sup>169</sup> CODIFICATION OF STATEMENTS ON AUDITING STANDARDS, Audit Risk and Materiality in Conducting an Audit, AU § 312.04 n.5 (American Inst. of Certified Pub. Accountants 1984).

<sup>170</sup> *Id.* at AU § 312.08.

<sup>171</sup> *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984).

discovered in previous financial statements on which they know the public is relying.”<sup>172</sup>

Absent a specific obligation, however, accountants do not have a positive duty to seek out and disclose illegal activity on the part of the company or its agents. Thus, for example, in *Ahmed v. Trupin*,<sup>173</sup> the court held that accountants have no positive “obligation to seek out fraud. If they do not know the data they audit is fraudulent, and the fraudulent nature of the data given them is not apparent, accountants are not liable if they audit it in accordance with GAAP.”<sup>174</sup> Other courts have reasoned that “while an accountant’s role may create a duty to disclose errors in financial statements, an accountant has no duty to disclose improper loans and investments since these wrongs are ‘not dependent on or tied to’ the role of an accountant.”<sup>175</sup>

The issue of the nature of an auditor’s duty was particularly important prior to the Supreme Court’s decision in *Central Bank of Denver v. First Interstate Bank of Denver*.<sup>176</sup> Before *Central Bank*, an accountant’s liability for aiding and abetting securities fraud under Rule 10b-5<sup>177</sup> could depend on a determination that the auditor had a duty to detect and report issuer misconduct.<sup>178</sup> While the judicial gloss on auditor disclosure duties was not consistent, the cases suggested a judicial willingness to impose on auditors whether narrowly or broadly drawn a duty to disclose under certain circumstances.<sup>179</sup> While aider and abettor

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<sup>172</sup> *Int’l Inv. Trust v. Cornfeld*, 619 F.2d 909, 927 (2d Cir. 1980).

<sup>173</sup> 809 F. Supp. 1100 (S.D.N.Y. 1993).

<sup>174</sup> *Id.* at 1111.

<sup>175</sup> *Shapiro v. Cantor*, 123 F.3d 717, 722 n.3 (2d Cir. 1997) (quoting *Cornfeld*, 619 F.2d at 925).

<sup>176</sup> 511 U.S. 164, 191 (1994) (holding that section 10(b) and Rule 10b-5 do not provide a basis for private actions against aiders and abettors).

<sup>177</sup> See 17 C.F.R. § 240.10b-5 (2003). In connection with the purchase or sale of any security, Rule 10b-5 forbids the use of “any device, scheme, or artifice to defraud, . . . [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made . . . not misleading, or [t]o engage in any act, practice, or course of business which operates . . . as a fraud upon any person.” *Id.*

<sup>178</sup> See, e.g., Robert A. Prentice, *Locating That “Indistinct” and “Virtually Nonexistent” Line Between Primary and Secondary Liability Under Section 10(b)*, 75 N.C. L. REV. 691, 761–69 (1997) (discussing aider and abettor liability before 1994); Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80, 83–86 (1981) (same).

<sup>179</sup> See Painter, *supra* note 73, at 1411–13 (discussing auditors’ duty to disclose). “The three most commonly used standards for defining an auditor’s duty

liability for auditors has disappeared, auditors now face the possibility of primary liability under Rule 10b-5.<sup>180</sup>

Judicial development of standards for determining accountant liability was sometimes tied to auditing standards. Thus, adherence to the standards of SAS 54 or former SAS 53 and 82 (superseded now by SAS 99) was said to provide a touchstone for determining whether auditor conduct was reckless enough to support a finding of scienter necessary for primary liability under section 10b-5.<sup>181</sup> The courts, however, did not adopt a uniform approach.<sup>182</sup> What clearly emerged from the cases was a sense that while professional standards were important in determining the scope and nature of legal obligations under statutory and case law, such standards were not always or necessarily dispositive of such legal liability. The professional standards increasingly a greater obligation imposed on auditors to be sensitive to corporate illegal conduct.

The primary statutory enactments focusing on auditor duties to detect and report are found in section 10A of the Exchange Act and in SOA. Under section 10A, auditors are required to include in their audits "procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts."<sup>183</sup> The procedures need not be designed to detect all illegal acts. The positive obligation imposed on auditors requires only the design of procedures

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to disclose a client's securities fraud include: duties narrowly prescribed by the accounting profession under GAAP and GAAS; duties broadly defined without regard to GAAP and GAAS; and duties narrowly defined without regard to GAAP and GAAS." Francine A. Ritter, Note, *Accountability of the Independent Accountant as Auditor in the Wake of Central Bank: Does the Implied Private Right of Action Survive Under Section 10(b) and Rule 10b-5?*, 31 SUFFOLK U. L. REV. 873, 881-82 (1998).

<sup>180</sup> See, e.g., *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 976 (C.D. Cal. 1994) (holding that there was a duty to withdraw or disclose in light of public reliance on prior audit reports).

<sup>181</sup> See, e.g., *In re SCB Computer Tech., Inc.*, 149 F. Supp. 334, 364 n.12 (W.D. Tenn. 2001) (stating that compliance with SAS No. 82 "would at most allow for a finding of negligence").

<sup>182</sup> See, e.g., *In re Software Toolworks, Inc.*, 50 F.3d 615, 627-28 (9th Cir. 1994) (holding that gross departures from auditing standards are not enough to demonstrate recklessness); *Ades v. Deloitte & Touche*, 799 F. Supp. 1493, 1501-02 (S.D.N.Y. 1992) (holding that gross deviation from auditing standard may be sufficient to prove scienter).

<sup>183</sup> 15 U.S.C. § 78j-1(a)(1) (2000).

targeted toward the detection of illegal acts that have a "direct and material effect" on the calculation of amounts in the financial statements.<sup>184</sup> Even that targeted obligation with respect to the design of procedures is further limited. The procedures need not detect all illegal acts with a direct and material effect; they only need to provide "reasonable assurance" that they will detect such illegal acts.<sup>185</sup> Thus, the *focus* of the procedures is on illegal acts with a direct and material effect on financial statement amounts, and the *effectiveness* of the procedures in detecting such illegal acts is to be determined by a "reasonable assurances" standard. The result is that auditors are not subject to an absolute liability standard for failing to detect every illegal act or even for failing to detect illegal acts with a direct and material effect on financial statement amounts. Nevertheless, the intended obligations of auditor's with respect to the design and implementation of audit procedures were to be greater than those previously provided under GAAS.<sup>186</sup>

This understanding of the focus of the monitoring obligation of auditors under section 10A, however, does not necessarily mean that auditors can implement procedures narrowly designed to detect only illegal acts with direct and material effect on financial statement amounts. The reporting and response provisions of section 10A contemplate the creation of a system capable of detecting the full range of illegal acts defined in section 10A(f). Section 10A(b) describes the obligations of an auditor who, in the course of conducting an audit, "detects or otherwise becomes aware of information indicating that an illegal act (*whether or not perceived to have a material effect on the financial statements of the issuer*) has or may have occurred."<sup>187</sup> This provision makes no sense unless it is understood to assume that the procedures created under the mandate of section 10A(a), while focusing on illegal acts with direct and material effect on financial statement amounts, will also result in the detection of, or make it more likely, that

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<sup>184</sup> *Id.*

<sup>185</sup> *Id.*

<sup>186</sup> The views of Harvey Pitt, SEC chairman at the time of the enactment of SOA, on the character of auditors' new obligations under section 10A were well known. See Harvey L. Pitt & David B. Hardison, *For Outside Accountants, The New Obligations Imposed by the Securities Litigation Reform Act Go Way Beyond Classical GAAS*, NAT'L L.J., Mar. 25, 1996, at B4.

<sup>187</sup> 15 U.S.C. § 78j-1(b)(1) (emphasis added).

information will be produced indicating that an illegal act has occurred. The expectation built into this provision clearly contemplates that the auditing procedures will detect or make it more likely that the auditor will become aware of the range of illegal acts defined in section 10A(f). Therefore, procedures designed to reduce the likelihood of detecting or becoming aware of information, which indicates that an illegal act has or may have occurred, appear contrary to the letter and spirit of section 10A(b).

This result is made clearer by the procedures which auditors must follow once they detect information about illegal acts described in section 10A(b)(1). Auditors are required to report illegal acts to the appropriate level of management once they "determine whether it is likely that an illegal act has occurred"<sup>188</sup> and "consider the possible effect of the illegal act on the financial statements of the issuer, *including any contingent monetary effects, such as fines, penalties, and damages.*"<sup>189</sup> Thus, while the procedures which auditors are required to design may be focused on a reasonable assurance of the detection of direct and material effect on financial statement amounts, the nature and scope of the auditor's reporting duty to management is far broader. The *focus* of the reporting obligation is on illegal acts as defined in section 10A(f), other than those which are "clearly inconsequential."<sup>190</sup> Consequential illegal acts include those with "direct and material effect on the determination of financial statement amounts"<sup>191</sup> and those with "contingent monetary effects, such as fines, penalties, and damages."<sup>192</sup> The *effectiveness* of the reporting obligation must necessarily be measured by the procedures used by the auditor, including (but not limited to) the procedures required under section 10A(a), yet it exists independent of the obligation to design the procedures described in section 10A(a). Clearly, section 10A creates a positive obligation to detect and report illegal acts. Such acts need not be narrowly connected with violations of the securities laws; they should necessarily include violations of the

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<sup>188</sup> *Id.* § 78j-1(b)(1)(A)(i).

<sup>189</sup> *Id.* § 78j-1(b)(1)(A)(ii) (emphasis added).

<sup>190</sup> *Id.* § 78j-1(b)(1)(B).

<sup>191</sup> *Id.* § 78j-1(a)(1).

<sup>192</sup> *Id.* § 78j-1(b)(1)(A)(ii).

discrimination, labor, environmental, consumer, and health and safety laws.

This positive obligation to detect and report, and especially to report illegal acts with indirect or contingent effects on financial statements, was reinforced by certain provisions applicable to auditors in SOA. As a part of their auditing procedures, SOA requires auditors to review the report submitted by management as part of its expanded MD&A analysis under SOA section 404.<sup>193</sup> The act provides that each "registered public accounting firm that prepares [or issues] the company's audit report [for the issuer shall] attest to, and report on, management's assessment of the effectiveness of the company's internal controls."<sup>194</sup> Read in a vacuum, the provision

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<sup>193</sup> Sarbanes-Oxley Act of 2002 § 404 (b), 15 U.S.C.A. § 7262(b) (West Supp. 2003). A few days after the adoption of final rules under SOA section 404, Scott A. Taub, the SEC's Deputy Chief Accountant, in prepared remarks stated:

The potential impact of the requirements for both management and auditors to issue reports related to issuers' internal controls cannot be understated. We believe that the increased attention to internal controls on the part of the management will reduce the potential for errors in the financial statements, including those due to fraud. The attestation by the auditor will provide additional assurance in this regard, and, not trivially, should also increase the quality of audits. In fact, Congress made it clear that it considers the internal control attestation by the auditor to be important to the financial statement audit by prohibiting the attestation from being a separate engagement.

Scott A. Taub, *The SEC's Internal Control Report Rules and Thoughts on the Sarbanes-Oxley Act*, Address at University of Southern California Leventhal School of Accounting SEC and Financial Reporting Conference, Pasadena, California (May 29, 2003) [hereinafter Taub Speech], <http://www.sec.gov/news/speech/spch052903sat.htm> (last visited Sept. 30, 2003). However, the SEC chose to limit the focus of the expanded reporting by management to the financial statements disclosed to investors by narrowly defining the term "internal control over financial reporting" as a process to provide reasonable assurance regarding the reliability of the financial statements for external purposes which must include procedures pertaining to recordkeeping, recording of transactions (with an emphasis on authorizations for receipts and expenditures), and prevention of unauthorized action with respect to assets. See *Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, Exchange Act Release No. 34-47986, 68 Fed. Reg. 36,636, 36,640 (June 18, 2003) (to be codified at 17 C.F.R. pts. 210, 228, 229, 240, 249, 270, 274).

<sup>194</sup> Taub Speech, *supra* note 193. The SEC's final rule provides:

Attestation report on management's assessment of internal control over financial reporting. The term attestation report on management's assessment of internal control over financial reporting means a report in which a registered public accounting firm expresses an opinion, or states that an opinion cannot be expressed, concerning management's assessment of the effectiveness of the registrant's internal control over financial

could be interpreted as adding little to the obligations of auditors. In this light, the provision merely builds on audit requirements refined recently in SAS 82, now modified as SAS 99.<sup>195</sup> Thus, drafting its final regulations to SOA section 404, the SEC resisted proposals "to adopt a considerably broader definition of internal control that would focus not only on internal control over financial reporting, but also on internal control objectives associated with enterprise risk management and corporate governance."<sup>196</sup>

It is, however, also possible to interpret the provision as effectively increasing the nature and character of the auditor's assessment, more directly imposing on management substantial additional responsibility for the development and maintenance of internal control systems under section 404. Read together with

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reporting (as defined in § 240.13a-15(f) or 240.15d-15(f) of this chapter) in accordance with standards on attestation engagements. When an overall opinion cannot be expressed, the registered public accounting firm must state why it is unable to express such an opinion.

Definitions of Terms Used in Regulation S-X, 17 C.F.R. § 210.1-02(a)(2) (2003).

It should be noted that attestation standards, once the sole province of accountant self-regulation, are now to be modified, at least with respect to public companies, through action by and under the guidance of, the Public Company Accountant Oversight Board (PCAOB), an entity created by SOA. The PCAOB has adopted the AICPA standards as interim measures and is now considering changes to attestation standards based, in part, on an exposure draft circulated by the AICPA. See Taub Speech, *supra* note 193.

<sup>195</sup> Indeed, section 404's obligation's are consistent with the auditor's duty under SAS No. 99 to review management's internal controls for purposes of detecting fraud in the financial statements. See SAS 99, *supra* note 150, at para. 19-27.

A public company's ability to withstand pressures to provide false or misleading information to the public depends a great deal on the effectiveness of internal controls. Effective internal controls are the best defense against fraudulent reporting. That is why the AICPA has for years strongly advocated internal control reporting by management, and we applaud the SEC for taking this step today.

James O'Malley, AICPA Senior Vice President for Public Affairs, AICPA Applauds SEC Action on Internal Controls (May 27, 2003), at <http://www.aicpa.org/news/2003/030527.asp> (last visited Sept. 30, 2003).

<sup>196</sup> Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 68 Fed. Reg. at 36,639. The SEC maintained that: "While we agree that these are important objectives, the definition that we are adopting retains a focus on financial reporting, consistent with our position articulated in the Proposing Release." *Id.* Indeed, the SEC made clear its reluctance to expand the responsibility of auditors beyond their traditional scope. "[I]ndependent accountants traditionally have not been responsible for reviewing and testing, or attesting to an assessment by management of, internal controls that are outside the boundary of financial reporting." *Id.* at 36,639-40.

section 10A, the auditor's SOA section 404 report and attestation add more than an additional review responsibility. Rather, the obligation to oversee management's review procedures under SOA section 404 necessarily requires the auditor to include procedures designed to provide reasonable assurance of detecting illegal acts with direct and material effect on the financial statements. Section 10A obligates the auditor in a SOA section 404 review to report to management—and possibly the SEC—every illegal act that is discovered and not inconsequential.<sup>197</sup> The result is not merely the amalgamation of a random of section numbers. The addition of SOA section 404 extends the positive character of an auditor's obligation to investigate to include the form and substance of management's own internal systems of control. In this sense, SOA section 404 to some extent undercuts the distinction made in SAS 54 between illegal acts with direct and indirect effects on the financial statements.<sup>198</sup>

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<sup>197</sup> Scott Taub described the SEC's sense of the nature of an auditor's obligation under SOA section 404:

While external auditors cannot make the initial evaluation and determination as to the effectiveness of internal controls, they are required to attest to management's assertion about the effectiveness of those controls. To do so, the auditing firm must perform enough work on internal controls to assure itself that 1) management has designed sufficient controls and put such controls in place, 2) management has performed sufficient testing to evaluate the effectiveness of those controls and 3) management's conclusion about the effectiveness of those controls is appropriate. The auditor will certainly need documentation of management's work in order to be able to complete its task, and may also need to reperform some of that work. The final rules do not specify the level of work that the auditor must do. Rather, the firm must determine the level of work to perform based on the attestation standards, the firm's knowledge of the company, and its experience and judgment. Much as with an opinion on financial statements, an auditor cannot be compelled to issue a report on internal controls if it is not satisfied with the procedures it has been able to perform.

Taub Speech, *supra* note 193.

