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Supervisory Attorney Liability under § 307 of Sarbanes-Oxley: Another Sand Trap for the Unwary

You are just beginning to absorb your own responsibilities under the SEC's new up-the-corporate-ladder rules implementing § 307 of the Sarbanes-Oxley Act when your colleagues remind you that, as general counsel, you have potential liability for those whom you supervise. Great Scott. Will it never end? Who is a supervisory counsel, and what is supervisory counsel's liability under the new regulations anyway? As it turns out, the answer, for once, is that it could be worse—thanks to those who pointed out to the SEC the degree to which the proposed rules deviated from the ABA's model rules. But there are still risks.

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As every corporate lawyer now knows, the U.S. Securities and Exchange Commission ("SEC") has followed the mandate of § 307 of the Sarbanes-Oxley Act[1] and promulgated an initial set of rules of professional conduct for attorneys who appear and practice before it on behalf of an issuer.[2] Given the confusion over responsibilities imposed by these rules, an important question that has been largely ignored is to ascertain which attorneys within a general counsel's office or a law firm may be held responsible for ensuring compliance with these rules. And to what extent do these rules depart from the standards under the *Model Rules of Professional Conduct* in imposing liability on supervisory attorneys for the unethical conduct of their subordinates? *(Got you there: I bet many of you did not even know that a supervisory attorney could be held responsible for the unethical conduct of subordinates!)*

Let's begin with Model Rule 5.1 to ensure that we all remember the ethical requirements imposed on supervisory lawyers:

> Responsibilities of Partners, Managers, and Supervisory Lawyers
> (a) A partner in a law firm, and a lawyer who individually or together with other lawyers possesses comparable managerial authority in a law firm, shall make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that all lawyers in the firm conform to the Rules of Professional Conduct.
> (b) A lawyer having direct supervisory authority over another lawyer shall make reasonable efforts to ensure that the other lawyer conforms to the Rules of Professional Conduct.
> (c) A lawyer shall be responsible for another lawyer's violation of the Rules of Professional Conduct if:

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(1) the lawyer orders or, with knowledge of the specific conduct, ratifies the conduct involved; or
(2) the lawyer is a partner or has comparable managerial authority in the law firm in which the other lawyer practices, or has direct supervisory authority over the other lawyer, and knows of the conduct at a time when its consequences can be avoided or mitigated but fails to take reasonable remedial action.

One can view the mandates of Model Rule 5.1 as threefold, proceeding from the most general to the most specific. Model Rule 5.1(a) imposes on lawyers with managerial authority the obligation to make reasonable efforts to ensure that the firm has in effect procedures giving reasonable assurance of compliance with ethical rules. "Firm," for these purposes would include the legal department of a corporation.[3] Model Rule 5.1(b) imposes obligations on a lawyer who has "direct supervisory authority over another lawyer [to] make reasonable efforts to ensure that the other lawyer" conforms to the ethical rules. Finally, Model Rule 5.1(c) describes the circumstances in which a lawyer will have sufficient knowledge of or involvement in the unethical conduct of another (either by ratifying the conduct or by failing to take remedial steps) to be held ethically responsible for the misconduct of another lawyer. Subsections (a) and (b), thus, provide that it is unprofessional conduct not to properly supervise. Subsection (c) makes a lawyer individually liable for more than inadequate supervision: the supervisory lawyer is individually liable for another lawyer's misconduct. Liability under Model Rule 5.1(c) is thus much more severe than (a) or (b) because the supervisor is liable for the acts of the subordinate.

With that background, let us turn to the SEC rule. The responsibility of supervisory attorneys with respect to the up-the-ladder reporting requirements of the SEC's new rules of professional conduct is set forth in § 205.4, the final version of which provides as follows:

§ 205.4 Responsibilities of supervisory attorneys.

(a) An attorney supervising or directing another attorney who is appearing and practicing[4] before the Commission in the representation of an issuer is a supervisory attorney. **An issuer's chief legal officer (or the equivalent thereof) is a supervisory attorney under this section.**
(b) A supervisory attorney shall make reasonable efforts to ensure that a subordinate attorney, as defined in § 205.5(a),[5] that he or she supervises or directs conforms to this part. **To the extent a subordinate attorney appears and practices before the Commission in the representation of an issuer, that subordinate attorney's supervisory attorneys also appear and practice before the Commission.**
(c) A supervisory attorney is responsible for complying with the reporting requirements in § 205.3 when a subordinate attorney has reported to the supervisory attorney evidence of a material violation.
(d) A supervisory attorney who has received a report of evidence of a material violation from a subordinate attorney under § 205.3 may report such evidence to the issuer's qualified legal compliance committee if the issuer has duly formed such a committee.[6]

In tracking the evolution of the final rules, we will see that the comments of the ABA and others clearly reshaped the rule to make it similar albeit not identi-

