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Corporate Gatekeeper in Ethical Perspective, The

Christopher T. Hines

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The Corporate Gatekeeper in Ethical Perspective

Christopher T. Hines*

Abstract

The fallout from the financial crisis continues to inform the development of corporate and securities law, and the new regulatory landscape for economic activity within the United States is beginning to take form. This evolutionary process, however, has been anything but stable or certain. As might be expected, in concert with such momentous change in law and policy, re-cremations for and associated investigations of past activity continue to affect competent regulators as well as market participants. Nevertheless, while many of the underlying causes of the financial crisis are now better understood by both policy makers and scholars, the question remains – given where we were, where do we go from here? While a definitive answer to such a question remains elusive, an additional perspective on the ethical issues of relevance to corporate and securities law may be helpful in considering the possible alternatives. In particular, the ethical rules of corporate gatekeepers in conflicts of interest scenarios are worthy of further consideration and discussion.

This article presents the argument that cases involving conflicts of interest in the corporate and securities law space may be viewed as primarily calling into question the ethical rules of the corporate gatekeeper. In support of such an argument, this article sets forth a framework for conflicts of interest scenarios that takes into account four categories of legal rules – activity rules, disclosure rules, liability rules and ethical rules. In adopting such a framework, this article will elaborate on an ethical perspective will be elaborated to address the ongoing development of corporate and securities law. Further, this article proposes further analysis in relation to disclosure rules on conflicts of interest policies for Compensation Committees as mandated by

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Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

This article is the second in a series that explores the intersection of corporate law and legal ethics.¹ Specifically, the present discussion concerns the foundations in doctrine and theory that may apply to issues of conflicts of interest within the ambit of corporate and securities law. Accordingly, the subject matter for discussion includes both rules of the professions – or first-order ethical rules – and rules as may be prescribed by the competent authority – that is, second-order ethical rules.

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I. INTRODUCTION

*It takes 20 years to build a reputation and five minutes to ruin it.
If you think about that, you'll do things differently.
– Warren Buffett²*

1. See, e.g., Christopher T. Hines, *Returning to First Principles of Privilege Law: Focusing on the Facts in Internal Corporate Investigations*, 60 U. KAN. L. REV. 33 (2011).

2. Editorial, *In Buffett We Trust*, FIN. TIMES, Apr. 4, 2011, <http://www.ft.com/cms/s/0/3a44e3c2-5eea-11e0-a2d7-00144feab49a,s01=1.html#axzz1UTO1n760>

“Reputation is a fleeting thing.”³ In the world of high finance, a master of the universe today can quickly become tomorrow’s cautionary tale.⁴ It is, therefore, unsurprising to find that in the aftermath of the financial crisis⁵ the professional reputations of numerous market actors and policy makers have experienced this very reversal of fortune.⁶ In many cases one may credibly

(“Whatever the strict legal status of the share purchases Mr. Buffett’s now-departed colleague, David Sokol, made in Lubrizol, they look impossible to justify from an ethical standpoint.”). As recounted in the report of the Audit Committee of Berkshire Hathaway to its Board of Directors, David Sokol, former Chairman of several Berkshire subsidiaries, engaged in certain purchases of shares of The Lubrizol Corporation prior to its acquisition by Berkshire in an all-cash transaction. Memorandum from the Audit Committee, Berkshire Hathaway Inc. to the Board of Directors, Berkshire Hathaway Inc., Trading in Lubrizol Corporation Shares by David L. Sokol, (Apr. 26, 2011), available at <http://www.berkshirehathaway.com/news/APR2711.pdf>. As a result of such revelations, Mr. Sokol resigned from Berkshire Hathaway. See News Release, Berkshire Hathaway Inc., Warren E. Buffett, CEO of Berkshire Hathaway, Announces the Resignation of David L. Sokol (Mar. 30, 2011), available at <http://www.berkshirehathaway.com/news/MAR3011.pdf>.