<sup>198</sup> See SAS 54, *supra* note 65, at AU §§ 317.05–.07. But the undercutting is by no means complete. In releasing the final regulations issued pursuant to SOA section 404, the SEC explained that

[w]e recognize that our definition of the term “internal control over financial reporting” reflected in the final rules encompasses the subset of internal controls addressed in the COSO Report that pertains to financial reporting objectives. Our definition does not encompass the elements of the COSO Report definition that relate to effectiveness and efficiency of a company's operations and a company's compliance with applicable laws and regulations, with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements,

This is particularly apparent in the SEC's "explicit reference to assurances regarding use or disposition of the company's assets" in the final regulations.<sup>199</sup> Though the financial reporting focus of the regulations would ordinarily make issues relating to assets unnecessary to a determination of the condition of the financial statements, procedures targeting operations may be necessary when management relies on systems that cannot provide reasonable assurance to the auditors of the value or condition of the assets represented in the financial statements.<sup>200</sup> This approach is amplified by SOA section 103(a)(2)(A)(iii), which requires the Public Company Accountant Oversight Board (PCAOB) to establish standards with respect to the testing of management's internal control procedures described in SOA section 404.<sup>201</sup>

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such as the Commission's financial reporting requirements. Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 68 Fed. Reg. at 36,640. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) report advocated a framework of controls in three categories—"effectiveness and efficiency of operations; reliability of financial reporting; [and] compliance with applicable laws and regulations." COSO, Executive Summary of Integrated Framework, [http://www.coso.org/publications/executive\\_summary\\_integrated\\_framework.htm](http://www.coso.org/publications/executive_summary_integrated_framework.htm) (last visited Sept. 30, 2003). COSO objectives, however, can vary for purposes of auditing, and might include operations, financial reporting, or compliance. The COSO definition, at least with respect to financial reporting, was incorporated into generally accepted auditing standards in 1997. See Statement on Auditing Standards No. 78, Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55, at 3 (American Inst. of Certified Pub. Accountants 1995); CODIFICATION OF STATEMENTS ON AUDITING STANDARDS, Consideration of an Internal Control in a Financial Statement Audit, AU § 319.06 (American Inst. of Certified Pub. Accountants 1990). The result is a partial incorporation of the COSO standard, focusing on financial reporting but touching on matters which might have a contingent effect on the financial statements.

<sup>199</sup> Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 68 Fed. Reg. at 36,640. The SEC explained that "[t]his provision is specifically included to make clear that, for purposes of our definition, the safeguarding of assets is one of the elements of internal control over financial reporting." *Id.*

<sup>200</sup> *Id.* at 36,641 n.57 (referencing the COSO Report). Indeed, even as the SEC explained its determination to limit the focus of the analysis and attestation of internal control in SOA section 404, it reminded auditors that this limitation did not act to otherwise limit their obligations under GAAP and GAAS. "Codification of Statements on Auditing Standards section 317 requires auditors to consider a company's compliance with laws and regulations that have a direct and material effect on the financial statements." *Id.* at 36,640 n.52.

<sup>201</sup> Specifically, SOA section 103 provides that the PCAOB

(A) [s]hall include in the auditing standards that it adopts, requirements that each registered public accounting firm shall—(iii) describe in each

Putting all of this together, it seems clear that, at a minimum, auditing standards, evolving judicial rules, and recent legislation impose a positive duty on auditors with respect to the detection and reporting of illegal acts. At its narrowest, this positive obligation is centered on illegal acts directly connected with the auditor's review of financial statement amounts. Even in this context, however, it seems clear that the auditor may not devise procedures indifferent to indirect affects on the financial statements, particularly illegal activities that may have a significant contingent effect. However, the trend of self-regulation, judicial decisions, and the federal securities laws appears to be directed toward a broader construction. An auditor's duty to monitor, even when centered on the financial accounting objective, requires some, and sometimes significant, attention to issuer operations. As Harvey Pitt, former SEC Chairman, suggested, auditors must "structure the audit process . . . to detect illegal acts by clients, to determine whether it is likely that an illegal act took place, to assess the potential financial consequences of any illegal acts that are uncovered."<sup>202</sup> This focus may, under the circumstances of the engagement, require the auditor to develop procedures that can lead to the detection of illegal acts.<sup>203</sup> These illegal acts can include actions that may result in liabilities with a contingent effect on the financial statements, including violations of discrimination, environmental and health and safety laws.

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audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer, required by section 404(b), and present (in such report or in a separate report)—(I)the findings of the auditor from such testing; (II)an evaluation of whether such internal control structure and procedures . . . .

Sarbanes-Oxley Act of 2002 § 103(a)(2)(A)(iii), 15 U.S.C.A. § 7213(a)(2)(A)(iii) (West Supp. 2003). See Establishment of Interim Professional Auditing Standards No. 2003-006, § 7, Rule 3000T (Pub. Co. Accounting Oversight Bd. 2003). These rules were approved by the Commission on April 25, 2003. *Id.*

<sup>202</sup> Harvey L. Pitt et al., *More than "Classical GAAS": Audits and Illegality Under the Litigation Reform Act*, 943 CORP. L. & PRAC. COURSE HANDBOOK SERIES. 445, 455 (Practicing Law Inst. 1996); see also Harvey L. Pitt & David B. Hardison, *supra* note 186, at B6.

<sup>203</sup> See Pitt et al., *supra* note 202, at 455 ("[A]uditors should consider whether additional [fraud detection] procedures are required, or whether procedures previously employed will suffice in the performance of their new statutory obligations.").

### B. *The Lawyer's Positive Monitoring Obligations*

Lawyers have experienced the greatest substantive change in the nature of their obligation to their clients and to public regulators. Prior to the passage of SOA, a lawyer's obligation was strictly centered on the client, and the paramount value of that relationship was confidentiality.<sup>204</sup> For years before 2002, academics and others criticized the legal profession for the ambiguity of its rules with respect to lawyer conduct in the face of client wrongdoing.<sup>205</sup> While ethical rules permitted a lawyer to refer misconduct to persons of higher authority in the organizational client, they mandate such disclosure.<sup>206</sup> SOA section 307 imposed on lawyers practicing before the SEC an obligation to report material violations to an appropriate level of management.<sup>207</sup> I have already argued that the scope of this duty to report is broad, and it may include an obligation to report violations of any law that might have a material impact on the corporation.<sup>208</sup> In this section, I argue that the nature of this obligation is broadly positive. Lawyers are not required merely to report evidence that might happen to come to their attention, but instead they have an additional, affirmative obligation to develop systems of gathering information that are reasonably likely to lead to the detection of evidence subject to reporting under SOA section 307.

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<sup>204</sup> See Nicole M. Healy, *The Impact of September 11th on Anti-Money Laundering Efforts, and the European Union and Commonwealth Gatekeeper Initiatives*, 36 INT'L LAW. 733, 744 n.73-74 (discussing the importance of protecting client confidences and describing SOA's lack of provision for the preservation of the attorney-client privilege in connection with the required disclosures).

<sup>205</sup> Fairly representative of this criticism was the following:

While the ABA's Model Rules prohibit lawyer participation in client crime or fraud, they set forth vague standards on what a lawyer should do affirmatively when confronted with crime or fraud, particularly within an organizational client. The lawyer must act in the "best interests of the organizational client," but the ABA has consistently refused to affirm that a lawyer for an organization must report illegal acts by the organization's agents to the board of directors or other highest authority in the organization.

Painter, *supra* note 73, at 1406. Professor Painter, of course, worked actively to change the ABA's position; his attempts, however, were unsuccessfully. See Memorandum from Richard W. Painter to ABA Ethics 2000 Commission in Support of Proposal to Amend Model Rule 1.13 (May 13, 1998), <http://www.abanet.org/cpr/painter/html>. (last visited Sept. 19, 2003).

<sup>206</sup> See MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2003).

<sup>207</sup> See *supra* note 22-23.

<sup>208</sup> See *supra* Part I.B.

The core of the reporting obligation in the final regulation is written in the passive voice:

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.<sup>209</sup>

The concern of the SEC appeared to be with the "triggering standard" rather than with the procedures that attorneys would have to adopt in order to comply with the reporting requirement.<sup>210</sup> The SEC was not concerned so much with *how* an attorney obtained information, or whether the attorney appeared to have an obligation to seek out information subject to reporting under section 205.3(b), but with the *nature* of the information sufficient to trigger the reporting.<sup>211</sup> This lack of concern was echoed by the organized bar and legal academics interested in the question of lawyer obligations under SOA section 307.<sup>212</sup> In this respect, the regulations under SOA

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<sup>209</sup> Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205.3(b)(1) (2003).

<sup>210</sup> See Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No., 34-46868, 67 Fed. Reg. ¶ 71,670, 71,681 (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. pt. 205). The SEC explained that in utilizing the "becomes aware" standard:

[T]he rule seeks to balance the likelihood of increased compliance with the law as a result of having an appropriate triggering standard that prompts the bringing of potentially illegal conduct to the attention of the issuer's management against the likelihood of decreased compliance resulting from reduced consultation with an issuer's attorneys through adoption of too high a standard.

*Id.*

<sup>211</sup> Thus, in the proposed regulations, the SEC explained:

The report required in Section 205.3(b) to prevent or minimize the harm to an issuer resulting from a material violation is internal. It involves no disclosure of confidential information outside the issuer. The report, moreover, is intended to prevent, if possible, misconduct that would injure the issuer and its shareholders, or at least to limit the injury. Accordingly, awareness of information leading an attorney reasonably to believe that a material violation has occurred, is occurring, or is about to occur appears to be the appropriate trigger for the obligation to make an internal report of the evidence of a material violation.

*Id.* at 71,681-82.

<sup>212</sup> See Koniak, *supra* note 116, at 227-30 (providing a good, if partisan,

section 307 stand in marked contrast to the focus and construction of the detection and reporting requirements imposed on auditors under the black letter of section 10A.<sup>213</sup> The effect of the difference, however, may be less stark than the differences in wording.

There are several sources providing some indication of the sort of investigation, or due diligence, required of outside counsel in connection with their reporting obligations under the regulations to SOA section 307. These consist of the SEC's response to comments about the "becomes aware" standard, the development of the SEC's position prior to the enactment of SOA, and most importantly, the development within state fiduciary duty of care jurisprudence of a standard of reasonable diligence for corporate fiduciaries. The SEC explained that only one commentator objected to the "becomes aware" language, but that the nature of the objection was cured with changes to the definition of "evidence of material violation."<sup>214</sup> Indeed, it might appear that the nature of the attorney's duty to detect is tied to the triggering of the reporting requirement. The lower the standard, the more extensive and positive the lawyer's obligation to report is. Despite a slew of negative comments,<sup>215</sup> the threshold of evidence sufficient to invoke the disclosure obligation is relatively low. To be subject to reporting up the ladder, the lawyer must conclude that the information revealed

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description of the focus of many of these people and organizations).

<sup>213</sup> See *supra* Part I.A.

<sup>214</sup> "The Comment of Federal Bar Counsel for example, objected to 'becomes aware' in (b)(1) but appears to have done so in connection with the proposed definition of 'evidence of a material violation.'" Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 34-47276, 68 Fed. Reg. 6296, 6306 n.71 (Feb. 6, 2003) (to be codified at 17 C.F.R. pt. 205) (quoting Comment of Federal Bar Counsel, at 12-13). The revisions made to that definition appear to address those objections.

<sup>215</sup> See *id.* at 6301-02. The SEC noted a number of comments suggesting a higher evidentiary threshold for the invocation of the detect and report rules. In the comments to the final regulations, the SEC noted that:

Nearly all practicing lawyers who commented found the reporting trigger in the rule too low and called instead for a subjective standard, requiring "actual belief" that a material violation has occurred, is ongoing, or is about to occur before the attorney would be obligated to make an initial report within the client issuer. The revised definition incorporates suggested changes into an objective standard that is designed to facilitate the effective operation of the rule and to encourage the reporting of evidence of material violations.

*Id.*

constitutes “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.”<sup>216</sup> The SEC went to some lengths to suggest that the standard would be objective.<sup>217</sup> However, it made some changes to the originally proposed standard to ensure that the trigger for reporting not be too low.<sup>218</sup>

Moreover, the SEC has indicated that it would treat the reporting obligations as consistent with the position it took in an earlier case.<sup>219</sup> The SEC noted that even lawyers were “‘obligated to take affirmative steps to ensure that appropriate action is taken to address the misconduct,’ including ‘disclosure of the matter to the entity’s board of directors, resignation from the firm, or disclosure to regulatory authorities.’”<sup>220</sup> In particular, the “the Commission has argued that attorneys should be held responsible for materials which they have drafted, or participated in drafting, that they knew would be included in a document to be filed with the Commission but which have been submitted without attribution or under another individual’s signature.”<sup>221</sup> This is consistent with the SEC’s

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<sup>216</sup> Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205.2(e) (2003). In reporting the final regulations, the SEC noted that “This formulation, while intended to adopt an objective standard, also recognizes that there is a range of conduct in which an attorney may engage without being unreasonable. . . . Under the revised definition, an attorney is not required (or expected) to report ‘gossip, hearsay, [or] innuendo.’” Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. at 6302.

<sup>217</sup> See Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. at 6301–02.

<sup>218</sup> See *id.* at 6302.

<sup>219</sup> See *In re of John H. Gutfreund*, 51 S.E.C. 93, 108–14 (Dec. 3, 1992) (reporting on investigation by a chief legal officer who learned of criminal misconduct by a corporate officer). In the release of the proposed regulations under SOA section 307, the SEC explained that “[s]ection 307 of the Act requires the Commission to promulgate minimum ethical standards for attorneys representing issuers, including an ‘up the ladder’ reporting requirement on attorneys as originally proposed by the Commission in *Carter and Johnson*.” Implementation of Standards of Professional Conduct for Attorneys, Securities Exchange Act Release No. 34-46868, 67 Fed. Reg. 71,670, 71,673 (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. pt. 205) (citations omitted).

<sup>220</sup> Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. at 71,672 (quoting *In re John H. Gutfreund*, 51 S.E.C. at 113-14).

<sup>221</sup> *Id.* at 71,676 (citing the SEC’s previous positions to this effect in *Newby v. Enron Corp.*, No. 02–20486, 2003 U.S. App. LEXIS 15059, (5th Cir. July 30, 2003), a

increased willingness to apply to lawyers those developing standards of monitoring conduct applicable to corporate fiduciaries.<sup>222</sup>

The SEC's use of developing standards of affirmative duty originally applicable to corporate fiduciaries accords with parallel developments in state corporate law with respect to the nature and extent of the monitoring duties of corporate fiduciaries. Prosecutors in connection with SEC enforcement actions incorporated these positive obligations at the federal level,<sup>223</sup> and they are likely to be influential in fleshing out the "become aware" standard under the SOA section 307 regulations. The state case that appears to have caught the eye of federal officials with respect to the development of a law regarding the obligation to monitor, is *In re Caremark International*.<sup>224</sup> *Caremark*, in a sense, represents the parallel efforts of the state courts to develop, and perhaps extend, the law of monitoring obligations, even as the federal government sought to develop its own law of monitoring through the federal securities laws. Indeed, the *Caremark* court was quite conscious of this parallelism and sought, to some extent, to harmonize its view of

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private class action suit in which the SEC filed amicus curiae briefs, and *Klein v. Boyd*, Nos. 97-143, 97-1261, 1998 U.S. App. LEXIS 2004 (3rd Cir. Feb. 12, 1998), *vacated by, reh'g granted*, 1998 U.S. App. LEXIS 4121 (3rd Cir. Mar. 9, 1998).

<sup>222</sup> For example, the SEC cited the information and disclosure standards applicable to corporate officers as relevant to the construction of lawyer reporting standards under SOA section 307. The SEC noted:

In 1997, the Commission issued another report of investigation in a matter involving officers and directors of W.R. Grace Co. The Commission concluded that these individuals failed to take action to ensure full and prompt disclosure of substantial retirement benefits the company had agreed to pay to its former CEO in the company's annual report, a 10K filing, and a proxy statement. The Commission issued the report in order "to emphasize the affirmative responsibilities of corporate officers and directors to ensure that the shareholders whom they serve receive accurate and complete disclosure of information required by the proxy solicitation and periodic reporting provisions of the federal securities laws." Although none of the officers and directors named in the matter were attorneys, the report emphasizes the affirmative duty of an issuer's management to correct misconduct and make full disclosure of relevant matters to investors.

Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. at 71,672-73 n.22 (quoting *In the Matter of W.R. Grace & Co.*, Exchange Act Release No. 34-39157, 53 S.E.C. 235, 236 (Sept. 30, 1997) (citations omitted).

<sup>223</sup> See *supra* notes 9-11 and accompanying text; *infra* notes 234-239 and accompanying text.

<sup>224</sup> 698 A.2d 959 (Del. Ch. 1996).

managerial monitoring obligations with the standards being developed at the federal level.<sup>225</sup> Chancellor Allen read from prior Delaware case law a positive duty to monitor. At its narrowest, the rule stands “for the proposition that, absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees.”<sup>226</sup> Chancellor Allen rejected the notion that a “corporate board has no responsibility to assure that appropriate information and reporting systems are established by management.”<sup>227</sup> The “essential predicate”<sup>228</sup> for reasonable compliance with a duty to detect and report is “relevant and timely *information*.”<sup>229</sup> In addition, Chancellor Allen observed:

Obviously the level of detail that is appropriate for such an information system is a question of business judgment. . . . Thus I am of the view that a director’s obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance.<sup>230</sup>

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<sup>225</sup> Chancellor Allen noted that the question of the scope of the duty to monitor: [H]as been given special importance by an increasing tendency, especially under federal law, to employ the criminal law to assure corporate compliance with external legal requirements, including environmental, financial, employee and product safety as well as assorted other health and safety regulations.

*Id.* at 969. He further explained that the increased penalties for corporate misconduct under the federal sentencing guidelines “offer powerful incentives for corporations today to have in place compliance programs to detect violations of law, promptly to report violations to appropriate public officials when discovered, and to take prompt, voluntary remedial efforts.” *Id.*

<sup>226</sup> *Id.*

<sup>227</sup> *Id.* at 969–70. Such a proposition “would not, in any event, be accepted by the Delaware Supreme Court in 1996.” *Id.* at 970.