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cal to the Model Rules. The proposed rules defined "supervisory attorney" in § 205.4(a) to include any attorney "supervising, directing, or having supervisory authority over another attorney."[7] In its comments to the proposed rule, the ABA criticized this definition: the ABA observed that it exceeded the obligations imposed on supervisory attorneys under Rule 5.1 of the *Model Rules of Professional Responsibility* "by including any attorney with supervisory authority over another attorney," such as partners or senior associates, even if such authority is unrelated to the particular matter involving the SEC.[8] The ABA contrasted the SEC proposal with Model Rule 5.1, which provides that a "lawyer having direct supervisory authority over another lawyer shall make reasonable efforts to ensure that the other lawyer conforms to the Rules of Professional Conduct."[9]

The ABA also criticized § 205.4(b) of the proposed rule, which provided that a supervisory attorney was responsible for ensuring compliance with the new rules and "with the statutes and other rules administered by the Commission," as well as the provision that a supervisory attorney will be deemed to be appearing and practicing before the SEC to the extent that a subordinate attorney appears and practices before the SEC.[10] By expanding a supervisory attorney's obligation to ensure compliance with all federal securities laws and by treating a subordinate attorney's appearance and practice before the SEC as that of the supervisory attorney, "without regard to whether the supervision relates to the matter involving appearing and practicing before the Commission or whether the supervisory attorney is even aware the subordinate attorney is so practicing," the ABA argued that the proposed rule placed "extraordinary burdens" on attorneys that "go well beyond the obligations imposed by Rule 5.1(c).[11] Under the Model Rule, the ABA pointed out, a supervisory attorney is responsible for a violation of an ethical rule by another attorney only "if he orders or knowingly ratifies the conduct or knows of the conduct and fails to take reasonable remedial action."[12]

In response to these objections,[13] the final SEC rules modified 205.4(a) to provide "that only a senior attorney who actually directs or supervises the actions of a subordinate attorney appearing and practicing before the Commission" will be considered a supervisory attorney subject to the rule.[14] According to the SEC, in cases in which the supervision or direction of a subordinate attorney concerns matters unrelated to the latter's appearing and practicing before the SEC, the senior attorney will not be considered a supervisory attorney under the rule.[15] With respect to § 205.4(b), the SEC eliminated the proposed requirement that a supervisory attorney ensure a subordinate attorney's compliance with the federal securities laws—only compliance with the new up-the-ladder rules must be ensured.

Do the modifications in the final rule defang § 205.4? Hardly.

Although it now resembles Model Rule 5.1,[16] § 205.4(b) still equates a subordinate attorney's appearance and practice before the SEC with that of the supervisory attorney. This provision means that every corporate chief legal officer or any other attorney who supervises another attorney practicing before the Commission is subject to the SEC rules and sanctions. Can a supervisory attorney be disciplined for failure to report up-the-ladder by the subordinate if the issue was not known to the supervisor? It would not seem that § 205.4(c) and (d) appear to impose duties on the supervisor if the supervisor is informed of the necessity to report by the subordinate. Can a supervisor be subject to SEC discipline under § 205 for failure to "make reasonable efforts to ensure that a subordinate attorney . . . conforms to [these rules]"? Very likely—although it may be that the supervisory lawyer would not be held individually liable for the misconduct of the subordinate attorney if the only sin were failure to supervise. That distinction, as we have observed, is the one drawn between Model Rules 5.1(a) and (b) on the one hand and 5.1(c) on the other. What is the extent of the duty on chief legal officers? In other words, what constitutes "reasonable efforts" under § 205.4(b)? Model Rule 5.1(b)—from which the "reasonable efforts" standard was derived—and the SEC commentary provide some direction. Here are some suggestions derived from the commentary to the Model Rules and the SEC's comments:[17]

- The general counsel should mandate the imposition of clear, mandatory, and specific procedures designed by lawyers schooled in the principles of § 205. ACCA may be able to assist in this regard. See generally ACCA's corporate responsibility page on ACCA Online℠ at www.acca.com/legres/corpresponsibility/index.php.
- The office should have periodic meetings to explain and review the SEC rules and to impress on subordinate attorneys the obligation to observe them. Records that such meetings were held should be maintained.
- The office should have a knowledgeable advisor available to consult on the obligations under Rule 205 and should strongly encourage subordinate attorneys to consult orally with that advisor with any questions.[18]

ACCA's second round of comments to the SEC address the issue raised in this column and are available on ACCA Online℠ at www.acca.com/advocacy/307comments2.pdf.

