Professional Responsibility

Pro:

Why *Central Bank* Should Be Overruled

*By Roger C. Cramton**

The lawyer's primary function is to counsel and assist clients in conduct that is "within the bounds of the law." The fundamental limitation on what lawyers may do for clients is stated in ABA Model Rule 1.2(d) as follows: "A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent ...." "Knows" is defined in Rules 1.0(f) as "actual knowledge of the fact in question," but broadened by the qualification that "[a] person's knowledge may be inferred from circumstances." The modern justification of the attorney-client privilege and the professional duty of confidentiality, a leading case tells us, is "to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice." The underlying assumption justifying lawyer confidentiality is that the "fully informed" lawyer will channel client conduct along lawful paths, furthering the public interest in "observance of law."

Most lawyers, most of the time, observe this fundamental duty. But lawyers are not above the law and they as well as others must be deterred from seeking short-term gain in assisting a client in illegal but profitable activities. Embarrassment at being caught and loss of peer repute operate in some professional communities as an effective restraint. But the growth in the size and dispersion of the profession and the dilution of personal responsibility flowing from practice in large organizations requires sturdy means of compensating those harmed by lawyers who wilfully or negligently assist a client's fraud and punishing lawyers who similarly assist a client's crime.

Professional discipline plays virtually no role in complex regulatory or corporate frauds or crimes. The applicable professional rules are ambiguous, sometimes discretionary and lawyer protective. The cases involve factual complexity and cost exceeding the staff and resources of disciplinary authorities. Only if the lawyer is convicted of a felony will these harms to third persons and the public result in professional discipline. The interests of third persons and the public are largely protected by the potential threat of civil and criminal liability and, now that Sarbanes-Oxley §307 is operative, SEC regulatory sanctions.

In 1994 the Supreme Court, reversing longstanding authority in all federal circuits, held in the *Central Bank* case[1] that a secondary actor in a securities transaction (e.g., an accountant or a lawyer) is not liable for damages for aiding and abetting a securities law violation. The decision did not rest on a policy determination that aiding and abetting liability of professional advisers is undesirable. Instead, the majority revisited the text of §10(b) of the 1934 Act and held that it did not explicitly authorize a private cause of action in this situation. The 1995 amendments to the 1934 Act also did not repudiate aiding and abetting liability for professional advisers; to the contrary, the SEC was specifically empowered to go after aiders and abettors for securities law violations. Aiding and abetting is also unlawful, and actionable, under state criminal and tort law and under some state securities statutes.

Central Bank's elimination of accessory liability requires that claims under §10(b) of the Securities Exchange Act of 1934 be framed as primary violations. Civil liability actions against accounting and law firms in a fraud situation now must cast them as primary violators of §10(b). Under *Central Bank* the plaintiffs must show that a defendant actually engaged in manipulative or deceptive acts or made fraudulent representations. As the *Central Bank* decision put it:

> Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable.[2]

The federal courts of appeals are divided on whether primary liability reaches a professional adviser who stays in the background, writing and approving the fraudulent financial statement or solicitation, but who does not make a misrepresentation in person, provide a legal opinion, or whose name is not included in the document. Several courts of appeals have upheld primary liability when the complaint alleges that the lawyer, aware of their falsity, anonymously drafted false representations that were relied on by investors;[3] on the other hand, other circuits have struck down such complaints.[4]

My own view is that it is wrong to make liability turn on whether or not the substantial participation of the professional adviser is concealed. Why should an anonymous draftsman escape responsibility for knowingly fraudulent representations merely because his identity is concealed? My position does push the margins of primary liability and the uncertainty on this question provides a strong argument for statutory overruling of *Central Bank* to permit aiding and abetting claims to be brought against lawyers and accountants. The lawyer, present at the time the fraud is committed and having reason to know about it, who substantially participates in facilitating the fraud, should be accountable to those who are harmed. The recent decision denying motions to dismiss in the lawsuit by Enron shareholders against Enron's lawyers, accountants and investment bankers suggests that the courts will extend primary liability if secondary liability is not recreated.[5]