<sup>228</sup> *Id.* at 970.

<sup>229</sup> *Id.*

<sup>230</sup> *Id.* Referring to *Caremark*, the Chief Justice of the Delaware Supreme Court suggested that

[s]uch compliance systems could reasonably be expected to identify wrongdoing when a compliance program could benefit the corporation under federal sentencing guidelines. Although *Caremark* is dictum in a Court of Chancery case approving a settlement of a derivative action, and is not Supreme Court precedent, my personal view is that the expectations of directors, therefore, progressed in the thirty-plus years from *Allis-Chalmers* to *Caremark*. . . . It was not a sudden leap of thirty years, however. In a 1980 law review article in *The Business Lawyer* that I co-

Some commentators have argued that failure to monitor a corporation's practices, leading to a successful discrimination suit, could constitute a breach of the duty of care under this standard.<sup>231</sup> *Caremark* provides the principal template for understanding the scope of any corporate monitor's obligations. It is a template some have argued has already been widely, if informally adopted, by public companies.<sup>232</sup> Its conscious resonances with developing federal policy, as applied to criminal actions, suggests that there is merit in carrying over its principles to lawyers' and other gatekeepers' emerging obligations to detect and report. Lawyer's good faith under the SOA section 307 regulation suggests the need to develop and implement at least some sort of rudimentary information gathering system appropriate to the nature of the corporation and the scope of the risk of "material violation."<sup>233</sup>

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authored with William Manning, Esquire, of the Delaware Bar, we noted that such expectations may already have evolved in the then-seventeen years following *Graham*.

E. Norman Veasey, *State-Federal Tension in Corporate Governance and the Professional Responsibilities of Advisors*, 28 J. CORP. L. 441, 446 (2003) (citing E. Norman Veasey & William E. Manning, *Codified Standard—Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919, 929–30 (1980)).

<sup>231</sup> See Leonard M. Baynes, *Racial Stereotypes, Broadcast Corporations, and the Business Judgment Rule*, 37 U. RICH. L. REV. 819, 872–73 (2003) (noting that broadcast executives could be liable for breach of the duty of care).

<sup>232</sup> Professor Lawrence Cunningham suggested that

[t]he SEC must promulgate rules requiring annual reports to contain an internal control report expressing management's responsibility for establishing and maintaining adequate internal controls for financial reporting and assessing their effectiveness. This mandate is a disclosure counterpart to substantial extant legal requirements broadly imposed by Congress in the 1977 Foreign Corrupt Practices Act, the milestone legislation mandating internal financial reporting controls in response to that period's equivalent of the Big Four Frauds. The disclosure's substantive reference also duplicates the practice followed by most companies pursuant to perceived mandates emanating from such influential state law cases as *In re Caremark International*.

Lawrence A. Cunningham, *supra* note 51, at 957.

<sup>233</sup> Sarbanes Oxley Act of 2002 § 307, 15 U.S.C.A. § 7245 (West Supp. 2003). In another sense, this construction of the obligation accords with the auditor's obligations under SAS 54 and 99. See *supra* notes 149–67 and accompanying discussion. It makes sense from a logistical and policy standpoint, especially for lawyers and accountants, to draw parallel connections between state and federal laws. This type of approach was used by the judge in *Caremark*.

*Caremark* extends beyond its state law confines. In its Principles of Federal Prosecution of Business Organizations,<sup>234</sup> the Department of Justice described the principles that prosecutors are to use in determining whether to seek charges against a corporation.<sup>235</sup> The principles suggest a number of factors prosecutors ought to consider in making this determination.<sup>236</sup> Among them is “the existence and adequacy of the corporation’s compliance program.”<sup>237</sup> The document, citing *Caremark*, states that: “In evaluating compliance programs, prosecutors may consider whether the corporation has established corporate governance mechanisms that can effectively detect and prevent misconduct.”<sup>238</sup>

In a sense, the SOA section 307 regulations institutionalize one facet of the sort of corporate governance mechanism for the detection and prevention of misconduct contemplated in the Department of Justice Guidelines. Institutionalization itself, however, must be effective if it is to carry any weight, that is, if it is to avoid being “merely a ‘paper program’[rather than one] designed and implemented in an effective manner.”<sup>239</sup>

A passive approach would tend to protect lawyers who hide or management that conceals. Such actions clearly were not intended by the provision. Legislative history suggests that lawyers would take an approach similar to that required of auditors.<sup>240</sup> Just as in the rules issued pursuant to SOA section 307, the emphasis was on an affirmative obligation to report rather than on the nature of the obligation to seek out reportable information.<sup>241</sup> Law firms seem to understand these implications.<sup>242</sup>

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<sup>234</sup> Memorandum from Larry D. Thompson, Deputy Attorney General, U.S. Dep’t of Justice, to Heads of Dep’t Components, U.S. Attorneys (Jan. 20, 2003), (establishing guidelines for the prosecution of corporations as well as all other types of business organizations), [http://www.usdoj.gov/dag/cftf/corporate\\_guidelines.htm](http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm) (last visited Sept. 11, 2003).

<sup>235</sup> See *id.* Part I (finding that corporations “should not be treated leniently because of their artificial nature”).

<sup>236</sup> See *id.* Part II (listing nine factors that should be considered in reaching a decision on how to properly treat a corporate client).

<sup>237</sup> *Id.*

<sup>238</sup> *Id.* at Part VII.

<sup>239</sup> *Id.*

<sup>240</sup> See 148 CONG. REC. S6551-52 (daily ed. July 10, 2002) (statement of Sen. Edwards) (describing the provision as “about making sure . . . lawyers . . . ensure that the law is being followed”).

<sup>241</sup> The SEC, in its release of the proposed section 307 regulations, summarized

Additional evidence suggesting that the obligations imposed under section 307 are active can be found in the ways in which the reporting requirements of sections 307 and 404 might work together. SOA does not explain the relationship between the reporting system created under section 307 and the requirements of section 404 for the preparation, testing, and disclosure of management's internal control report.<sup>243</sup> Under rules to be created by the SEC, section 404 will impose on companies the obligation to create and report on their internal

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the legislative history to this effect:

This appears to have been the expectation of the Senators who drafted [s]ection 307 of the Act. *See* 148 Cong. Rec. S6552 (July 10, 2002) (statement of Sen. Edwards) ("the SEC shall make one rule in particular, and it is a simple rule with two parts. No. 1, a lawyer with evidence of a material violation has to report that evidence either to the chief legal counsel or the chief executive officer of the company. No. 2, if the person to whom that lawyer reports doesn't respond appropriately by remedying the violation, by doing something that makes sure it is cured, that lawyer has an obligation to go to the audit committee or to the board. It is that simple. . . . If the CEO can do a short investigation, for example, and figure out that no violation occurred, then the obligation stops there. But if there is a serious violation of the law, the appropriate response is clear: The CEO has to act promptly to remedy the violation. If he doesn't, the lawyer has to go to the board. It is that simple."). *Accord id.* at S6555 (statement of Sen. Enzi) ("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."), S6556 (statement of Sen. Corzine) ("when lawyers are aware of a potential violation, they do have a duty to investigate. And if they determine there is a material violation of law—not some small violation, some insignificant rule—that violation should be remedied by the corporation. If it is not remedied, it is the duty of the lawyer, under our language, to report it to the board.").

Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 34-46868, 67 Fed. Reg. 71,670, 71,681 n.38 (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. pt. 205).

<sup>242</sup> In an article published in the *ABA Journal*, the author noted with approval that, after the passage of SOA, "[i]n some cases, law firms are examining their own internal management and operational structures in efforts to minimize their levels of risk under Sarbanes [Oxley]." Jenny B. Davis, *Sorting Out Sarbanes-Oxley*, 89 A.B.A. J. 44, 49 (2003).

<sup>243</sup> Sarbanes-Oxley Act of 2002 §§ 307, 404, 15 U.S.C.A. §§ 7245, 7562 (West Supp. 2003).

control structure as well as procedures for financial reporting.<sup>244</sup> Further, reporting companies will have to assess the effectiveness of the internal control structure, and accounting firms providing services to the company will have to attest to and report on management's assessment of the internal controls.<sup>245</sup> The company's outside counsel, rather than its auditors, will likely have a hand in creating and implementing these internal control systems.<sup>246</sup>

The quality and sufficiency of lawyer disclosure is subject to review by company management as well as the company's outside auditors.<sup>247</sup> In effect, it might be possible for both management and auditors, in the course of preparing, reviewing, and certifying a section 404 report, to review and pass on the quality and sufficiency of a lawyer's reporting obligations under section 307. In this context, the company and its auditors might be obliged, in order to meet their obligations, to provide the necessary evidence to establish liability on the part of lawyers to third parties affected by section 307 disclosures. Thus, lawyers and general counsel will have a clear incentive to create systems of review designed to detect material violations. The prudent lawyer, in the course of advising management on its disclosure, as well as of its design and implementation of internal control systems, will carefully review customer and employee

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<sup>244</sup> See *id.* § 404, 15 U.S.C.A. § 7262.

<sup>245</sup> See *id.*

<sup>246</sup> Section 201(a) of the Sarbanes-Oxley Act added new Section 10A(g) to the Securities Exchange Act of 1934 which prohibits auditors from performing non-audit services for their audit clients. Among the non-audit services affected are financial system design and implementation. See *id.* § 201, 15 U.S.C.A. § 78j-1(g). In that connection, the SEC adopted "rules, consistent with our previous rules, that prohibited the accounting firm from providing any service related to the audit client's information system, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client's financial statements." Strengthening the Commission's Requirements Regarding Auditor Independence, Exchange Act Release No. 34-47265, 68 Fed. Reg. 6006, 6011 (Feb. 5, 2003) (to be codified at 17 C.F.R. pts. 210, 240, 249, 274). Specifically citing the auditor's obligations under SOA section 404, the SEC explained that "[d]esigning, implementing, or operating systems affecting the financial statements may place the accountant in a management role, or result in the accountant auditing his or her own work or attesting to the effectiveness of internal control systems designed or implemented by that accountant." *Id.* at 6012.

<sup>247</sup> See Sarbanes-Oxley Act of 2002 § 404, 15 U.S.C.A. § 7262; Strengthening the Commission's Requirements Regarding Auditor Independence, 68 Fed. Reg. at 6014 (citing AU §319) (noting that auditors must gain an understanding of a client's system of internal controls when conducting an audit under GAAS).

complaints, governmental inquiries, anonymous reports, litigation threatened or instituted, and company-generated analyses of industry-related problems. The prudent lawyer will also have to present evidence to document his or her compliance with detection and reporting requirements. Furthermore, a reasonably prudent lawyer will institute a rudimentary system that will create a reasonable likelihood that information that lawyers are expected to review will indeed come to the attention of, and be reviewed by, the lawyer burdened with a SOA section 307 obligation.

### III. LIABILITY TO THIRD PARTIES FOR FAILURE TO MONITOR

I have suggested a set of possible interpretations of the obligations imposed on auditors under section 10A of the 1934 Act and on lawyers pursuant to section 307 of SOA, which extend the nature and scope of obligations and potentially extend liability for acts or the failure to act against which lawyers and accountants had been previously protected. Under section 10A, auditors have a positive obligation to develop procedures to detect the commission of illegal acts by the corporation.<sup>248</sup> Likewise, SOA requires lawyers to report evidence of a material violation "of fiduciary or similar duty to the issuer recognized under an applicable Federal or State statute or at common law."<sup>249</sup> In both cases, the reporting requirement extends well beyond a narrowly tailored set of corporate non-compliance. It is likely that both lawyers and accountants have a duty to report evidence of discrimination by the corporation or its employees and agents.<sup>250</sup>

In this section I explore, at least preliminarily, the extent to which the application of the detection and disclosure rules, as I have suggested they might be applied, create additional bases of liability for lawyers and auditors representing corporate clients. First, I examine the extent to which the regulations themselves protect lawyers and accountants from liability in connection with their detection and reporting obligations. Next, I suggest that

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<sup>248</sup> See Private Securities Litigation Reform Act of 1995 § 301, 15 U.S.C. § 78j-1 (2000).

<sup>249</sup> Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205.2(d) (2003).

<sup>250</sup> See discussion *supra* Part I.A-B.

protection is limited in connection with assertions of liability as principals under the securities laws or for violations of other laws. In addition, I will suggest the ways in which such reporting information might serve as a useful source of discovery for litigants seeking to prove corporate misconduct, especially in connection with violations of labor, employment, and environmental laws. Lastly, I will focus on corporate violations of discrimination laws as an example of the possible operation of the statutes.

The extension of liability for lawyers and accountants might come as something of a surprise. In both cases, the regulations promulgated by the SEC attempt to insulate auditors and lawyers from liability to third parties for compliance (or non-compliance) with their reporting obligations.<sup>251</sup> With respect to auditor liability related to reporting illegal acts, section 10A provides independent public accountants with protection from liability "in a private action for any finding, conclusion, or statement expressed in a report made" to the SEC under section 10A.<sup>252</sup> Moreover, the SEC has taken the position that such disclosure to the issuer is non-public and not the basis for liability to third parties. In promulgating the regulations under section 10A applicable to auditors, the SEC stated its view that:

Rule 10A-1 is based on the premise that the notices and reports under section 10A are to assist the Commission in performing its enforcement responsibilities and, therefore, will be non-public. Disclosure to the public of issuers' illegal acts will continue to be made in modified audit reports or, when the auditor has resigned, been dismissed, or elected not to stand for re-election, on Form 8-K.<sup>253</sup>

The regulations to SOA section 307 provide similar protection for lawyers with an obligation to disclose evidence of wrongdoing. "Nothing in this part is intended to, or does, create a private right of action against any attorney, law firm, or issuer based upon compliance or noncompliance with its provisions."<sup>254</sup>

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<sup>251</sup> See 17 C.F.R. § 205.7 (stating that there is no private right of action against attorney for compliance or non-compliance and that the authority to enforce compliance vested exclusively in the SEC).

<sup>252</sup> 15 U.S.C. § 78j-1(c) (2000).

<sup>253</sup> Implementation of Section 10A of the Securities Exchange Act of 1934, Exchange Act Release No. 34-38387, 62 Fed. Reg. 12,743, 12,745 (March 18, 1997) (to be codified at 17 C.F. R. pts. 210, 240).

<sup>254</sup> 17 C.F.R. § 205.7(a).

The protection afforded under this provision is meant to extend broadly.

The Commission is of the view that the protection of this provision should extend to any entity that might be compelled to take action under this part; thus it extends to law firms and issuers. The Commission is also of the opinion that . . . it must extend to both compliance and non-compliance under this part.<sup>255</sup>

The regulation also includes a statement of the SEC's exclusive jurisdiction to enforce compliance with a lawyer's obligation to report evidence of a material violation of law.<sup>256</sup> "The provision is intended to preclude, among other things, private injunctive actions seeking to compel persons to take actions under this part and private damages actions against such persons."<sup>257</sup>

These limitations may have little effect on the ability of litigants to reach the information generated in compliance with gatekeeper duties by accountants and auditors. More importantly, the safe harbor provisions of section 10A and the section 307 regulations may not limit the liability of lawyers and accountants with respect to issuer discrimination reported to management in all circumstances. Knowledge of possible discriminatory conduct, of a magnitude sufficient to justify communication with management, may create a duty on the part of the reporting lawyer or accountant, independent of the statutory duty to report.

#### A. *Discovery.*

The availability of either information gathered or reports prepared by outside monitors can be very useful to plaintiffs in suits against a corporation. They can also be very useful to committees of independent directors evaluating shareholder derivative actions. Discovery related to information produced by gatekeepers is particularly important in two respects. First, such information can provide evidence that the board's own

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<sup>255</sup> Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 34-47276, 68 Fed. Reg. 6296, 6315 (Feb. 6, 2003) (to be codified at 17 C.F.R. pt. 205).

<sup>256</sup> See 17 C.F.R. § 205.7 (b).

<sup>257</sup> Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. at 6315.

monitoring system, as designed, was ineffective or otherwise failed. Information in this event might support claims that the directors breached their duty of care for failure to develop adequate and reasonable monitoring systems.<sup>258</sup> Second, assuming that the monitoring system itself worked well, such information can provide evidence that the board ignored or failed to utilize information provided by the monitoring system. Information, in this case, would tend to show that the directors breached their duty of care for failure to act on information of corporate wrongdoing.<sup>259</sup>

### 1. Auditors

There may be circumstances under which reports prepared or information gathered by auditors may be subject to discovery.<sup>260</sup> Though auditors are not required to design an audit to provide reasonable assurance of detection of illegal acts with indirect effects on the financial statements, principles of good practice by auditors suggest that an auditor ought to document compliance with SAS 54.<sup>261</sup> The SEC has suggested that such disclosure may be anticipated in connection with an auditor's compliance with the detect-and-report requirements of section 10A,<sup>262</sup> even though section 10A reports would not be

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<sup>258</sup> See Wade, *supra* note 11, at 406-10 (providing an application of an argument to this effect in the context of discrimination suits). Wade argues that had the Texaco board implemented efforts to satisfy the duty of care through monitoring and responding immediately to discrimination claims, the company would not have faced such adverse economic consequences. *Id.*

<sup>259</sup> For an application of an argument to this effect in the context of discrimination suits, see, for example, Leonard M. Baynes, *supra* note 231, at 862-63. Baynes argues that board members of the broadcasting corporations could lose the benefits of the business judgment rule if their decisions were irrational, not fully informed, or if they failed to properly monitor the diversity within the corporation by not placing enough emphasis on creating minority-based television shows. *Id.* He also argues that an executive's breach of duty of care will mainly focus on the type and quality of the decision-making processes. *Id.* at 874-81.

