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Read Before Whistleblowing: What Every Lawyer Needs to Know

In wake of ethics opinion, lawyers in New York — if not elsewhere — must think hard before considering whether to participate in the Dodd-Frank Whistleblower Award Program.

A recent SEC whistleblower award of $14 million may offer a persuasive incentive for lawyers to blow the whistle on a client's perceived wrongdoing. However, a subsequent ethics opinion from the Committee on Professional Ethics of the New York County Lawyers' Association will give lawyers pause. As the SEC whistleblower award program gains momentum, New York lawyers may be well-advised to wait for the courts to determine whether the SEC's rules can pre-empt state rules of professional conduct.

Background

On October 1, 2013, the US Securities and Exchange Commission (SEC) announced a watershed $14 million award paid to an unidentified whistleblower who provided information that led to an enforcement action involving the recovery of investor funds.[1] This was by far the highest award paid to date under the SEC whistleblower award program established pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Without a doubt, there are potentially enormous incentives for individuals to come forward with information and participate in the SEC whistleblower award program. What about for lawyers?

On the heels of the SEC's announcement, the Committee on Professional Ethics of the New York County Lawyers' Association (NYCLA) weighed in on that question for New York lawyers. On October 7, 2013, NYCLA issued a formal opinion concluding that New York lawyers "presumptively may not ethically serve as whistleblowers for a bounty against their clients under the Dodd-Frank [Act] because doing so generally gives rise to a conflict between the lawyers' interests and those of their clients" — or their former clients, for that matter.[2] Thus came the first shot against the SEC's attempted preemption of state lawyer ethics rules under its whistleblower award program.

The opinion serves as a reference guide for New York lawyers considering the intersection between the SEC whistleblower award program and their duties of confidentiality and loyalty to clients. It also may have implications for lawyers outside of New York.[3]

SEC Whistleblower Rules Applying to Lawyers: A Quick Overview

The SEC whistleblower award rules, adopted in 2011, provide for the payment of awards to whistleblowers who report securities law violations to the SEC. Several factors determine eligibility for an

award, such as providing the SEC with "original information" about a violation of the securities laws that "leads to the successful enforcement by the Commission" of an action in which the Commission obtains (but does not necessarily collect) monetary sanctions exceeding $1 million.[4] The rules generally exclude lawyers from eligibility for monetary whistleblower awards if they try to use information obtained while performing their professional duties to blow the whistle on a client or employer. Lawyers may not use such information to participate in the award program if the information is obtained through a privileged communication or in connection with the legal representation of a client on whose behalf the whistleblowing lawyer or the whistleblower's employer or firm is providing services.[5]

However, the SEC award rules carve out three exceptions to these exclusions that apply to lawyers. A lawyer may disclose confidential client information to the SEC without client consent and seek an award if such disclosure would be permitted under the SEC's lawyer conduct rules, the applicable state lawyer conduct rules, or "otherwise."[6]

SEC's Lawyer Conduct Rules: Permitting "Reporting Out" While Purporting to Preempt State Ethics Rules

The SEC's lawyer conduct rules, codified as Part 205 of Title 17 of the Code of Federal Regulations and thus colloquially known as the "Part 205" rules,[7] apply only to lawyers "appearing and practicing" before the Commission in the context of providing legal services for an "issuer." Therefore, the eligibility exceptions in the SEC whistleblower rules created by reference to Part 205 apply only to such lawyers. "Appearing and practicing" is broadly defined, however. The definition includes, for example, merely advising on a US securities law issue regarding a document that the lawyer has notice will be incorporated into a document to be filed with or submitted to the Commission. "Issuer" is also broadly defined; to include any person controlled by an issuer, where a lawyer provides legal services to such person on behalf, at the behest or for the benefit of the issuer, regardless of whether the lawyer is employed or retained by the issuer.