3. Although reputation itself may have an evanescent quality, it would appear that practitioners of law have long understood this momentary aspect of one’s professional reputation. See, e.g., Hon. William A. Sutherland, The Facts in the Case, Lecture to Law Students of Rochester, New York (1895), in 3 AM. LAW. 544, 545 (1895) (“Reputation is a fleeting thing. There is not one here tonight who can name twenty lawyers prominent fifty years ago. We pass into forgetfulness as the farmer and the merchant and the hackdriver, and when we appear before another tribunal from which there is no appeal it will be better for us to have done our duty by our clients than have sought a little cheap glory for ourselves.”).

4. See, e.g., TOM WOLFE, THE BONFIRE OF THE VANITIES (1987) (telling the fictional tale of the downfall of Sherman McCoy, Wall Street hotshot and self-proclaimed “Master of the Universe”). Although many in the United States still suffer from the resulting effects of the financial crisis, the national mood has yet to reach that which existed in Florence on February 7, 1497. See, e.g., DAVID HACKETT FISCHER, THE GREAT WAVE: PRICE REVOLUTIONS AND THE RHYTHM OF HISTORY 67-68 (1996) (describing the so-called “burning of the vanities,” during which crowds of Florentines burned paintings, books, and other symbols of luxury in an attempt to seek atonement for their sins). Unlike the historical Florentines, we have yet to burn away the purported occasions of sin – that is, our credit cards, overpriced homes and various personal effects purchased in the age of easy credit. See, e.g., Consumer Credit, FED. RESERVE STATISTICAL RELEASE, (Aug. 5, 2011), available at <http://www.federalreserve.gov/Releases/g19/20110805/g19.htm> (“Consumer credit increased at an annual rate of 4-1/4 percent in the second quarter. In June, consumer credit increased at an annual rate of 7-3/4 percent, with revolving credit increasing at a rate of 8 percent and nonrevolving credit increasing at a rate of 7-1/2 percent.”).

5. For purposes of this Article, I continue to adopt the commonly used phrase of “financial crisis” to refer to the late 2000s global financial crisis. See, e.g., Hines, *supra* note 1, at 37 n.20.

6. See, e.g., ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM –

argue that such criticisms may be unfounded or excessive,⁷ nevertheless, the fact remains that financial disaster has its consequences.⁸ One of these consequences is that the reputation of those persons in positions of economic influence and authority will, by necessity, suffer.⁹

The fallout from the financial crisis continues to inform the development of corporate and securities law, and the new regulatory landscape for economic activity within the United States is beginning to take form.¹⁰ This evolutionary process, however, has been anything but stable or certain.¹¹ As might be expected, in concert with such momentous change in law and policy, recriminations for and associated investigations of past activity continue to affect competent regulators as well as market participants.¹² Nevertheless,

AND THEMSELVES 85 (2009) (“By the summer of 2007, however, America’s second Gilded Age had come shockingly to an end, and [former Federal Reserve Chairman Alan] Greenspan’s reputation lay in tatters.”).

7. See, e.g., Bill George, *Why Leaders Lose Their Way*, HBR BLOG NETWORK (June 8, 2011) <http://blogs.hbr.org/hbsfaculty/2011/06/why-leaders-lose-their-way.html> (“It’s lonely at the top, because leaders know they are ultimately responsible for the lives and fortunes of people. If they fail, many get deeply hurt. They often deny the burdens and loneliness, becoming incapable of facing reality. They shut down their inner voice, because it is too painful to confront or even acknowledge; it may, however, appear in their dreams as they try to resolve conflicts rustling around inside their heads.”).

8. See THE FIN. CRISIS INQUIRY COMM’N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 23 (2011) (“The economic impact of the crisis has been devastating. And the human devastation is continuing. The officially reported unemployment rate hovered at almost 10% in November 2010, but the underemployment rate, which includes those who have given up looking for work and part-time workers who would prefer to be working full-time, was above 17%. And the share of unemployed workers who have been out of work for more than six months was just above 40%.”).