<sup>260</sup> See, e.g., *United States v. Arthur Young & Co.*, 465 U.S. 805, 813-15 (1984); see also Michael J. Sharp & Abraham M. Stanger, *Audit-Inquiry Responses in the Arena of Discovery: Protected by the Work-Product Doctrine*, 56 BUS. LAW. 183, 205 (2000) (providing a discussion of traditional understanding in this regard).

<sup>261</sup> See, e.g., Linda B. Specht, *The Auditor, SAS 54 and Environmental Violations*, J. ACCT., Dec. 1992, at 67, 68 ("The auditor should document compliance with Statement on Auditing Standards no. 54, *Illegal Acts by Clients*, and assess the adequacy of the client's treatment and disclosure of . . . contingencies.").

<sup>262</sup> Thus, the SEC has explained that though an auditor's section 10A reports to management and the SEC might remain confidential, the "[d]isclosure to the public

subject to disclosure, at least at the time made.<sup>263</sup> Auditor work papers are usually subject to discovery.<sup>264</sup> Discovery should include any auditor documentation of compliance with SAS 54. The information in the auditor documentation might provide evidence of client knowledge or intent of a kind especially useful in discrimination cases.

Moreover, work papers prepared in connection with an auditor's section 10A compliance might also be subject to discovery. It can be argued that the safe-harbor rules, which provide protection only against private lawsuits grounded on an auditor's section 10A compliance, and disclosure with respect to the section 10A reports, do not extend to work papers.<sup>265</sup> The case may be clearer for discovery where the work papers, or the information contained therein, are used in the course of the audit and are necessary for an attestation review of management's internal control report under SOA section 404, or otherwise in connection with the conduct of the audit. Any such documentation may also provide evidence of any auditor misconduct. For example, complicity by accountants, directly or indirectly, to hide or alter evidence of client misconduct may be discovered through a review of auditor SAS 54 documentation.

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of issuers' illegal acts will continue . . . in modified audit reports." Implementation of Section 10A of the Securities Exchange Act of 1934, Exchange Act Release No. 34-38387, 62 Fed. Reg. 12,743, 12,745 (March 18, 1997) (to be codified at 17 C.F.R. pts. 210, 240). The SEC referred to the auditor's obligations with respect to its audit report under SAS No. 54. *See id.* at 12,744-45.

<sup>263</sup> *See id.* at 12,745.

<sup>264</sup> *See, e.g., Arthur Young & Co.*, 465 U.S. at 817-18 (holding that work-product immunity for attorney papers is not applicable to independent auditor's work papers and endowing the work papers of an independent auditor with a work-product immunity from discovery would destroy the appearance of auditor's independence by creating the impression that the auditor is an advocate for the client); *see also PepsiCo, Inc. v. Baird, Kurtz & Dobson LLP*, 305 F.3d 813, 815-16 (8th Cir. 2002) (holding that quality control assessments prepared by auditor were not protected by accountant-client privilege under Illinois law); *Inspiration Consol. Copper Co. v. Lumbermens Mut. Cas. Co.*, 60 F.R.D. 205, 210 (S.D.N.Y. 1973) (holding that for purposes of discovery, an independent accountant may be a general auditor subject to normal discovery).

<sup>265</sup> Thus, it could be argued that the safe-harbor confidentiality rules covers only the reports made to management, but not the information on which the report is based. This would correspond to the difference between protection of work product and lack of protection of information which might find its way into a work product protected writing. Otherwise, auditors might be tempted to hide information within reports.

More importantly, the documents might contain information leading to evidence of corporate misconduct.

Discovery of audit papers need not rest solely or primarily on an assertion of auditor liability. There are good reasons for seeking discovery of this material, especially where the corporation is alleged to have engaged in no financial statement misconduct. The sort of information that might be available in this way may lead to evidence critical to the presentation of an effective suit against the corporation for its illegal acts, especially with respect to discrimination, environmental, and health or safety issues. Commentators have suggested:

[A]uditors presumably will want to have some information about . . . illegal or improper acts that have been found by management or the audit committee during the preceding fiscal year. Customer complaints, governmental inquiries, anonymous reports, litigations instituted and threatened, and any internal analyses of industry-specific problems . . . Are all subjects into which auditors may deem [of interest].<sup>266</sup>

Even though some of this information may be contained in a form protected from discovery, as work product and privileged information, discovery attempts aimed at auditor communications relating to corporate internal controls may lead to the production of significant information in actions other than securities fraud cases.<sup>267</sup> Management representations to auditors may provide circumstantial evidence of motive or bad intent. Both section 10A and the auditor's increased involvement in management's MD&A now provide additional, and perhaps important, sources of information for plaintiffs in cases alleging corporate misconduct.

## 2. Outside Counsel

Likewise, there may be circumstances under which the reports prepared by lawyers may be subject to discovery. Like much of the communication between a corporation and its counsel, lawyer up-the-ladder reports required under the regulations to section 307 are likely protected as privileged. The

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<sup>266</sup> See Pitt et al., *supra* note 2033, at 455-56.

<sup>267</sup> See Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Exchange Act Release No. 34-47986, 68 Fed. Reg. 36,636, 36,645-47 (June 18, 2003) (to be codified at 17 C.F.R. pts. 210, 228, 229, 240, 249, 270, 274).

SEC has been sympathetic to the bar's concern about the effect of participation in the corporate monitoring process on the scope and availability of attorney-client privilege. Indeed, lawyers might have thought they dodged the disclosure bullet when the SEC withdrew proposed rule 205.3(b)(3) which provided that "[t]he attorney reporting evidence of a material violation shall take steps reasonable under the circumstances to document the report and the response thereto and shall retain such documentation for a reasonable time."<sup>268</sup> Documentation would have extended to the Chief Legal Officer, who would have been required to document the inquiry in response to the report.<sup>269</sup> In addition, the reporting attorney would have been required to document the response to her report.<sup>270</sup> Fear of discovery among the practicing bar appears to have provided at least some motivation for the SEC's change of heart.

[C]ommentators opined that the documentation requirement might increase the issuer's vulnerability in litigation. They noted that a report will be a "treasure trove of selectively damning evidence" and, while the Commission may be of the view that such documentation should be protected by the attorney-client privilege, the applicability of the privilege will be decided by the courts. Thus, there is considerable uncertainty as to whether it will be protected. At a minimum, it was contended, assertions of privilege will be met with significant and prolonged legal challenges.<sup>271</sup>

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<sup>268</sup> Implementation of Standards of Professional Conduct for Attorneys, Securities Exchange Act Release No. 34-46868, 67 Fed. Reg. ¶ 71,670, 71,684 (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. pt. 205); Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 34-47276, 68 Fed. Reg. 6296, 6306 (Feb. 6, 2003) (to be codified at 17 C.F.R. pt. 205). The SEC suggested that the reporting requirements were imposed to create incentives to handle reports more thoughtfully "if those involved memorialized their decisions." *Id.* at 6306.

<sup>269</sup> Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. at 6306.

<sup>270</sup> See Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205.3(b)(8) (2003) (stating what an attorney shall do with an adequate document response); *id.* at § 205.3(b)(9) (stating what an attorney should do with an inadequate document inadequate response).

<sup>271</sup> Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. at 6307 (citing, in part, to Comments of the American Corporate Counsel Association, at 5, and referencing Comments of Corporations Committee, Business Law Section, the State Bar of California, at 10). This fear is not unfounded. See, e.g., *In re Columbia/HCA Healthcare Corp. Billing Practices. Litig.*, 293 F.3d 289, 305-

However, the SEC cautioned that "in the absence of an affirmative documentation requirement, prudent counsel will consider whether to advise a client in writing that it may be violating the law."<sup>272</sup> The SEC also suggested "responsible corporate officials may direct that such matters be documented."<sup>273</sup>

In these circumstances, the withdrawal of the regulations appears to be as little more than a paper victory. It is true enough that reporting lawyers need not report material violations in writing, nor do corporate clients need to memorialize their investigations. It is, however, likely that both outside counsel and the corporate client will produce writings relating to their obligations under the SOA section 307 regulations. Moreover, the internal controls report requirements of SOA section 404, along with its enhanced reporting obligations, suggest that it is more likely than not that both lawyers and the corporate client will document of material violation.<sup>274</sup> First, both the corporate client and outside counsel will want evidence of compliance with their obligations under the securities laws. At a minimum, preparation of some sort of documentation may be necessary or prudent as support for the discussion of the internal controls now required as part of management's MD&A disclosure. More importantly, perhaps, the corporate client's auditors may demand documents in connection with their certification obligations under SOA section 404.<sup>275</sup> Documentation of some sort, whether oral comments

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07 (6th Cir. 2002) (holding that privilege is waived when privileged records turned over to federal prosecutors).

<sup>272</sup> Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. at 6307.

<sup>273</sup> *Id.*

<sup>274</sup> SOA section 404 requires management to produce an internal control report. That report must contain a statement describing the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting and containing an assessment of the effectiveness of the structures and procedures used for internal control of the issuer's financial reporting. Sarbanes-Oxley Act of 2002 § 404(a), 15 U.S.C.A. § 7262 (West. Supp. 2003).

<sup>275</sup> SOA section 404 provides in part:

With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements

reduced to written (if summary) form by auditors as part of any necessary testing of the efficacy of the statements, assertions in the internal controls report, or written comments provided by management or counsel, may be required by auditors as support for their statutory attestation under SOA section 404(b). In this context, both lawyers and auditors ought to remember the observation of one commentator:

Even the most competent auditor faces a losing battle in court if nothing in the workpapers supports an exercise of judgment in these matters. Although GAAS does not require documentation of compliance with SAS no. 54, juries are not necessarily convinced, nor monetary judgments necessarily limited, by the argument that the auditor complied with GAAS.<sup>276</sup>

Prudentail concerns create substantial incentives for lawyers to produce documentation. First, SOA requires detection and reporting by lawyers,<sup>277</sup> though it is arguably protected in some instances by the attorney-client privilege. More importantly, issues of both privilege and work product protection have become increasingly complex, especially where the company faces investigation by the federal government as well as private actions which might bear a direct relationship to those investigations.<sup>278</sup> Waivers of the attorney-client privilege

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issued or adopted by the Board.

*Id.* § 404(b), 15 U.S.C.A. § 7562(b).

<sup>276</sup> Specht, *supra* note 261, at 72.

<sup>277</sup> See *supra* Part I.B.

<sup>278</sup> See generally Lance Cole, *Revoking Our Privileges: Federal Law Enforcement's Multi-Front Assault on the Attorney-Client Privilege (And Why it is Misguided)*, 48 VILL. L. REV. 469 (2003) (examining how federal law enforcement is encroaching on the attorney-client privilege). On the problems of defendants facing multiple federal government investigations, see, for example, Mark D. Hunter, *SEC/DOJ Parallel Proceedings: Contemplating the Propriety of Recent Judicial Trends*, 68 MO. L. REV. 149, 162-67 (2003). For a discussion on the impact of secrecy agreements in this context, see, for example, Susan P. Koniak, *Are Agreements to Keep Secret Information Learned in Discovery Legal, Illegal, or Something in Between?*, 30 HOFSTRA L. REV. 783, 783-788 (2002). The practicing bar has become very sensitive to the issues raised by this increasingly popular practice. See, e.g., Thomas Brom, *Full Disclosure*, CAL. LAW., June 2003, at 33.

Moreover, the SEC is itself proposing changes that would make it easier for it to obtain otherwise confidential client material. See SEC, REPORT PURSUANT TO SECTION 704 OF THE SARBANES-OXLEY ACT OF 2002, 45-47 (Jan. 24, 2003) [hereinafter SEC 704 Report], <http://www.sec.gov/news/studies/SOA704report.pdf>. The Commission proposes amendment of the Exchange Act to permit parties to produce privileged or protected materials to the SEC without being deemed to waive

and work product protection are now a common demand by federal prosecutors<sup>279</sup> that compound the problem for outside counsel to the benefit, potentially, of counsel for plaintiffs' lawyers in discrimination, environmental, and similar actions against the corporation. Steve Freccero, a partner in the San Francisco offices of Morrison & Feorster, noted that

[b]y the same token, waiver of privilege can have enormous consequences. It's rare that all you're faced with is a DOJ investigation. You are more likely to have multiple investigative bodies and parallel civil litigation. You may reach an agreement with government investigators regarding

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the privilege or other protection with respect to others. *Id.* at 45.

<sup>279</sup> See David M. Zornow & Keith D. Krakaur, *On the Brink of a Brave New World: The Death of Privilege in Corporate Criminal Investigations*, 37 AM. CRIM. L. REV. 147, 155-56 (2000). The authors note:

Corporations now fear that a less-than-complete disclosure will not count as "thorough" cooperation and may increase the chance of an indictment and the severity of any penalty. Exploiting this fear, federal prosecutors are now licensed to take a short cut around "cooperation or immunity agreements" by requesting privilege waivers "if necessary" to the investigation. . . . The federal government thus effectively encourages the solicitation of privilege waivers for the sake of obtaining evidence that it formerly sought through the traditional means of grand jury subpoenas and the conferral of immunity.

*Id.* The authors have a point. The SEC recently announced a thirteen factor policy to be used to aid the SEC in determining whether to reward cooperation by an issuer under certain circumstances. See Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 34-44969 (Oct. 23, 2001) (parent company not subject to SEC action where its financial statements were misstated as a result of the actions of the comptroller of a subsidiary of the parent company), <http://www.sec.gov/litigation/investreport/34-44969.htm>. In addition to swift investigation, disciplinary action and public disclosure, the parent company cooperated with the SEC in many significant respects.

The company pledged and gave complete cooperation to our staff. It provided the staff with all information relevant to the underlying violations. Among other things, the company produced the details of its internal investigation, including notes and transcripts of interviews of Meredith and others; and it did not invoke the attorney-client privilege, work product protection or other privileges or protections with respect to any facts uncovered in the investigation.

*Id.* The SEC, however, would not institutionalize the thirteen factors as either rule or regulation. The SEC stated that "we are not adopting any rule or making any commitment or promise about any specific case; nor are we in any way limiting our broad discretion to evaluate every case individually, on its own particular facts and circumstances." *Id.*

confidentiality, but plaintiffs' counsel may demand that they too should have access to all your internal interviews.<sup>280</sup>

At the same time, the federal corporate sentencing guidelines also create incentives for waiver. "[C]omplying with the guidelines may require waiving privileges, which has significant potential adverse consequences for both employees and the corporation in subsequent criminal and civil proceedings involving the same conduct."<sup>281</sup> Waiver may also work to the benefit of third-party plaintiffs seeking information to support their actions.

SOA also requires assertions by management to the investing public, which relies in part on those communications or the failure to make the necessary communications under SOA section 307.<sup>282</sup> In the hands of management, in the form of the MD&A discussion of management under SOA section 404, as well as in connection with auditor's needs pursuant to their attestation function, it may be possible for documentation of "material violations" to be produced in discoverable form.<sup>283</sup> Plaintiff's counsel in large scale discrimination, environmental, health and safety and other lawsuits will likely take advantage of this possibility by attempting aggressive discovery targeted on those documents.

### B. *Liability as a Principal Under Securities Acts*

Since the decision in *Central Bank of Denver v. First Interstate Bank of Denver*<sup>284</sup> liability for securities laws violations as an aider and abettor has been eliminated for lawyers and accountants.<sup>285</sup> However, the reporting obligations

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<sup>280</sup> Update: *White-Collar Legal Defense*, CAL. LAW., Aug. 2003, at 43-44. The SEC itself is aware that "[u]nder current law, however, a party who produces privileged or protected material to the Commission runs a risk that a third party, such as an adversary in private litigation, could obtain that information by successfully arguing that production to the Commission waived the privilege or protection." SEC 704 Report, *supra* note 278, at 45.

<sup>281</sup> Cole, *supra* note 278, at 539.

<sup>282</sup> Sarbanes-Oxley Act of 2002 § 404(a), 15 U.S.C.A. § 7262 (West Supp. 2003).

<sup>283</sup> To some extent, corporate counsel will resist production not only on the grounds of privilege, but more likely in the SOA section 404 context, on the work product privilege. See, e.g., FED. R. CIV. P. 26(b)(5) ("Claims of Privilege or Protection of Trial Preparation Materials").

<sup>284</sup> 511 U.S. 164 (1994). For commentary on the case see Joel Seligman, *The Implications of Central Bank*, 49 BUS. LAW. 1429, 1429-41 (1994).