NOTES

1. Pub. L. No. 107-204, 116 Stat. 745, 784 (2002).
2. Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6320 (2003) (to be codified at 17 C.F.R. pt. 205). Briefly stated, these rules require an attorney that appears and practices before the SEC on behalf of a company to report up the ladder within the company whenever the attorney becomes aware of evidence of a material violation of the securities laws or a breach of fiduciary duty. The SEC had also proposed a rule that would require the attorney to withdraw from representation and notify the SEC if the attorney reasonably believed that the organization's directors either had made no response or had made an inappropriate response to the attorney's up-the-ladder report. *See* Proposed Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71670, 71705–71706 (proposed Dec. 2, 2002). Because of numerous comments received in response to this proposal, known as the "noisy withdrawal" provision, however, the SEC has extended the comment period on this proposed rule and has also proposed an alternative approach. *See* Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6324 (proposed Feb. 6, 2003).
3. *See* the definition of "firm" in Model Rule 1.0.
4. The phrase "appearing and practicing before the Commission" has its own definition, which can be summarized as the provision of legal services to an in issuer that includes any of the following: the transacting of any business with the SEC; representing the issuer in SEC administrative proceedings or in connection with any SEC investigation, inquiry, information request, or subpoena; providing advice concerning the securities law or the SEC's regulations with respect to any document to be filed in any manner with the SEC; or advising as to whether certain information is required to be filed in any manner with the SEC. Standards of Professional Conduct for Attorneys, *supra* note 2, 68 Fed. Reg. at 6320 (to be codified at 17 C.F.R. § 205.2(a)).
5. Section 205.5(a) defines a subordinate attorney as any "attorney who appears and practices before the Commission in the representation of an issuer on a matter under the supervision or direction of another attorney (other than under the direct supervision or direction of the issuer's chief legal officer (or the equivalent thereof)." Standards of Professional Conduct for Attorneys, *supra* note 2, 68 Fed. Reg. at 6323 (to be codified at 17 C.F.R § 205.4).
6. Standards of Professional Conduct for Attorneys, *supra* note 2, 68 Fed. Reg. at 6323 (to be codified at 17 C.F.R § 205.4). (Emphasis supplied.)
7. Proposed Standards of Professional Conduct for Attorneys, *supra* note 2, 67 Fed. Reg. at 71706.
8. Comments of the American Bar Association, dated Dec. 18, 2002, at 23 (emphasis in original) (available at www.abanet.org/poladv/letters/other/comment_letter.pdf).
9. *ABA Model Rules of Professional Conduct*, Rule 5.1(b) (2003). (Emphasis supplied.) Subsection (a) of the rule imposes upon partners, as well as other lawyers with comparable management authority in the firm, the obligation "to make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that all lawyers in the firm conform to the Rules of Professional Conduct." Under subsection (c), partners, managerial lawyers, and supervisory attorneys will be held responsible for ethical violations committed by other attorneys if they knew of the conduct at a time when its consequences could have been avoided or mitigated but failed to take reasonable remedial action.
10. Proposed Standards of Professional Conduct for Attorneys, *supra* note 2, 67 Fed. Reg. at 71706.
11. Comments of the American Bar Association, *supra* note 8, at 23.
12. *Id. See supra* note 6.
13. Similar objections were raised by several commenters. *See* Standards of Professional Conduct for Attorneys, *supra* note 2, 68 Fed. Reg. at 6313.
14. *See supra* note 2.
15. "Conversely, an attorney who typically does not exercise authority over a subordinate attorney but who does direct the subordinate attorney in the specific matter involving the subordinate's appearance and practice before the Commission is a supervisory attorney under the final rule." *See supra* note 2.
16. Section 205.4(a)'s classification of an issuer's chief legal officer as a supervisory attorney subject to the requirements of the rule is also analogous to Model Rule 5.1(a)'s imposition of compliance obligations on law firm partners and/or managers. Under Model Rule 5.1(a), however, the obligation imposed on partners and managerial lawyers is directed to the firm as a whole, requiring them to "make reasonable efforts to ensure that the firm has in effect measures giving reasonable assurance that all lawyers in the firm conform to the Rules of Professional Conduct." Unlike the SEC rule, moreover, under which an issuer's chief legal officer "cannot avoid responsibility . . . by claiming a lack of knowledge of, or supervision over, the actions of subordinate attorneys," Proposed Standards of Professional Conduct for Attorneys, *supra* note 2, 67 Fed. Reg. at 71695, responsibility for specific misconduct by an attorney cannot be imposed on a partner or managerial attorney unless the partner or managerial lawyer had had knowledge of the misconduct and had either ratified it or failed to take reasonable remedial action when able to do so. *ABA Model Rules of Professional Conduct*, Rule 5.1(c).
17. *ABA Model Rules of Professional Conduct*, Rule 5.1, cmt. 6. According to the SEC, § 205.4(b) requires the supervisory attorney to take "affirmative steps" to ensure compliance with the rules, but "leaves to the professional judgment of the supervisory attorney how best to accomplish this goal." The SEC, however, "would expect that these steps would include the creation of procedures for subordinate attorneys to report evidence of material misconduct they learn about and, perhaps, periodic meetings for the purpose of discussing how to address such matters." Proposed Standards of Professional Conduct for Attorneys, *supra* note 2, 67 Fed. Reg. at 71695. As to how the courts have variously construed the term "reasonable efforts" under Model Rule 5.1, *see Supervisory and Subordinate Lawyers*, LAW. MAN. ON PROF. CONDUCT 91:101 (ABA/BNA).
18. *See* Proposed Standards of Professional Conduct for Attorneys, *supra* note 2, n. 17.