9. See, e.g., *Bush’s Final Approval Rating: 22 Percent*, CBSNEWS, Feb. 11, 2009, <http://www.cbsnews.com/stories/2009/01/16/opinion/polls/main4728399.shtml> (“President Bush will leave office as one of the most unpopular departing presidents in history, according to a new CBS News/New York Times poll showing Mr. Bush’s final approval rating at 22 percent.”).

10. See, e.g., Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended at 12 U.S.C. §§ 5301-5641).

11. See Geoffrey C. Hazard Jr., *Doing the Right Thing*, 70 WASH. U. L. Q. 691, 694 (1992) [hereinafter Hazard, *Doing the Right Thing*]; Hines, *supra* note 1, at 59 n.123.

12. See *SEC Enforcement Actions: Addressing Misconduct that Led to or Arose from the Financial Crisis*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/spotlight/enf-actions-fc.shtml> (last updated Jan. 9, 2013) (reporting key statistics through January 9, 2013 on seventy entities and individuals charged, and \$1.65 billion in total penalties, disgorgement, and other monetary relief).

while many of the underlying causes of the financial crisis are now better understood by both policy makers and scholars, the question remains – *given where we were, where do we go from here?*

While a definitive answer to such a question remains elusive, an additional perspective on the ethical issues related to corporate and securities law may be helpful in considering the possible alternative answers to the question posed.¹³ In particular, the ethical rules of corporate gatekeepers¹⁴ in conflicts of interest scenarios are worthy of further consideration and discussion.¹⁵ This Article presents the argument that cases involving conflicts of interest in

13. This Article is the second in a series that explores the intersection of corporate law and legal ethics. *See Hines, supra* note 1. Specifically, the present discussion concerns the foundations in doctrine and theory that may apply to issues of conflicts of interest within the ambit of corporate and securities law. Accordingly, the subject matter for discussion includes both rules of the professions – or first-order ethical rules – and rules as may be prescribed by the competent authority – that is, second-order ethical rules. *See infra* Part II.D.

14. In concert with the ongoing scholarship of corporate gatekeepers, this Article will adopt the definition of the corporate gatekeeper as enunciated by Professor John Coffee. JOHN C. COFFEE JR., GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE 2 (2006) (“[T]he gatekeeper is an agent who acts as a reputational intermediary to assure investors as to the quality of the ‘signal’ sent by the corporate issuer. The reputational intermediary does so by lending or ‘pledging’ its reputational capital to the corporation, thus enabling investors or the market to rely on the corporation’s own disclosures or assurances where they otherwise might not.”). This said, it is important to note that the term “gatekeeper” is a metaphor, and is not a description as such. Indeed, in cases where an in-house legal department hires the services of an independent firm on difficult legal disputes, the reputation of such an independent firm may include the ability – either real or imagined – of obtaining favorable results in questionable cases. Accordingly, in connection with the notion of the corporate gatekeeper as a reputational intermediary, the gatekeeper in question may also be viewed as an “usher.” Here, the function of the “usher” – again, in a metaphorical sense – would be to ensure that that certain persons (or things) would proceed through the gate to their (or its) proper place, with only the most egregious cases being stopped in transit. In this sense, corporate attorneys often serve a function that more resembles that of the usher in that their incentives are often such that passing the gate (e.g., successfully closing a corporate transaction) is deemed the optimum of professional performance. I thank Professor Hazard for making these important observations.