<sup>285</sup> *Central Bank*, 511 U.S. at 191. The government, however, may still seek

imposed under section 10A and under the regulations to SOA section 307 may permit the assertion of securities fraud actions against lawyers and auditors as principals. Indeed, the trends in federal law toward convergence of the conceptualization of the duties and roles of the auditor and outside counsel are well evidenced within the context of auditor/outside counsel primary liability under Rule 10b-5.<sup>286</sup>

### 1. Auditors

Section 10A(c) eliminates an auditor's liability in private rights of action for "any finding, conclusion, or statement expressed in a report made pursuant to the [auditor detect-and-report provisions of section 10A(b)] including any rule promulgated pursuant thereto."<sup>287</sup> Liability arising from the violation of the securities laws themselves, however, may not be covered under the safe harbor. Commentators have suggested that section 10A "may expose auditors to increased litigation for failure to discover and disclose illegal acts other than management fraud. These situations could expose auditors to securities fraud lawsuits based upon direct primary liability under Rule 10b-5."<sup>288</sup> These obligations arise independently of GAAP. Though some courts have suggested that an auditor's duties are co-extensive with GAAP,<sup>289</sup> other courts have suggested that GAAP may be a factor, but not necessarily the determinative factor, in determining auditor liability.<sup>290</sup>

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criminal sanctions against lawyers and accountants for aiding and abetting securities fraud. See 18 U.S.C. § 2 (2000) (providing general authority to charge under federal criminal statutes).

<sup>286</sup> See *infra* notes 306-17 and accompanying text (discussing the extension of primary liability to outside counsel under Rule 10b-5).

<sup>287</sup> Implementation of Section 10A of the Securities Exchange Act of 1934, Exchange Act Release No. 34-38387, 62 Fed. Reg. 12,743, 12,746 n.34 (Mar. 18, 1997) (to be codified at 17 C.F.R. 210, 240).

<sup>288</sup> Calderon & Kowal, *supra* note 163, at 430-31. The authors contend that section 10A's disclosure obligations run directly to investors, and as such, breach of the whistle-blowing obligation should give rise to Rule 10b-5 liability. *Id.*

<sup>289</sup> See *Chill v. Gen. Elec. Co.*, 101 F.3d 263, 270 (2d Cir. 1996) ("Allegations of a violation of GAAP provisions or SEC regulations, without corresponding fraudulent intent, are not sufficient to state a securities fraud claim."); *Monroe v. Hughes*, 31 F.3d 772, 775-76 (9th Cir. 1994).

<sup>290</sup> See, e.g., *Hochfelder v. Ernst & Ernst*, 503 F.2d 1100, 1113-15 (7th Cir. 1974) (finding that other factors include the possible misleading of defendant accounting firm by plaintiff, the extent other agencies investigated the existence of fraud, and the existence of causal connection between the breach of duty of inquiry

Currently, the appellate courts have split on the question of the nature of the conduct sufficient to bring accountants within the primary liability provisions of section 10b-5. At least one court has held that accountants may be primarily liable for statements made by others where the accountants reviewed the statements and played a significant role in the drafting and editing of the statements.<sup>291</sup> Another court has found primary liability possible "when [a secondary actor], acting alone or with others, creates a misrepresentation even if the misrepresentation is not publicly attributed to it."<sup>292</sup> On the other hand, the Tenth Circuit declined to adopt a "rule allowing liability to attach to an accountant or other outside professional who provided 'significant' or 'substantial assistance' to the representations of others."<sup>293</sup> The Tenth Circuit, instead, adopted a narrower rule which requires that outside counsel or auditors "must themselves make a false or misleading statement (or omission) that they know or should know will reach potential investors" for primary liability to attach.<sup>294</sup> The Second Circuit has adopted a similar standard.<sup>295</sup>

The corporate scandals that gave rise to SOA may well have an impact on the willingness of courts to find primary liability. In *In re Enron Securities, Derivative & ERISA Litigation*,<sup>296</sup> the federal district court, in a broadly worded opinion, denied the motions to dismiss claims of primary liability under the securities laws against Vinson & Elkins, Enron's primary outside counsel, and Arthur Anderson, Enron's primary outside accountants.<sup>297</sup> The district court provided a laundry list of

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and disclosure and the facilitation of the underlying fraud so that adequate inquiry and subsequent disclosure would have led to the discovery of the underlying fraud or its prevention).

<sup>291</sup> See *In re Software Toolworks, Inc.*, 50 F.3d 615, 628 n.3 (9th Cir. 1994); see also *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 970 (C.D. Cal. 1994) (finding that primary liability attaches to accounting firm that was "intricately involved" in the creation of false documents).

<sup>292</sup> *Carley Capital Group v. Deloitte & Touche, L.L.P.*, 27 F. Supp. 2d 1324, 1334 (N.D. Ga. 1998).

<sup>293</sup> *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1227 (10th Cir. 1996).

<sup>294</sup> *Id.* at 1226.

<sup>295</sup> See *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998) ("[A] secondary actor cannot incur primary liability under [10b-5] for a statement not attributed to that actor at the time of its dissemination.").

<sup>296</sup> 235 F. Supp. 2d 549 (S.D. Tex. 2002).

<sup>297</sup> See *id.* at 708.

conduct constituting primary violation of the securities laws.<sup>298</sup> The district court applied the principle that allegations of violations of GAAP, standing alone, are not sufficient to make out a claim for primary liability against auditors.<sup>299</sup> However, the district court found sufficient allegations of additional conduct to support an allegation of scienter.<sup>300</sup> The Enron litigation will have a long course to run before the law is settled with respect to its application to Arthur Anderson and the other parties involved. I believe, however, in light of Congress's

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<sup>298</sup> Thus, the district court concluded that

[L]ead Plaintiff has identified numerous violations by Arthur Andersen of GAAS, GAAP, risk factors for fraud, accounting rules, and rules of professional conduct for accounts that Arthur Andersen violated. Yet Arthur Andersen certified that Enron's financial statements for 1997–2000 were in compliance with GAAP and its audits of the financial statements complied with GAAS. Moreover it knew its reports would be relied upon by present and potential investors in Enron securities. It also consented to having the audited financial statements included in registration statements, prospectuses, and annual shareholders' reports that were filed by Enron during the Class Period. Lead Plaintiff has also alleged that Arthur Andersen destroyed documents to conceal its fraudulent accounting. All of these constitute primary violations under § 10(b).

*Id.* at 706.

<sup>299</sup> “[T]he mere publication of inaccurate accounting figures, or a failure to follow GAAP, without more does not establish scienter. The party must know that it is publishing materially false information or the party must be severely reckless in publishing such information.” *Id.* at 707. (quoting *Melder v. Morris*, 27 F.3d 1097, 1103 (5th Cir. 1994)). Failure to follow GAAP, of course, is also a necessary element of a fraud claim, but does not go toward the element of intent or recklessness, standing alone.

<sup>300</sup> The specific factual allegations indicating the requisite level of scienter included:

Arthur Andersen's comprehensive accounting, auditing, and consulting services to Enron necessarily made it intimately privy to the smallest details of Enron's alleged fraudulent activity. Lead Plaintiff has described several similar prior fraudulent audits of other companies, establishing a pattern of such conduct, and the SEC's and courts' repeated imposition of penalties on Arthur Andersen and its employees, including the consent decree and injunction from the Waste Management fraud which was in effect at the time Lead Plaintiff alleges that Arthur Andersen violated § 10(b) in auditing Enron.

*Id.* at 706. The district court also found significant the details of a telephonic conference between Arthur Anderson principals in which most of the information relating to the fraudulent conduct of its client was discussed, but a decision was made to continue the representation “because Enron's business was so lucrative.” *Id.* at 706–07. The plaintiffs also produced evidence of internal “e-mails and internal memoranda between and among Arthur Andersen employees . . . before the '99 financial statements were issued that reflect Arthur Andersen's knowledge and intent to continue in the fraudulent scheme.” *Id.* at 707.

understanding of the scandal leading to this litigation and to the enactment of SOA, that the allegations against Arthur Anderson may well come to provide a nice laundry list of conduct to be avoided in order to avoid claims of primary liability under the securities laws. The SEC, however, is not waiting. It continues to take an aggressive stance in bringing litigation. In a case filed in April 2003,<sup>301</sup> the SEC claimed that Chancellor Corporation's outside auditors were liable as principals for securities fraud.<sup>302</sup> With respect to the auditors, the SEC also alleged that the auditor could not have been unaware that the company was preparing to file financial statements that contained material misrepresentations, triggering the auditor's section 10A obligations.<sup>303</sup> In this case, the auditor's conduct in failing to detect and report misconduct, in issuing a clean audit report, and in reviewing subsequent disclosures by the issuer, was sufficient to constitute both a basis for violation of section 10A, and section 10B, and Rule 10b-5.<sup>304</sup> The auditor's failure to report violations constitutes a violation of section 10A, and this failure to report constitutes a critical component of the auditor's course of conduct which exposes the auditor to liability as a principal for the fraud of the issuer.<sup>305</sup>

## 2. Outside Counsel

Like auditors, lawyers no longer face the prospect of liability in private actions for aiding and abetting securities fraud under Rule 10b-5.<sup>306</sup> On the other hand, courts have been willing to extend primary liability to outside counsel under Rule 10b-5.<sup>307</sup> As a result, it has become "hornbook law" to avoid conduct drawing direct attention to the work of the outside counsel to

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<sup>301</sup> SEC v. Chancellor Corp., No. 03-10762 MEL (D. Mass., filed April 24, 2003), <http://www.sec.gov/litigation/complaints/comp18104.htm> (last visited Sept. 30, 2003). The defendants include certain officers, an outside director, and the issuer's outside auditor. *See id.* at para. 1-6.

<sup>302</sup> *See id.* at para. 83-86. The SEC alleged that the auditors failed to substantiate the propriety of the issuer's financial statement disclosures in a number of respects in the face of obvious warning signs. *See id.* at para. 67-82.

<sup>303</sup> *See id.* at para. 121-25.

<sup>304</sup> *See id.* at para. 7, 67-82.

<sup>305</sup> *See id.*

<sup>306</sup> *See supra* notes 165-70 and accompanying text.

<sup>307</sup> *See, e.g.,* Wright v. Ernst & Young LLP, 152 F.3d 169, 174-76 (2d Cir. 1998); Carley Capital Group v. Deloitte & Touche, L.L.P., 27 F. Supp. 2d 1324, 1333-34 (N.D. Ga. 1998).

minimize the potential for primary liability under the securities laws. "For lawyers and others involved in transactions, it has become extremely important to remain 'behind the scenes,' avoiding unnecessary contact with the parties on the other side of transactions. This helps prevent one avenue that can open one up to primary liability."<sup>308</sup> As with auditors, the scandals of the early twenty-first century may rewrite the common understanding of the standards for imposing primary liability on outside counsel under the securities laws, and especially what it means to be "behind the scenes." In the Enron litigation,<sup>309</sup> the district court refused to dismiss the primary liability claims against Vinson & Elkins, Enron's outside counsel.<sup>310</sup> The court rejected the claims by Vinson & Elkins that its role was merely that of a behind the scenes secondary agent charged with a primary duty of keeping client confidences under relevant rules of professional responsibility.<sup>311</sup>

Instead, the complaint alleges that the two were in league, with others, participating in a plan, with each participant making material misrepresentations or omissions or employing a device, scheme or artifice to defraud, or engaging in an act, practice or course of business that operated as a fraud, in order to establish and perpetuate a Ponzi scheme that was making them all very rich.<sup>312</sup>

There were a number of facts alleged that made the allegations credible to the court. Most of these will likely serve as a litmus test for law firms serving public companies in the future. Among the facts alleged were those that went to a showing that Vinson & Elkins affected the very devices at the heart of the scheme to defraud.<sup>313</sup> For purposes of motivation,

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<sup>308</sup> LARRY D. SODERQUIST, UNDERSTANDING THE SECURITIES LAWS § 12:12, at 12-33 (3d ed. 2001).

<sup>309</sup> *In re Enron Corp. Sec. Derivative and ERISA Litig.*, 235 F. Supp. 2d 549 (S.D. Tex. 2002).

<sup>310</sup> *See id.* at 705.

<sup>311</sup> *See id.* at 704-05.

<sup>312</sup> *Id.* at 704.

<sup>313</sup> The district court specified the following:

Vinson & Elkins was necessarily privy to its client's confidences and intimately involved in and familiar with the creation and structure of its numerous businesses, and thus, as a law firm highly sophisticated in commercial matters, had to know of the alleged ongoing illicit and fraudulent conduct. Among the complaint's specific allegations of acts in furtherance of the scheme are that the firm's involvement in negotiation and structuring of the illicit partnerships and off-the-books SPEs, whose

the court was content to look to the large fees that Vinson & Elkins earned for its alleged work.<sup>314</sup> Though the court suggested that under other circumstances the absolute public silence of Vinson & Elkins might have cut against liability, the plaintiffs had alleged a number of instances of public interventions by the law firm in connection with the matters it handled for Enron.<sup>315</sup> The nature of the participation of outside counsel necessary to support a claim for primary liability can be contrasted with the sorts of activities that might shield outside lawyers. While the district court found that the complaint could survive a motion to dismiss its allegations of primary liability against Vinson & Elkins, the same court held that the allegations against another law firm, Kirkland & Ellis, did not rise to a cognizable claim for primary liability.<sup>316</sup> According to the court, plaintiffs failed to allege facts other than that Kirkland & Ellis, unlike Vinson & Elkins, performed little more than "routine" legal work, never made statements which could be relied on by third parties, and otherwise did nothing that directly tied its work to disclosure obligations under the securities laws.<sup>317</sup>

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formation documentation it drafted, as well as that of the subsequent transactions of these entities. It advised making Kopper manager of Chewco so that Enron's involvement in and control of the SPE would not have to be disclosed, drafted "true sales" opinions that Lead Plaintiff asserts were essential to effect many of the allegedly fraudulent transactions. Vinson & Elkins was materially involved in the New Power IPO, and it structured and provided advice on the Mahonia trades, all actions constituting primary violations of § 10(b).

*Id.*

<sup>314</sup> See *id.* at 704–05.

<sup>315</sup> Thus, for example, the court looked to

Vinson & Elkins made the alleged fraudulent misrepresentations to potential investors, credit agencies, and banks, whose support was essential to the Ponzi scheme, and Vinson & Elkins deliberately or with severe recklessness directed those public statements toward them in order to influence those investors to purchase more securities, credit agencies to keep Enron's credit high, and banks to continue providing loans to keep the Ponzi scheme afloat. Therefore Vinson & Elkins had a duty to be accurate and truthful. Lead Plaintiff has alleged numerous inadequate disclosures by Vinson & Elkins that breached that duty.

*Id.* at 705.

<sup>316</sup> See *id.* at 705–06.

<sup>317</sup> The court explained that

While the allegations against Kirkland & Ellis may indicate that it acted with significant conflicts of interests and breached professional ethical standards, unlike its claims against Vinson & Elkins, Lead Plaintiff has

In this emerging context, the lawyer's obligations under SOA section 307 add another layer of obligations whose breach may consist of acts which, taken with those of corporate fiduciaries, can constitute fraud within the meaning of section 10b-5. Outside counsel who participate in the creation and marketing of fraudulent devices, and outside counsel who discover evidence of potential fraud in the construction, marketing, explanation, or disclosure of corporate actions and fail to report such evidence to management, or fail to distance themselves from those schemes after reporting, face a heightened likelihood that their conduct could give rise to an inference of scienter necessary to maintain an action against them as primary violators. Likewise, the failure to create and implement procedures that might lead to the detection of "material violations" with respect, at least, to the outside counsel's engagement might also provide evidence of a sufficient level of recklessness to suggest scienter.

*C. Direct Liability For Other Corporate Illegal Acts.*

Most of the commentary to section 10A and the regulations under SOA section 307 focuses on auditor and lawyer liability under the securities acts.<sup>318</sup> I have suggested that the breadth of liability could extend significantly farther. In particular, given the scope of the monitoring obligations and the positive obligations to detect and report even the possibility of contingent liability, auditors and outside counsel ought to become especially sensitive to the possibility that they might become liable, along with their corporate client, for violations of laws other than the securities laws. While it is true enough that the "material effect

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not alleged that Kirkland & Ellis exceeded activities would be protected by an attorney client relationship and the traditional rule that only a client can sue for malpractice because it never made any material misrepresentations or omissions to investors or the public generally that might make it liable to nonclients under § 10(b). Any documents that it drafted were for private transactions between Enron and the SPEs and the partnerships and were not included in or drafted for any public disclosure or shareholder solicitation. Any opinion letters that the firm wrote are not alleged to have reached the plaintiffs nor been drafted for the benefit of the plaintiffs. It was not Enron's counsel for either its securities filings or its SEC filings. Thus the Court grants Kirkland & Ellis' motion to dismiss.

*Id.* at 706.

<sup>318</sup> See, e.g., Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 33-8150; Fed. Reg. ¶ 71,670, 71,689 n.57.

on financial statement amounts"<sup>319</sup> standard would tend to limit the reach of liability, as recent discrimination litigation against some of the largest public companies in the United States has shown,<sup>320</sup> discrimination cases with potentially significant effects on financial statement amounts are not rare.

The basis of liability as principals, for laws other than the securities laws, will necessarily draw by analogy, at least to some extent, to the emerging law of primary liability under the securities laws for auditors and outside counsel. The crux of liability will likely depend, in general, on the willingness of courts to construe some set of auditor and lawyer conduct as constituting active participation in the corporation's illegal conduct. To that extent, the example of Vinson & Elkins participation in Enron's securities and financial schemes may prove helpful to courts. *Scienter* may or may not be material for illegal conduct other than for violation of the securities laws. Where the underlying statutes are predicated on "knowing" violation, the *scienter* rules of primary liability for auditors and lawyers may be influential. This area of law is substantially unexplored. I merely suggest here a set of possibilities that may, with time, be exploited by plaintiffs' counsel in cases alleging misconduct by public companies other than misconduct relating to the securities laws.