Restoration of aiding and abetting liability under federal securities laws would not establish a novel principle or have untoward consequences. As already indicated, lawyers and other professional advisors are engaged in counseling and assisting clients. Legal rules, the profession's own ethics rules, and the civil and criminal law throughout the country prohibit and punish lawyers who aid and abet a client's crime or fraud. The existence of civil liability for aiding and abetting a federal securities law violation for the half-century prior to *Central Bank* did not threaten the viability or health of the accounting or legal professions or have other harmful consequences. On the contrary, the existence of such liability was a primary deterrent to wrongful conduct.

During the 1990s changes in the law and in professional practice have had the effect of leading accountants and lawyers to believe that they were immune from legal liability when acquiescing in the desires of corporate managers to ignore legal limits on corporate conduct, resulting in many situations in which illegality was assisted. Legal risks declined because of *Central Bank* and other decisions;[6] the enactment in 1995 of the Private Securities Litigation Reform Act of 1995 raised pleading standards, substituted proportionate liability for joint and several liability, restricted the application of RICO to securities fraud class actions, and provided a safe harbor for forward-looking information.[7] The SEC, which retained broad regulatory and enforcement authority, was hampered in carrying out its responsibilities by limited staff and funding.

Meanwhile, in the private sector dramatic changes in the organization, size, and culture of law practice encouraged reckless compliance with the requests of demanding corporate clients.[8] The spread of limited liability partnerships accentuated the willingness of partners to ignore the risks that other partners were taking. Today's emphasis on the "bottom line," both in corporations and law firms, gives rise to a culture valuing the false prestige and status that flows from being among the leaders in the annual listings of profits per partner. The result is a systemic problem that requires systemic solutions, and one of them is the statutory overruling of *Central Bank.*

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Footnotes

[1] *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). For discussion of the effect of *Central Bank* on secondary actors, see Jill E. Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants,* 99 Colum. L. Rev. 1293 (1999); Melissa Harrison, *The Assault on the Liabilty of Outside Professionals: Are Lawyers and Accountants Off the Hook?*, 65 U. Cinc. L. Rev. 473 (1997); and Douglas M. Branson, *Chasing the Rogue Professional After the Private Securities Litigation Reform Act of 1995,* 50 SMU L. Rev. 91 (1996).

[2] 511 U.S. at 191.

[3] See *Klein v. Boyd*, Fed. Sec. L. Rep. (CCH) & 90,136, vacated on grant of rehearing en banc (3rd Cir. 1998) (lawyer "spoke" to the investors by drafting the solicitation documents even though his identity was unknown to those solicited); *In re Software Tools*, 50 F.3d 615 (9th Cir.1994) (substantial participation in drafting is sufficient if there is "a reasonable inference that [the firm] knew or recklessly disregarded false information").

[4] *Anixter v. Home-States Production Co.*, 77 F.3d 1215 (10th Cir.1996) (no primary liability for representations made by others); and *Ziemba v. Cascade International Inc.*, 2001 U.S. App. Lexis 15529 (11th Cir.2001) (complaint must include an allegation that law firm made misrepresentations or omissions upon which the investors relied).

[5] *In re Enron Corp. Securities Derivative & ERISA Litig.*, 2002 WL 31854963 (S.D.Tex. Dec. 20, 2002).

[6] E.g., Lampf v. Gilbertson, 501 U.S. 350, 359-61 (1991) (significantly shortening the statute of limitations applicable to securities frauds).

[7] Pub.L. No. 104-67, codifying scattered sections of 15 U.S.C.

[8] See John C. Coffee, Jr., Understanding Enron: "It's About the Gatekeepers, Stupid," 57 Bus. Law. 1403 (arguing that during the 1990s the expected liability costs associated with gatekeeper acquiescence in managerial misbehavior went down while the expected benefits went up, resulting in many corporate restatements, failures and frauds).