As the NYCLA opinion describes, under the SEC Part 205 rules, "the disclosure of client confidences outside the organization is a last resort, not a first step." Part 205 deals primarily with when a lawyer must cause reporting "up the ladder" within the confines of the issuer because the lawyer has become aware of evidence of a "material violation" by the issuer or an issuer's agent. The reporting obligations in Part 205 do not *require* "reporting out" to the SEC — that is, revealing confidential information related to the representation to the Commission without the issuer's consent — or to anyone else in any circumstance. Part 205 does, however, sometimes *permit* lawyers it covers to "report out" to the SEC, to the extent the lawyer reasonably believes necessary in any of the following cases:

- To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors[8]

- To prevent the issuer, in a Commission investigation or administrative proceeding, from committing perjury, suborning perjury, or knowingly and willfully perpetrating a fraud upon the Commission (*e.g.*, by concealing a material fact or making a materially false representation)

- To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the lawyer's services were used[9]

The Commission realized when it adopted Part 205 in 2003 that permitting lawyer disclosure under these three circumstances could conflict with a lawyer's state law duty of confidentiality, so the Commission included the following preemption clause in Part 205: "Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, this part shall govern."[10] A related "good faith" safe-harbor provision in Part 205 states: "An attorney who complies in good faith with the provisions of this part shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other United States jurisdiction where the attorney is admitted or practices."[11]

A number of commenters on the proposed Part 205 rules had questioned the Commission's authority to preempt state ethics rules, however, at least without being explicitly authorized and directed to do so by Congress.

NYCLA Sets Up a Potential Roadblock

The NYCLA opinion notes that the New York Rules of Professional Conduct (RPC) prevent a lawyer generally from disclosing confidential information, but present six categories of exceptions to the general rule in RPC 1.6(b) if the circumstances are such that "the lawyer reasonably believes [disclosure is] necessary." Three of the six exceptions are relevant here.

First, RPC 1.6(b)(2) permits a lawyer to disclose confidential information that the lawyer believes is reasonably necessary to prevent a client from "committing a crime," which overlaps to some degree with the "material violation" of the securities laws described in Part 205. However, "not all securities violations rise to the level of a crime." Thus, "[t]o the extent that [Part] 205 permits (but does not require) reporting out of client confidences that amount to a material violation of the securities laws, regardless of whether the client's conduct amounts to a crime or whether the lawyer's services were used, [the Part 205 Rule] is broader than, and inconsistent with, the New York RPC exceptions to the confidentiality requirement."

Second, under RPC 1.6(b)(3), a lawyer may reveal confidential information when he or she believes it is reasonably necessary to withdraw an opinion or other representation by the lawyer still relied upon by a third party, if the opinion was based on materially inaccurate information or is being used to further a crime or fraud. Here, the RPC and Part 205 are in "essential agreement that disclosure is permissible."

Finally, under RPC 1.6(b)(6), a lawyer may reveal confidential information "when permitted or required under these Rules or to comply with other law or court order." However, as with the other five exceptions to RPC 1.6(b), under RPC 1.6(b)(6) disclosure of client confidential information may be made only "to the extent the lawyer reasonably believes necessary." But Part 205 does not *require* reporting out, and thus, says the NYCLA opinion, such reporting is not "reasonably necessary" under RPC 1.6(b)(6). And:

> Even when disclosure is permitted under the New York Rules, for example, when clear corporate wrongdoing rising to the level of crime or fraud has been perpetrated through the use of the lawyer's services, preventing wrongdoing is not the same as collecting a bounty. Even in cases of clear criminal conduct or fraud, the lawyer's disclosure must be limited to reasonably necessary information.
>
> As a general principle, there are few circumstances, if any, in which, in the Committee's view, it would be reasonably necessary within the meaning of RPC 1.6(b) for a lawyer to pursue the steps necessary to collect a bounty as a reward for revealing confidential material....

The opinion also addresses what it calls an "even more significant ethical issue" — there is "presumptively" a conflict of interest under New York RPC 1.7 (the main conflict rule regarding current clients) "when a corporate lawyer, functioning as a lawyer, seeks to collect a whistleblower bounty." The opinion notes that "the prospect of financial benefit could place the attorney's personal interests in potential conflict with those of the client" and may "cloud a lawyer's professional judgment." Moreover, the opinion states — not surprisingly — that in some circumstances the whistleblower award conflict may be unwaivable. Without reference to the $14 million award just announced by the SEC, the opinion notes that "[i]ndeed, where an attorney can hope to claim close to a $10 million bounty by reporting a securities fraud of $30 million or more...the conflict may be unwaivable. Such large sums of money would tend to cloud lawyers' professional judgment, influencing lawyers to report out a violation regardless of their clients' interests."