#### 1. Auditors

I have already suggested that the section 10A safe-harbor provisions can be interpreted as fairly limited in scope.<sup>321</sup> The report itself may not be used as a basis for liability. On the other hand, the safe-harbor provisions of section 10A do not provide protection against liability for the illegal activities themselves, at least to the extent that the auditor had an independent duty to act or not act. Early commentators got it right when they observed that:

[P]laintiffs' attorneys may cite the auditor's new duty under [section 10A] to detect and disclose illegal acts to support their securities fraud allegations which now must be pled with factual particularity. Plaintiffs may allege that an auditor's failure to detect fraudulent or illegal acts demonstrates the

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<sup>319</sup> 15 U.S.C. § 78j-1(a)(1) (2000).

<sup>320</sup> See *supra* notes 38-44 and accompanying text.

<sup>321</sup> See discussion *supra* Part II.A.

requisite scienter or recklessness to sustain a primary section 10(b) or Rule 10b-5 fraud liability claim. In fact, recent successful federal securities lawsuits against accountants alleging direct primary fraud violations may fuel future litigation under [section 10A].<sup>322</sup>

The courts have emphasized that auditors face primary liability under Rule 10b-5 where the auditor knows that its audit opinions would reach investors.<sup>323</sup> On the other hand, "an outside accounting firm might be blameless where it had no reason to know that its client would use its audit report to sell securities."<sup>324</sup> Knowledge or use of auditor opinions extends to the reliance on auditor data on a company's 10-K periodic reports.<sup>325</sup> Liability under section 10b extends to "a document such as a press release, annual report, investment prospectus, or other such document on which an investor would presumably rely."<sup>326</sup>

These concepts are not necessarily new or newly applied to auditors. However, they do suggest the contours of liability derived from auditor obligations under section 10A based on either the failure to report illegal activities that ought to have been detected or on complicity in the fraud of the issuer. Auditors would not be liable in private suits for failure to meet their obligations under section 10A.<sup>327</sup> Instead, liability would derive from the product of that failure, financial statement amounts that materially misrepresent the financial condition of the company or otherwise contribute to misleading disclosure by the company. Where the failure involves a material contingency,<sup>328</sup> the auditor's failure to comply either with

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<sup>322</sup> Jeanne Calderon & Rachel Kowal, *supra* note 162, at 449-50 (1998) (citing *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441, 1445-46 (11th Cir. 1997) and *Edward J. DeBartolo Corp. v. Coopers & Lybrand*, 928 F.Supp. 557, 559-60 (W.D. Pa. 1996)).

<sup>323</sup> *Anixter v. Home-Stake Prod.*, 77 F.3d 1215, 1227 (10th Cir. 1996).

<sup>324</sup> *McGann v. Ernst & Young*, 102 F.3d 390, 397 (9th Cir. 1996) (citing *Frymire-Brinati v. KPMG Peat Marwick*, 2 F.3d 183, 189-90 (7th Cir. 1993)).

<sup>325</sup> *See id.* (discussing dissemination of false information in 10-K report).

<sup>326</sup> *SEC v. Rana Research, Inc.*, 8 F.3d 1358, 1362 (9th Cir. 1993); *accord Semerenko v. Cendant Corp.*, 223 F.3d 165, 175-76 (3rd Cir. 2000) (regarding accountant primary liability).

<sup>327</sup> 15 U.S.C. § 78j-1(c).

<sup>328</sup> *See FINANCIAL ACCOUNTING STANDARDS BOARD*, *supra* note 116, at 4-7 (describing disclosure guidelines for auditors dealing with loss and gain contingencies).

auditing standards or the requirements of the SEC<sup>329</sup> might contribute to primary liability under Rule 10b-5.

## 2. Outside Counsel

For lawyers, the monitoring and reporting requirements under the regulations to SOA section 307, when amplified by traditional ethical rules, suggest that the failure of lawyers to detect and report illegal acts of corporate clients might well subject lawyers to liability as principals. The extent of liability might well depend on the adequacy of the mechanisms in place for detection of illegal acts as well as on the lawyer's conduct once credible evidence of the acts becomes known *or should be apparent* to the lawyer.

At least since the 1980s, ethical rules have prohibited a lawyer from assisting a client in conduct that the lawyer knows is criminal or fraudulent.<sup>330</sup> The comments to that section of the rules suggest that the consequences of a failure to observe the rule appropriately include the lawyer running the risk of becoming a party to the criminal or fraudulent course of action.<sup>331</sup> The comments distinguish between "presenting an analysis of legal aspects of questionable conduct and recommending the means by which a crime or fraud might be

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<sup>329</sup> See Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Exchange Act Release No. 34-26831, 54 Fed. Reg. ¶ 22,427 (May 24, 1989) (to be codified at 17 C.F.R. pts. 211, 231, 241, 271). A disclosure duty exists where management is aware of an uncertainty that is reasonably likely to have a material effect on the company's financial condition. *Id.* at 22,249. Where management cannot objectively evaluate the reasonable likelihood of occurrence, management must evaluate the uncertainty on the assumption that it will occur. *Id.* at 22,430. For auditors, this may require both procedures that elicit representations from management and counsel and procedures that in certain cases test those representations. All of that is subject to discovery and may provide the basis for primary liability on the auditor's failure to comply with their duty.

<sup>330</sup> See MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2002).

A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

*Id.* For a discussion of the changes to Rule 1.2 in the course of the ABA's Ethics 2000 project, see Margaret Colgate Love, *The Revised ABA Model Rules of Professional Conduct: Summary of the Work of Ethics 2000*, 15 GEO. J. LEGAL ETHICS 441, 447-48 (2002).

<sup>331</sup> See MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2002) cmt. 9-13.

committed with impunity.”<sup>332</sup> With respect to a client’s course of action already begun or continuing, the comment describes the lawyer’s responsibility as “especially delicate.”<sup>333</sup> In this case the lawyer must avoid drafting or delivering fraudulent documents, suggesting methods for concealing the wrongdoing, and continuing to assist the client in conduct the lawyer may have thought was legal but thereafter discovers is not.<sup>334</sup> In the latter case, the comment suggests withdrawal from the representation, and in those cases in which “withdrawal alone might be insufficient” and “[i]t may be necessary for the lawyer to give notice of the fact of withdrawal and to disaffirm any opinion, document, affirmation or the like.”<sup>335</sup>

Of course, the ethical rules are narrowly tailored to give lawyers the benefit of the doubt in many cases. The triggering standard is knowledge, not suspicion. Also, there appears to be no obligation to implement procedures to guard against or detect client misconduct. The ethical obligation posits as unethical the lawyer actually in cahoots with the client in engaging consciously and deliberately in acts of actual misconduct. Ignorance is rewarded with protection against liability, but more importantly, ignorance permits the lawyer to continue to represent the client. Withdrawal is required only on discovery of ongoing misconduct, and disaffirmation is suggested only to the extent necessary to protect the lawyer from continued implication in the client’s affairs.

These basic ethical norms, however, take on new meaning when read in light of the detection and reporting obligations of the SOA section 307 regulations. The obligation to detect and report has the potential to make it more likely that lawyers will come across evidence of illegal client activity. Lawyers who see the obvious and fail to make inquiries and who help the company produce disclosure statements to investors indicating no reason to worry about the potential for material effects on financial statement amounts by reason of litigation potential are the lawyers who may well breach breached their obligations to *detect*. Furthermore, they way compounded the breach by aiding the company in creating a false picture. These situations,

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<sup>332</sup> *Id.* at cmt. 9.

<sup>333</sup> *Id.* at cmt. 10.

<sup>334</sup> *See id.*

<sup>335</sup> *Id.*

similar to what Cheryl Wade suggested with respect to director liability for corporate discrimination, might also have some applicability to outside counsel.<sup>336</sup>

Once the obligation to report has been triggered under SOA section 307, the question for the lawyer becomes: How does my report to the corporation change my relationship to the corporation and to the acts that I have reported? The simplest and best answer for lawyers is: no change. But the SOA section 307 regulations, like the Model Rules of Professional Conduct, appear to require the lawyer to resign in the event the corporation does not satisfactorily address the lawyer's report. Clearly, if the reporting lawyer does not obtain a satisfactory response to her report, and fails to resign or do anything else about it, there is a good chance that she will be deemed to have joined in the illegal act she originally reported to the corporation. "Regardless of the decision on the duty to disclose, the organization does have a duty to discontinue any conduct that violates the law. If the organization does not discontinue the activities revealed as a result of the investigation, that inaction itself becomes fraud."<sup>337</sup> The extent of her primary liability will depend on the nature of the illegal act and her exact course of conduct after her report. The more she appears to have joined or acquiesced in the illegal scheme, the greater the likelihood of liability. As such, for example, continuing to perform services for

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<sup>336</sup> See Cheryl L. Wade, *Corporate Governance Failures and the Managerial Duty of Care*, 76 ST. JOHN'S L. REV. 767 (2002). Professor Wade, in examining the discrimination lawsuits against Texaco, suggests that:

Even if Texaco's board did not have a complete understanding of the complaints made by Texaco's minority employees, their managers certainly did. The court made no attempt to address the "reckless indifference" of Texaco's officers. Nor did the court distinguish between the level of care that should be exercised by inside, as opposed to outside, directors. Even if Texaco's board had no reason to ask officers about racial discrimination, the boards of companies with few or no minorities among senior managers or executives may be recklessly indifferent to the possibility of litigation and large settlements if they fail to ask their officers the right questions in the aftermath of the large settlements paid by Texaco and Coca-Cola. In other words, the boards of large public companies should inquire about racial discrimination in order to avoid the negative publicity and huge settlements that plagued Texaco and Coca-Cola.

*Id.* at 784-85; see also discussion *supra* notes 42-45 and accompanying text (discussing discrimination actions against large public companies).

<sup>337</sup> Gabriel L. Imperato, *Internal Investigations, Government Investigations, Whistleblower Concerns: Techniques to Protect Your Health Care Organization*, 51 ALA. L. REV. 205, 226 (1999).

the issuer in the face of evidence of discrimination may change the character of the lawyer or accountant's relationship to the discrimination to that of a discriminatory scheme. But even if the lawyer obtains what she perceives to be a satisfactory response, it is not clear that she, on that basis, will avoid liability. Should both she and the corporation prove to be wrong about the extent of liability, it is possible that she might face liability as a principal.<sup>338</sup>

Federal whistleblower protections included in the Sarbanes-Oxley Act appear to provide little protection from liability for either outside counsel or auditors. SOA is not clear about the relationship between the section 307 requirements and the protections afforded under the section 806 whistleblower provisions.<sup>339</sup> For outside counsel, SOA whistleblower provisions, if read narrowly, could appear to provide little protection for lawyers. While section 806 extends protection to employees of a company against retaliation by the employer under certain specified circumstances,<sup>340</sup> it may not extend to suits by unrelated parties for acts undertaken as an employee. The encouragement of reporting under section 307 should not be read as encouragement of reckless or negligent over-reporting which results in damage to the company. Consequently, statutes that protect employees reporting wrongdoing might not protect the wrongdoing of the reporting employees.

A broader reading of the intent of the whistleblower provisions might lead to a different result. If the purpose of the protection is to encourage reporting, then employee liability based on that reporting would seem to create disincentives to robust reporting under section 307. Since the disclosure of section 307 reporting may be a function of a company's obligations under section 404, as overseen by the company's outside auditors, it would be plausible to argue that any damage alleged was not caused by the reporting employee but rather by the reporting company and its auditors. As such, the employee should escape liability to third parties, at least in circumstances

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<sup>338</sup> While clearly she might not have had the intent to commit or participate in the illegal act under these circumstances, her assessment, if made recklessly because of lapses in her information systems or due diligence, might be sufficient to impose primary liability. *See id.* at 225-26.

<sup>339</sup> Sarbanes-Oxley Act of 2002 § 806, 18 U.S.C.A. §1514A (West Supp. 2003).

<sup>340</sup> *See id.* § 806(a)(1)-(2), 18 U.S.C.A. § 1514A(a)(1)-(2).

in which the section 307 reporting might be covered by the whistleblower protections of section 806.<sup>341</sup>

However, the SEC, in its final regulations implementing section 307, may have taken the position that a lawyer's obligations under section 307 are not covered by the protections of section 806. The regulations provide that:

An attorney formerly employed or retained by an issuer who has reported evidence of a material violation under this part and reasonably believes that he or she has been discharged for so doing may notify the issuer's board of directors or any committee thereof that he or she believes that he or she has been discharged for reporting evidence of a material violation under this section.<sup>342</sup>

The SEC explained that the "provision, an important corollary to the up-the-ladder reporting requirement, is designed to ensure that a chief legal officer . . . is not permitted to block a report to the issuer's board or other committee by discharging a reporting attorney."<sup>343</sup> It is possible to interpret that this provision to apply only to lawyers employed directly by an issuer and that its effect is directed primarily at the obligation to report. Thus, it may be that the notification right under section 205.3(b)(10) may be in addition to any protection offered to the lawyer under section 806, to the extent those are otherwise available.

#### *D. A Hypothetical Application*

I have suggested that section 10A and the regulations under SOA section 307 can, under the right circumstances, be used to extend primary liability to auditors and outside counsel for the client corporation's violation of the anti-fraud provisions of the securities laws and that they might also be useful to enhance discovery.<sup>344</sup> I have also suggested an interpretation of sections

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<sup>341</sup> Of course, the circumstances under which this may occur may be quite limited, given the potential narrowness of the application of the protection of the whistleblower provision.

<sup>342</sup> Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205.3(b)(10) (2003).

<sup>343</sup> Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 34-47276, 68 Fed. Reg. 6296, 6309 (Feb. 6, 2003) (to be codified at 17 C.F.R. § 205).

<sup>344</sup> See *supra* Part III.A.

10A and SOA section 307 which might be used to make a case for asserting liability against a corporation's auditors and outside counsel for violations by the client corporation of other laws such as environmental and discrimination laws.<sup>345</sup> In this section, I provide a sketch of the sort of facts that might point to liability on the basis I have suggested.

The *key to liability* is generally simple: alleging facts sufficient to convince a judge or jury that outside counsel or the auditors became partners in the unlawful conduct. The matter of the *quid pro quo* is also a simple matter, the prospect of continuing the business relationship and charging large fees to the company.<sup>346</sup> The *effect* of section 10A and the SOA section 307 regulations in this context is also simple. By increasing the obligations of outside counsel and the auditors to the company, positive duties have been created on the part of both of these actors to detect and report corporate misconduct. The failure to detect and report, or the continued participation of outside counsel or the auditors in the company's affairs in the face of detectable and reportable events which have gone uncorrected, suggests not mere approval but collusion, and this collusion increases the likelihood of characterization of outside counsel or auditor conduct as actionable.

There are a number of circumstances that might provide a case for lawyer or auditor liability for a corporation's breaches of laws other than the securities laws. For purposes of this section, I limit myself to violations made by the client company of the discrimination laws. Consider the following imaginary set of facts:

Company is a corporation whose shares have been publicly traded on a national stock exchange for a number of years. It employs 5,000 people in plants scattered throughout the United

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<sup>345</sup> See *supra* Part III.B.

<sup>346</sup> See William T. Allen & Arthur Siegel, *Threats and Safeguards in the Determination of Auditor Independence*, 80 WASH. U. L.Q. 519, 520 (2002).

No fact more tellingly establishes that independence remains potentially problematic, even though consulting is now made illegal, than the fact that Arthur Anderson reportedly received approximately \$26 million in audit fees from Enron. Worldcoms[sic] audit fees were of the same magnitude. Audit fees of this size are alone large enough to tempt audit partners from the narrow path of rectitude. Thus, complex issues of auditor independence do remain after passage of the Sarbanes-Oxley Act.

*Id.*

States. Most of the employees are hourly workers employed in low-skill manufacturing and assembly positions. Company's board consists of 15 people, ten of whom are "independent"; the rest are officers of Company. The Board is divided into a number of committees. One of these, the Audit Committee, is composed of six of the independent board members, two of whom are the chief financial officers of their respective companies, and both of whom are CPAs. Since *Caremark*,<sup>347</sup> Company has implemented systems of internal monitoring. These consist of programs of formal reporting up the corporate chain of command to the board, as well as formal and informal procedures for "whistleblowing." These programs have concentrated on financial statement issues. Since the passage of SOA, Company has augmented its programs of internal control in order to comply with the requirements of SOA. In particular, the Audit Committee has been given additional authority with respect to financial statement monitoring, and a procedure for anonymous disclosure to the Audit Committee has been instituted.

Counsel is a large law firm representing a number of public companies. Counsel has 100 partners and 200 associates working in several practice groups, the largest of which are litigation, corporate/securities, commercial, employment law, and tax. Counsel prides itself on a culture of partner independence and exposure to clients. Although multiple partners and associates may perform work for a client, there are only, at best, ad hoc procedures for communication between them, especially if the lawyers are working out of different practice groups. Counsel has represented Company for years, from which it earns substantial fees. Although Partner X has been the "billing partner" for years, concentrating principally on securities laws issues, Partner Y and Partner Z have been handling Company's labor and environmental issues for a number of years. In addition, anywhere from four to fifteen associates may be working on Company matters from time to time. Company's General Counsel is a former partner of Counsel. General Counsel has hired a number of younger lawyers away from Counsel. Relations between the office of Company's General Counsel and Counsel are extremely close.

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<sup>347</sup> 698 A.2d 959 (Del. Ch. 1996). See *supra* notes 224-33 and accompanying text. (discussing the *Caremark* case with respect to the development of the law of the obligation to monitor).

Counsel has prepared the employee handbook, counseled Company extensively on employee hiring and termination policy, counseled on specific cases involving worker termination, and developed the terms of employment used by the company. Counsel has litigated a number of lawsuits filed by former employees, including suits alleging employment discrimination. A few of these have drawn significant attention in the popular press, and Partner Y was quoted extensively in newspapers and on local television to the effect that Company has never done anything wrong and had never discriminated against any racial or ethnic group. After some of these suits were settled, Counsel advised Company on a number of changes it could make to minimize its exposure to such suits in the future. In connection with its securities-laws obligations to Company, Counsel has chosen to make no changes to its procedures. These procedures consist of the usual client due diligence and circulation of internal memoranda to firm partners seeking information material to Company for purposes of disclosure and responses to the annual auditor's request for information. While the system has worked well enough in the past, there have been occasions when busy partners have forgotten to respond and securities filings have had to be amended. With respect to litigation and other claims, Counsel has always taken a very conservative approach with respect to disclosure, especially to Auditor.

Company's financial statements have been audited by Auditor, a large firm providing accounting and related services worldwide. Auditor has provided auditing, tax accounting, and general consulting services to Company since it went public. It has earned substantial fees for these services in the past. Since the passage of SOA, however, Auditor has limited its work to auditing and tax accounting services, for which it continues to receive fees that are material to the profitability of the firm. These services include year-end audit responsibilities and limited review of other financial reports required to be filed under the securities laws. Auditor and Counsel have provided similar services for a number of companies and many of the partners and associates of Counsel and Auditor are well known to and trust one other. In addition, many former partners and employees of Auditor now are employed in accounting and finance positions in Company. As a result, relations between Auditor and Company are deep and strong.

Company has demanded increased flexibility in its freedom to hire workers. A number of employees, from senior management down to plant managers, have quietly sought to be able to hire only those people with whom they felt a compatibility. Counsel has been more than happy to comply with the requests for help in this context. Company's employee workforce is 60% white and 20% Asian. Of the remaining 1,000 employees, about 700 are Hispanic, mostly female, and 300 are African-American, mostly male, employees, all in the lowest paying jobs. Company's management is overwhelmingly white. Company's finance department has hired a number of Asian employees; however, most of them are quite junior. They have joked to their counterparts working for Auditors that they describe themselves as the "coolie labor" at the Company because they suspect they will have to leave to get promoted. When a low level employee of Auditor asked why they never said anything, she was told that at Company it never paid to be too vocal because people who stood out that way tended to have very short tenures at Company. The gist of this conversation was passed on to the partner in charge. The partner dismissed the conversation, characterizing it as nothing more than whining by young people.

For a number of years, the number of unlawful termination lawsuits alleging racial and ethnic discrimination, have been rising. More of these cases have been settled and the amounts paid in settlement have been growing. When the increase was brought to the attention of Counsel's Partner Y, she explained it away by suggesting that hungry plaintiffs' counsel with poor law school educations brought on the increase. Indeed, the only response of Counsel, along with senior management of Company, was to rework the employee manual and other terms of employment so that while the rate of hiring minority employees increased, so did the rate of termination. In addition, and with Counsel's concurrence, Company retained a public relations firm that produced a video for distribution to the public, which stated that Company offered an open and diverse workplace where people from every background could feel they could rise as far as their talents could take them. Partner X appeared briefly in the video. In addition, the Company continues to report to its investors that employee relations are excellent and that the

company's new and expanded monitoring systems will ensure no disclosure or financial statement problems.

It was not uncommon for ethnic jokes to be circulated widely via e-mail within Company's management. Many of these were forwarded to associates at Auditor and Counsel. These were brought to the attention of the senior managers at Counsel and Auditor. After Partner X talked with his counterpart at Auditor, Auditor's and Counsel's complaining employees were told that they were being too hypersensitive and ought to keep their opinions to themselves. They were told that, if they didn't like the e-mails, they should tell the sender to stop sending them those sorts of jokes. Additionally, several of Counsel's associates have noted the absence of a diverse workforce and have mentioned this to Partners X and Y. Moreover, both Counsel and Auditor's employees reported on the lack of diversity in their own contacts with Company during the course of their legal and audit work for Company.

Neither Counsel nor Auditor have fulfilled their detect and report obligations under section 10A or the SOA section 307 regulations. Counsel, however, has worked extensively with management on its MD&A disclosures. Management's discussion and assessment of the effectiveness of Company's internal control structures and its procedures for financial reporting under SOA section 404(a)<sup>348</sup> were based on informal conversations between Counsel, the Audit Committee, and management staff.<sup>349</sup> In the course of the preparation of that disclosure, Counsel learned that the Audit Committee received an increasing number of anonymous complaints about lack of diversity and incidents characterized as originating in racial or ethnic animus. These were referred to management. Management explained that these were a result of agitation by outsiders. The Audit Committee members have joked about these complaints and suggested that the disgruntled employees go back where they came from or made light of the complaints in some other way. Indeed, both Auditor and Counsel learned during the course of their review that the Audit Committee was especially offended to learn about an off network internet site

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<sup>348</sup> Sarbanes-Oxley Act of 2002 § 404(a), 15 U.S.C.A. § 7262 (West Supp. 2003).

<sup>349</sup> On this basis the Company's principal executive and financial officers signed the certification in the form required by Sarbanes Oxley § 302(a), 15 U.S.C.A. § 7241 and the regulations thereunder.

called "The Discriminatory Company: Sharing Examples of Discrimination at Company," which contained a large number of complaints about incidents of race and ethnic discrimination at the Company. Both Counsel and Auditor personnel viewed the site. The auditors reviewing management's assessments of its internal controls were also made aware of the complaints and the responses of Company management and the board. But the auditors neither discussed this with Counsel nor looked further into the matter.<sup>350</sup>

The hypothetical related above is full of missteps. It is meant to illustrate the ease with which clumsiness, the refusal to institute systems of information gathering and review, and an ingrained blindness to data from the lower level employees of both the client company and the monitors themselves, can with little effort produce a set of facts which might well give rise to inferences of both primary liability for securities fraud and joint liability for discrimination. A few factors should be considered with regards to outside counsel:

1. Is there an internal monitoring system in place at the firm?

The implementation of procedures for gathering information acquired from all of the lawyers performing work for the client company may be an important factor for assessing Counsel compliance with its obligations. In the hypothetical, Company implemented monitoring systems after *Caremark* and updated the systems after SOA. Company has acted conservatively and adopted a course of conduct that should increase the likelihood that potential violations will be caught early. Counsel, on the other hand, has taken a more aggressive position. It has chosen to make no changes to its internal procedures in the face of the adoption of the SOA section 307 regulations. This choice may impede Counsel's ability to reasonably detect evidence of wrongdoing and, in addition, may make it more difficult to prove that Counsel was not negligent (or worse) in its compliance with its monitoring obligations.

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<sup>350</sup> Because the audit team was split into groups, the senior members of the Auditor never learned about the pattern of suit, settlement, and complaints relating to employee terminations, even though junior members of the audit team had run across these and their counterparts in Company's finance department raised some very discrete concern.

2. Is there a culture of communication within the firm?

That is do the labor lawyers speak with the securities or business lawyers? Having a monitoring system in place, whether formal or informal does not guarantee compliance, or an easy means to minimize exposure to liability. Current federal prosecutorial principles applicable to corporations should serve as a caution in this respect:

[T]he existence of a compliance program is not sufficient, in and of itself, to justify not charging a corporation for criminal conduct undertaken by its officers, directors, employees, or agents. Indeed, the commission of such crimes in the face of a compliance program may suggest that the corporate management is not adequately enforcing its program.<sup>351</sup>

In this hypothetical, lawyers in Counsel do not communicate efficiently with each other. This will increase the chances that something important may be missed. *Caremark* makes it clear that communication is crucial to detection and reporting. Here, Counsel operates in a way that makes it more difficult to gather, analyze and report evidence of wrongdoing to the appropriate officer of Company.

3. Is there a procedure for anonymous reporting?

This is especially important for associates who fear discipline where one of the outside counsel's partners may be involved with management in unlawful activity of which the other partners are unaware.<sup>352</sup> Counsel has no procedure for

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<sup>351</sup> Memorandum for the Deputy Attorney General, *supra* note 9, at Part VII.A (entitled "Charging a Corporation: Corporate Compliance Programs").

<sup>352</sup> Fear of discipline, of course, is not limited to associates. *See, e.g.*, *Bohatch v. Butler & Binion*, 977 S.W.2d 543, 547 (Tex. 1998) (holding no liability to a partnership where it expelled a junior partner from a firm after reporting a more senior partner for over-billing). The *Bohatch* court recognized the conundrum created by its decision:

We emphasize that our refusal to create an exception to the at-will nature of partnerships in no way obviates the ethical duties of lawyers. Such duties sometimes necessitate difficult decisions, as when a lawyer suspects overbilling by a colleague. The fact that the ethical duty to report may create an irreparable schism between partners neither excuses the failure to report nor transforms expulsion as a means of resolving that schism into a tort.

*Id. But see* *Wieder v. Skala*, 80 N.Y.2d 628, 635-38, 609 N.E.2d 105, 108-09 (N.Y. 1992) (stating that an associate terminated for reporting misconduct of another associate had a valid contract claim based on implied obligation to comply with rules of legal profession).

anonymous reporting. Were one of the partners to engage in wrongful activity in collusion with Company, Counsel itself may face liability. This is a problem the importance of which Arthur Anderson discovered only after the Enron collapse when it failed to successfully blame one of its partners for any of the wrongdoing ascribed to the firm.<sup>353</sup> Lawyers will now face the same sort of problem in similar circumstances. In this hypothetical, for example, it might have been useful to provide a means of informing the other partners in Counsel about the appearance of Partner X in the Company video.

4. Does the firm represent the client company in labor matters, for example does the firm prepare or advise on the preparation of the employee handbook, counsel on employee hiring and termination policy, counsel on specific cases, develop terms of employment used by the client company, help negotiate collective bargaining or other employment agreements?

In the Enron context, Vinson & Elkins found itself unable to extricate itself from the lawsuits against its client because it had contributed to a history that lent itself to an interpretation of collusion with the company in its wrongdoing.<sup>354</sup> In the hypothetical, Counsel may be crossing the line as well. Counsel has advised Company of how to improve hiring and termination procedures in order to comply with recent developments in discrimination lawsuits. Counsel made representations to the press in connection with some of the lawsuits but with perhaps broader implications. Especially damaging, potentially, was Counsel's participation in the creation of the video. Counsel in the future may have to have firmly in mind the distinction made

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<sup>353</sup> "Some of these people will even trot out the hoary (and discredited) old saw that they were 'just following orders.'" Nancy B. Rapoport, *Enron, Titanic and the Perfect Storm*, 71 *FORDHAM L. REV.* 1373, 1393 (2003) (citing Tom Fowler, *Ex-Anderson Auditor Defended; Aide: Boss Was Told to Shred Files*, *HOUS. CHRON.*, Mar. 7, 2002, at 1 ("An assistant to the Arthur Andersen lead partner who handled the Enron account said she believes her boss was just following orders when he told workers to destroy Enron-related documents last fall.")). A year after enactment of SOA, the emerging common knowledge suggests that provisions for the anonymous reporting of suspected illegal conduct is now "a requirement for public companies." Association of Certified Fraud Examiners, *Federal Sentencing Guidelines Changing* (Nov. 19, 2003), available at [http://www.cfenet.com/411/FederalSentencingGuidelinesChanging.asp?Source=FIN\\_2003\\_11\\_19](http://www.cfenet.com/411/FederalSentencingGuidelinesChanging.asp?Source=FIN_2003_11_19) (Last visited Nov. 19, 2003).

<sup>354</sup> See *supra* notes 315-17 and accompanying text.

by the district courts between the conduct of Kirkland & Ellis, on the one hand,<sup>355</sup> and Vinson & Elkins, on the other hand.<sup>356</sup>

5. To what extent are firm lawyers aware of their client surroundings?

Does the firm make a point of noticing the obvious things, for example, that the only females employed at its corporate headquarters are secretaries and file clerks, and the only African Americans are technicians and janitors? Counsel is aware of past discrimination suits. Counsel allows compatibility hiring. Several associates of Counsel and Auditor have noticed a lack of diversity in Company's work force after working with contacts in Company; some have received ethnically pointed e-mails and have gotten other hints of potential trouble at the Company. The information of the web site itself, let alone its very existence, provides a large amount of evidence which, at a minimum, might be worth exploring.<sup>357</sup> In adopting the final regulations to SOA section 307, the SEC sought to assure the practicing bar that it would not be required to *report*, or expected to report, " 'gossip, hearsay, [or] innuendo.' Nor is the rule's reporting obligation triggered by 'a combination of circumstances from which the attorney, in retrospect, should have drawn an inference,' as one

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<sup>355</sup> See *supra* note 318 and accompanying text.

<sup>356</sup> See *supra* notes 315-17 and accompanying text.

<sup>357</sup> Those who think such sites are a rarity would do well to surf the internet. A number of such sites have been the object of some discussion.

Many of the "complaint" Web sites contain forums for disgruntled current and ex-employees. The *walmartsucks.com*, *chasebanksucks.com* and *bestbye.com* sites are three of the more popular among such employees. Most employee complaints seem to revolve around poor treatment of lower-ranking employees by management. While rooted in some element of truth, many complaints are one-sided, exaggerated and sometimes outright false. Nevertheless, when an anti-company Web site is set up by existing employees, employers must be aware that taking action against the site could violate labor laws. If a site discusses company policies and invites other employees to comment, then it can be considered "concerted activity" and is protected by the National Labor Relations Act (NLRA). In short, where the company does not sponsor the Web site or host it on company servers, there may be little the company can do to shut down employee forums. As discussed below, however, companies can pursue employees and non-employees who the company believes are revealing confidential information and spreading false rumors.

Ronald F. Lopez, *Corporate Strategies for Addressing Internet "Complaint" Sites*, 14 INT'L L. PRACTICUM 101, 104 (2001).

commentator feared.”<sup>358</sup> Information that may not be sufficient to trigger reporting, standing alone, however, may be sufficient to put Counsel on notice investigate carefully. Both lawyers and accountants should be aware of the SEC’s view, with respect to evidence of material violation: “The evidence of a material violation that an attorney first becomes aware of may be the tip of an iceberg and, may, on its face, appear unlikely to result in substantial injury to the issuer.”<sup>359</sup>

6. To what extent do the lawyers ask questions?

There is, by now, in most large firms representing public companies quite well oiled machinery for the acquisition of business and other purposes built around the “legal audit.”<sup>360</sup> Surely, in that context, it is difficult to remain oblivious or be shy in conducting such audits with respect to key issues. Partners seeking material for disclosure have access to internal

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<sup>358</sup> Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 34-47276, 68 Fed. Reg. 6296, 6302 (Feb. 6, 2003) (to be codified at 17 C.F.R. pt. 205).

<sup>359</sup> Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 34-46868, 67 Fed. Reg. 71,670, 71,682 (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. pt. 205) (commenting on proposed section 205.3(b), “[w]hen an attorney ‘becomes aware’ of information that would lead an attorney reasonably to believe in the existence of a material violation would turn, at least in part, on the attorney’s training, experience, position, and seniority. Attorneys are not necessarily expected to identify issues they are not equipped to see”).

<sup>360</sup> For a classic study, see, for example, Louis M. Brown, *Legal Audit*, 38 S. CAL. L. REV. 431, 436–45 (1965) (commenting on the structuring legal audits for preventative lawyering). In the health care area today, one commentator noted that “[f]or example, one recently published guide designed to give corporate counsel an overview to legal audits and investigations contained over 25 chapters and 800 pages on a variety of regulatory regimes, from antitrust to urine testing, and still did not discuss laws specific to health care organizations.” James G. Sheehan, Book Review, 24 J. LEG. MED. 135, 135–36 (2003) (reviewing LINDA A. BAUMAN, *HEALTH CARE FRAUD AND ABUSE: PRACTICAL PERSPECTIVES* (2002)). Some commentators have begun to suggest the institutionalization of legal audits within the structure of public company boards.

A more formal mechanism for empowering directors to obtain legal advice is the establishment of a legal audit committee. A committee whose mission is to ensure legal compliance could focus on the quality of the corporation’s legal resources and could demand that the corporation’s lawyers, both in-house and outside counsel, thoroughly inform directors and officers as they make corporate policy. Such a committee could provide an additional mechanism for regular information flow between the board and the lawyers.

Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons?*, 48 VILL. L. REV. 1097, 1136 (2003).

memoranda, even if it is out of date or lacking appropriate information. At some point, Counsel and Auditor have to look around and ask the obvious: Is discrimination taking place? In this context, it should not be enough for lawyers to claim it is none of their business.<sup>361</sup>

7. To what extent do lawyers test the conclusions of management with respect to areas of high-risk litigation, such as compliance with discrimination laws?