Also, the opinion states, New York RPC 1.9 "protects the confidences of former clients, which may not be disclosed to the client's detriment unless pursuant to an exception under New York RPC 1.6(b)." The opinion concludes that lawyers may not seek whistleblower bounties based on information regarding a former client "that could not have been revealed in the course of representation," generally precluding the lawyer's participation in the SEC whistleblower award program.

As for the SEC's claim that its Part 205 rules can preempt state ethics rules where the rules are inconsistent, the NYCLA opinion states that preemption is a question of substantive law, to be applied by the courts to specific facts in each case, a question beyond the NYCLA committee's jurisdiction.

Conclusion and Considerations

Taking implicit issue with the SEC's preemption provisions, the NYCLA opinion concludes that "New York lawyers, in matters governed by the New York Rules of Professional Conduct, may not disclose confidential information, relating to current or past clients, under the Dodd-Frank whistleblower regulations, except to the extent permissible under the New York Rules of Professional Conduct," which, as described above, significantly circumscribe what is permitted to be disclosed in comparison to the SEC's rules. The opinion also concludes that New York lawyers "presumptively may not ethically collect whistleblower bounties in exchange for disclosing confidential information about their clients under the whistleblower provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act because doing so generally gives rise to a conflict between the lawyers' interests and those of their clients."

In its opinion, NYCLA notes that preemption of state law by federal law is a matter for the courts. In fact, the SEC preemption and "good faith" provisions have not yet been evaluated by any court. They have, however, been questioned and criticized by two state bar associations.[12] Given a particular case, the ethics authorities in New York, or any jurisdiction, could challenge the SEC's preemption rule and seek to discipline or at least investigate the conduct of a lawyer who claims to be within a Part 205 exception but appears also to have violated state duties of confidentiality and/or loyalty.

A New York lawyer who considers seeking a monetary award under the SEC whistleblower award program would be well advised to read the NYCLA ethics opinion and review any statements SEC officials may make about this issue. The lawyer then should be equipped to decide whether reporting the misconduct he or she perceives is worth the risk of a state disciplinary investigation.

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Endnotes

1 SEC Press Release, "SEC Awards More Than $14 Million to Whistleblower" (October 1, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539854258. The SEC Press Release notes that "[b]y law, the SEC must protect the confidentiality of whistleblowers and cannot disclose any information that might directly or indirectly reveal a whistleblower's identity." *See also* our Client Alert No. 1591, SEC Issues First Large Award in Whistleblower Program (October 2013), *available at* http://www.lw.com/thoughtLeadership/lw-sec-first-large-whistleblower-award.

2 New York County Lawyers' Association Committee on Professional Ethics Formal Opinion 746 (October 7, 2013), *available at* http://www.nycla.org/siteFiles/Publications/Publications1647_0.pdf (NYCLA Opinion).

3 For a more expansive discussion of these issues that goes beyond New York law, see the Latham & Watkins white paper "Will Award-Seeking Whistleblower Lawyers Be Caught Between Conflicting SEC and State Ethics Rules?" available at http://www.lw.com/thoughtLeadership/SEC-whistleblower-ethics-conflict.

4 See 17 C.F.R. § 240.21F-3(a).

5 Section 922 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) added new Section 21F to the Securities Exchange Act of 1934, which describes the award program. Awards range between 10 percent and 30 percent of money collected in the SEC and related actions.

6 Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934, Release No. 34-64545, at 56 (May 25, 2011) at 249.

7 See generally Implementation of Standards of Professional Conduct for Attorneys (Final Rule), Securities Act Release No. 33-8185, Exchange Act Release No. 34-47276 (Jan 29, 2003).

8 "Material violation means a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law." 17 CFR § 205.2(i).

9 17 CFR § 205.3(d)(2).

10 17 C.F.R. § 205.1.

11 17 C.F.R. § 205.6(c).

12 See SEC General Counsel Giovanni P. Prezioso, Letter Regarding Washington State Bar Association's Proposed Opinion on the Effect of the SEC's Attorney Conduct Rules (July 23, 2003) (citations omitted), *available at* http://www.sec.gov/news/speech/spch072303gpp.htm; see also, Ethics Alert, The New SEC Attorney Conduct Rules v. California's Duty of Confidentiality (Spring 2004), *available at* http://ethics.calbar.ca.gov/LinkClick.aspx?fileticket=7xTdfWYEC3k%3D&tabid=834.