Due diligence requires more than off the cuff explanations from management. Here, there were a number of facts well-known to Counsel that suggested a greater involvement in issues of discrimination. Both the answers given by management and the Audit Committee were far too facile and in need of some testing. Of course, the problem in the hypothetical goes deeper. Counsel is dangerously close to becoming, if it is not already, an active participant in the Company's employment strategies. Acceptance of explanations from management and the Audit Committee in the form described above adds what might be strong circumstantial evidence of collusion.

8. To what extent does outside counsel talk to auditors?

Traditional relationships between auditors and lawyers have been formal at best and for good reason.<sup>362</sup> Before SOA and the addition of federal and state prosecutors to the questionable tactic of cooperation, including "voluntary" waiver of privilege and work product protection, communication could well imperil attorney-client privilege as well as the willingness of corporate clients to speak candidly to lawyers. Management's heightened disclosure obligations, however, as well as outside counsel's independent obligations to the company, effectively expose it to disclosure information which in years past might well have been considered work product or privileged. It stands to reason that significant litigation over the course of the next several years will substantially rewrite law and expectations in this area.<sup>363</sup>

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<sup>361</sup> See, e.g., Wade, *supra* note 336, at 784-85.

<sup>362</sup> This formality, of course, was memorialized in the rules relating to lawyer responses to audit letter requests. See A.B.A., AUDITOR'S LETTER HANDBOOK 13-14 (1990).

<sup>363</sup> Indeed, the aggressive attack on privilege by prosecutors, in combination with extensions of federal regulatory powers, makes issues of privilege once a

In this case, there was substantial informal discussion between Counsel and Auditor at virtually every level of their respective organizations, but there was little formal communication. The informal communication tended to be undervalued, and the formal communication was overblown in importance. Yet, in the hypothetical, it is possible that evidence of illegal acts or material violations such as discrimination could have been more usefully developed with greater communication between Auditor and Counsel.

9. Does Counsel have procedures or standards in place for determining under what circumstances SOA section 307 reporting must be made?

Do Counsel's personnel recognize evidence of "material violations" should they come across it? Counsel has no such procedures. Everyone is flying blind. The result is an increased likelihood that Counsel will neither have control of its own disclosure obligation process, nor be able to determine when disclosure might be required. When added to Counsel's failure to institute procedures for detecting evidence of wrongdoing, Counsel appears to have deliberately (or at least recklessly) acted to avoid learning anything that it might have to report. In this hypothetical, though, Counsel could not help but learn about evidence of material violations. The problem here is a lack of any guidance for "processing" information received in order to make reasonable assessments its character of the information, an assessment which, in turn, indicated, if any. Moreover, in this case, given the history of discrimination lawsuits,<sup>364</sup> outside

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governmental investigation is commenced. Lawyers and auditors ought to reconsider the boundaries of their communication in light of the emerging realities, not the theoretics, of disclosure, privilege, and waiver. *See, e.g.,* Michael A. Simons, *Vicarious Snitching: Crime, Cooperation, and Good Corporate Citizenship*, 76 ST. JOHN'S L. REV. 979, 996-98 (2002).

Now, prosecutors take a far more aggressive approach. If a corporation hopes to avoid indictment, it may have to disclose the factual findings of the internal investigation, to disclose all of the information gathered during the internal investigation, to waive the attorney-client privilege and work-product protection, to terminate the offending employees, to replace management, and even to actively assist the government in covert investigations of employees, competitors, vendors, and clients. To prosecutors, this "super-cooperation" is simply "good corporate citizenship." To corporations, it can be a minefield.

*Id.* at 996-97 (citations omitted).

<sup>364</sup> *See supra* notes 40-45 and accompanying text.

counsel might be recklessly indifferent under SOA section 307 for failing to test for compliance.

10. With respect to securities law disclosure, is the firm reasonably confident that the material statements contained in the disclosure documents, the preparation and review of which are the responsibility of the firm, are truthful?

In particular, lawyers will have to pay attention to management's SOA section 404 disclosures. This section raises two issues. The first relates to the reliability of management's disclosure which was partially discussed at No. 8 above. The second relates to issues of discovery. To a certain extent, information used to prepare disclosure documents will be subject to discovery. Moreover, certain information will have to be produced to support management's position with respect to intent and knowledge. These documents, however, could be very damaging in a discrimination lawsuit. In this hypothetical, disclosure from the Company's monitoring system, the intervention of Counsel in the preparation of the video and Company's labor matters, the web site, and other information create a strong suggestion that statements made to investors might not be truthful in a material way. Specifically, the Company has not disclosed the likelihood of exposure to potentially significant liability for violating the discrimination laws. Counsel and Auditor face, to differing degrees, the prospect of liability as principals, as well.

A few factors should be considered with regards to auditors:

1. Several of the points described above are equally applicable in the auditing context.<sup>365</sup>

In particular, auditors can no longer rely on "financial statements only by tunnel vision" as a limiting characterization of their obligations. In the hypothetical, Auditor personnel

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<sup>365</sup> Communication within the audit team has been emphasized by the profession in the context of financial statement fraud. See SAS 99, *supra* note 150, at para.14-18. "Communication among the audit team about the risks of material misstatement due to fraud also should continue throughout the audit—for example, in evaluating the risks of material misstatement due to fraud at or near the completion of the field work." *Id.* at para. 18. This framework for audit work, extended to include illegal acts specified in SAS 54, ought to characterize the work of auditors in the field who seek to minimize liability. See *supra* notes 157-58 and accompanying text.

appear all too ready to discount information about Company's potential exposure to liability for discrimination. Auditors here cannot hide behind SAS No. 54<sup>366</sup> merely because the issue of discrimination is not directly tied to financial statement amounts. Auditors are well aware of the large loss contingencies and actual expenses incurred by large clients in connection with the defense and settlement of discrimination lawsuits. Discrimination suits form an everyday part of corporate compliance. Among the greatest lapses in this hypothetical was the Audit partner's willingness to quickly dismiss information gathered by lower level Auditor employees.<sup>367</sup> For example, the evidence suggesting retaliatory discharges, a common enough practice in certain circumstances, might well have required greater inquiry. Indeed, one of the great failings of Auditor and Counsel in the hypothetical is the ease with which the suggestions and opinions of junior members of the team are dismissed. At the same time, auditors may now be required to be more proactive in discussions with the audit committee, especially with respect to information which might have been received by the audit committee that bears on possible illegal acts with material effects on the financial statements.<sup>368</sup>

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<sup>366</sup> See *supra* notes 150–61 and accompanying text.

<sup>367</sup> In this connection, SAS 99, *supra* note 150, provides some guidance for the auditor. In particular, the exhibit to SAS 99 would suggest that the sort of conduct exhibited in the hypothetical by Company employees should have alerted auditors to possible fraud or other illegal activity. See *id.*; see also *id.* at 64–66 (describing elements of a positive work environment).

<sup>368</sup> In this regard, consider the proposed change to AU § 316 recently proposed by the AICPA:

Section 10A of the Securities Exchange Act of 1934 requires each audit committee to establish procedures for (a) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (b) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters. For entities subject to these requirements, the auditor should inquire as to the procedures placed in operation, and complaints received or concerns expressed under the procedures established by the audit committee as a result of these requirements.

AICPA Auditing Standards Board, Exposure Draft: Proposed Statement on Auditing Standards, Sarbanes-Oxley Omnibus Statement on Auditing Standards 22 (April 1, 2003), [http://www.aicpa.org/download/auditstd/ed2003\\_0401\\_sas\\_s-o.pdf](http://www.aicpa.org/download/auditstd/ed2003_0401_sas_s-o.pdf) (last visited Sept. 30, 2003).

2. Of primary importance to auditors, however, is the need to accept that the borders of their obligations to the client company have been extended, whether they like it or not.

Hiding one's head in the sand of the narrowly circumscribed "financial statements" will now offer little protection. Awareness of the obvious and following through on clues that appear during the course of a review will require a broader scope of investigation. To some extent, the accounting profession is not oblivious to these realities. This is underlined by SAS No. 99's emphasis on the exercise of "professional skepticism when considering the possibility that a material misstatement due to fraud could be present."<sup>369</sup> In this case, the auditors clearly failed to meet the SAS No. 99 standard. The excuse, of course, is that such skepticism was not required since the problem in the hypothetical involved a "legal" issue rather than one directly related to financial statement fraud. However, even under a loose reading of the standards of SAS 54,<sup>370</sup> it might appear reckless at best for Auditor to fail to bring the matter more forcefully to the attention of the Board. It would not be too great a stretch, under the facts described above, to paint a merely auditor as a willing participant in a deliberate scheme to discriminate. In the hypothetical, it seems fairly clear that there were sufficient facts of which both Auditor and Counsel not only should have been made aware active monitoring systems could reasonably have been expected to pick up enough information to warrant further inquiry but of which they were made aware. These facts, at a minimum, should have triggered further inquiry.

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<sup>369</sup> See SAS 99, *supra* note 150, at para. 2. Indeed, lawyers might well learn from auditors in this regard:

The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.

*Id.* at para. 13.

<sup>370</sup> See *supra* notes 150–61 and accompanying text.

3. Are reporting obligations triggered under section 10a (for Auditor) and the SOA section 307 regulations (for Counsel)?

From my perspective, the information was, by the time of the preparation of the SOA section 404 disclosures, sufficiently well developed to have warranted reporting. An objection could be made, of course, that a reporting of sorts was made. Counsel certainly sought information from management and the Audit Committee. Given the facile nature of the response, however, informal inquiry would not have been sufficient in this case. The failure to make formal reports to management or to the Board, as necessary in this case, would provide some additional circumstantial evidence of the complicity of both Auditor and Counsel in the Company's discriminatory activities. Recall also that the quid pro quo for complicity in this case would be substantial given the fees received for services rendered.

4. To what extent is there real independence among Auditor, Counsel, and Company?

The issue of auditor independence has become increasingly important. Section 10A as well as other governmental and industry initiatives have focused on this issue in order to promote confidence in financial reporting and thus to strengthen the integrity of financial markets. Good arguments have been made that such initiatives have had perverse effects on independence.<sup>371</sup> Indeed, where there are close relationships between employees of Company and Auditor, those relationships might create "an additional incentive for auditors to care more about the care-and-feeding of their clients than about the integrity of the audit services being provided."<sup>372</sup> The SOA Auditor conflict of interest rules seek to ameliorate this problem, but they do not solve it.<sup>373</sup> The same arguments, to some extent,

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<sup>371</sup> See Jonathon Macy & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1175-76 (2003).

<sup>372</sup> *Id.* at 1178 (citing *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 647 (S.D. Tex. 2002)) (discussing independence of in-house audits and noting that more than three hundred accounting and finance positions at Enron were filled with former Arthur Anderson employees).

<sup>373</sup> In fact, SOA section 206 creates his problem, making it unlawful for a registered public accounting firm to perform for an issuer any audit service required by this title, if a *chief executive officer, controller, chief financial officer, chief accounting officer* or any person

might also be made with respect to lawyer independence. Where, for example, the General Counsel of Company is a former partner of Counsel, and the legal department of the client Company is made up of former employees of Counsel, in today's environment, it might be difficult to convince regulators or the markets that there is a sufficient degree of independence between outside lawyers and the client company. Though these past connections alone might not be questionable, they could provide another bit of the circumstantial evidence used to paint a picture of collusion.

5. In the event of an unsatisfactory response to formal reporting of evidence of material violations or illegal activities, is resignation the only viable option?

Perhaps the better view was nicely summarized a number of years ago:

I would suggest that in securities matters (other than those where advocacy is clearly proper) the attorney will have to function in a manner more akin to that of auditor than to that of the attorney. This means several things. It means that he will have to exercise a measure of independence that is perhaps uncomfortable if he is also the close counselor of management in other matters, often including business decisions. It means he will have to be acutely cognizant of his responsibility to the public who engage in securities transactions that would never have come about were it not for his professional presence. It means that he will have to adopt the healthy skepticism toward the representation of management which a good auditor must adopt. It means that he will have to do the same thing the auditor does when confronted with an intransigent client—resign.<sup>374</sup>

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serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit.

Sarbanes-Oxley Act of 2002 § 206, 15 U.S.C.A. § 78j-1(l) (West Supp. 2003). There is, however, no corresponding limitation for movement at lower levels between auditors and client companies. Had Arthur Anderson adhered to SOA section 206 rules, it is not clear that the outcome in *In re Enron* would have been different. See *In re Enron*, 235 F. Supp. 2d at 647.

<sup>374</sup> A.A. Sommer, Jr., *The Emerging Responsibilities of the Securities Lawyer*, Address to the Banking, Corporation & Business Law Section of the N.Y. State Bar Ass'n (Jan. 24, 1974), in LARRY D. SODERQUIST & THERESA GABALDON, *SECURITIES REGULATION* 617-19 (4th ed. 1999).

Silence has been the great temptation of auditors since the passage of section 10A, sometimes to their regret.<sup>375</sup> Silence will likely be more costly to auditors under section 10A and lawyers under the detect-and-report regime of SOA 307 regulations in the future, at least if imaginative plaintiffs' counsel and sympathetic courts have anything to do with it.

The hypothetical related above contains illustrations of conduct best avoided under the heightened post-SOA monitoring regimes. As plaintiff's counsel contemplates a class action discrimination lawsuit against Company, circumstances like these might well prompt such counsel to look at the exposure of auditors and outside counsel as well. The extent of disclosure by Company in its securities law filings and in other public information, coupled with the apparent collusion of Company's auditors and lawyers, may be sufficient to support liability of the outside counsel and auditors. Moreover, for securities holders facing a loss of value as a consequence of the Company's liability for widespread discrimination, the auditors and lawyers, under these circumstances, might also share primarily liability for securities fraud.

#### CONCLUSION WITH A LOOK TOWARD THE FUTURE

Lawyers and accountants have tried to recast both the SOA section 307 regulations and the detect-and-report obligations under section 10A as species of re-articulations of understandings within already existing provisions.<sup>376</sup> Compliance with some sort of very narrowly defined set of obligations under this view will ensure protection both from liability under the respective gatekeeper provision and from liability as principal wrongdoers. Thus reduced in scope and thrust, auditors and lawyers would appear to have nothing more than the obligation to report to management those fairly

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<sup>375</sup> See, e.g., Darin Bartholomew, *Is Silence Golden When it Comes to Auditing?*, 36 J. MARSHALL L. REV. 57, 93-98 (2002). "Even after section 10A(b) was enacted and prior to the Sarbanes-Oxley amendments to section 10A, independent auditors have sometimes hesitated to engage in whistleblowing activity." *Id.* at 93.

<sup>376</sup> See, e.g., Jeffrey W. Stempel, *The Sarbanes-Oxley Act: Lawyer Professional Responsibility, and a Heightened Role For Business Lawyers*, NEV. LAW., March 2003, at 8. Accountants have sought to defend against action by the SEC on similar grounds. See, e.g., *S.E.C. v. Solucorp Indus. Ltd.* 197 F. Supp. 2d 4, 10 (S.D.N.Y. 2002); *In re Sunterra Corp. Sec. Litig.*, 199 F. Supp. 2d 1308, 1321 (M.D. Fla. 2002); *In re Sunbeam Sec. Litig.*, 89 F. Supp. 2d 1326, 1337 (S.D. Fla.1999).

substantial items of evidence of wrongdoing that they might encounter by chance. Serendipity can thus reward sophisticated guile on the part of management, or at least provide lawyers and auditors with the defense of management guile whenever liability is asserted.

I have tried to demonstrate, however, that neither section 10A nor SOA section 307 were written so narrowly. The intention of Congress to create positive detection and reporting obligations, substantial in scope and not limited by the sort of game playing that outside professionals and their clients have become accustomed to playing,<sup>377</sup> is apparent from the context in which both statutes were enacted. The fact that both the SEC<sup>378</sup> and private litigants have been slow to acknowledge or take advantage of these changes does not alter either the character or the scope of the new obligations.

Among the unexplored but potentially far reaching effects of section 10A and the SOA section 307 regulations are the ways in which private litigants, especially private litigants asserting claims for corporate violation of law other than the securities laws, may be able to take advantage of the monitoring provisions now written into the federal securities laws. I have tried to show how in the context of recent discrimination actions against large public companies like Coca-Cola and Texaco the provisions of section 10A may serve as a source of discovery for plaintiffs. Equally important, the conduct of auditors and outside counsel might also provide the basis for the assertion of claims against either or both.

The sort of narrow and prissy reading of section 10A and SOA advanced by the accounting and legal professions may provide each of them some comfort. Juries hearing cases, however, in which auditors and lawyers seek exculpation by resort to a highly technical defense of "I didn't have to report it" or "I wasn't required to act on my suspicions" may be less willing to give the provisions the sort of narrow interpretation which,

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<sup>377</sup> The relationship between the management of Enron and its outside counsel provide a case in point. For a critical discussion, see Coffee, *supra* note 16, at 1403-05; Koniak, *supra* note 115, at 201-10.

<sup>378</sup> For an example of a case where the SEC chose to litigate under section 10A see, *Solucorp Industries*, 197 F. Supp. 2d at 4. While there may be more coming, it is clear that the SEC's prosecutorial reticence has given the auditing community some sense of protection against the broader implications of the duties imposed on the profession by Section 10A.

while plausible, is not required. Only the future will tell whether the statutes are ultimately enforced broadly or whether they are meant merely as window dressing for a business-as-usual approach to the duties of outside counsel and auditors.