15. The first article in this series explored the longstanding debate concerning the appropriate limits of the attorney-client privilege in connection with an internal corporate investigation. *See Hines, supra* note 1, at 39. In turn, this second article will explore the interplay of another core set of rules for legal ethics – that is, conflicts of interest rules. Although each of these articles should be considered separate inquiries into the intersection of corporate law and legal ethics, the hope and intent is that applying these two important sets of rules of legal ethics (i.e., privilege and conflicts rules) to current developments in corporate and securities law will assist further research in such areas of scholarship.

the corporate and securities law space may be viewed as primarily calling into question the ethical rules of the corporate gatekeeper.¹⁶

In support of such an argument, Part II of this Article sets forth a framework for conflicts of interest scenarios that takes into account four categories of legal rules – activity rules, disclosure rules, liability rules and ethical rules. Specifically, the discussion of each of the categories of legal rules will proceed as follows: (i) for activity rules, the restrictions on services offered by auditors pursuant to section 201 of the Sarbanes-Oxley Act;¹⁷ (ii) for liability rules, the ongoing debate concerning whether secondary liability under section 10(b) of the Exchange Act¹⁸ should be available to federal securities class action plaintiffs in light of the Court’s decisions in *Central Bank of Denver v. First Interstate Bank of Denver*¹⁹ and *Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc.*;²⁰ (iii) for disclosure rules, proxy disclosure rules in relation to codes of ethics for senior financial officers²¹ and compensation committee independence standards;²² and (iv) for ethical rules, the relevant rules concerning conflicts of interest as provided in the Model Code of Professional Responsibility,²³ the Model Rules of Professional Conduct²⁴ and the Attorney Conduct Rules.²⁵ In adopting such a framework, an ethical perspective will be elaborated to address matters within the ongoing development of corporate and securities law.²⁶

16. Of note, the question of conflicts of interest necessarily implicates questions as to the independence of the corporate gatekeeper. *See, e.g.*, MODEL RULES OF PROF’L CONDUCT R. 1.7 cmt. 1 (2012) (“Loyalty and independent judgment are essential elements in the lawyer’s relationship to a client.”). As will be discussed, the new rules on independence standards for Compensation Committees as part of the Dodd-Frank reforms provide an area where one may further explore the more practical application of the discussion provided herein. *See infra* Part III.A.2.

17. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 201, 116 Stat. 745 (2002) (codified as amended at 15 U.S.C. §§ 7201-66).

18. *See* 15 U.S.C. § 78j(b) (2006).

19. 511 U.S. 164 (1994).

20. 552 U.S. 148 (2008).

21. *See* Sarbanes-Oxley Act § 406.

22. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 124 Stat. 1376 (2010) (codified as amended at 12 U.S.C. §§ 5301-5641).

23. *See* MODEL CODE OF PROF’L RESPONSIBILITY CANONS 5, 9 (1981).

24. *See* MODEL RULES OF PROF’L CONDUCT R. 1.7-1.13 (2012).

25. *See* 17 C.F.R. §§ 205.1-205.7 (2012).

26. Given the plethora of regulations that have been or will be promulgated by the Securities and Exchange Commission (SEC) and other administrative agencies pursuant to Dodd-Frank, by necessity this Article will limit its focus to one regulatory rule of interest. Specifically, this Article focuses on the independence standards for Compensation Committees and related proxy disclosure that is currently under consideration. *See* Dodd-Frank § 952; Listing Standards for Compensation Committees, 76 Fed. Reg. 18966-01 (Apr. 6, 2011) (to be codified at 17 C.F.R. pts. 229, 240); *see*

Part III of this Article will discuss in greater detail the primacy of ethical rules of the corporate gatekeeper by first comparing the categories of conflicts rules as initially described in Part II. In making such a comparison, I will argue for an ethical perspective in instances where the corporate gatekeeper is an actor.²⁷ Further, I will suggest that such an ethical perspective may also engage with recent scholarly discourse regarding the theoretical approaches taken in each of the Model Code of Professional Responsibility and the Model Rules of Professional Conduct.²⁸ As a means of further substantiating this line of reasoning, I propose further analysis in relation to disclosure rules on conflicts of interest policies for Compensation Committees as mandated by Dodd Frank,²⁹ and provides some concluding thoughts on the manner in which an ethical perspective as to the corporate gatekeeper may be more broadly considered as part of the ongoing development of corporate and securities law.³⁰

II. CATEGORIES OF CONFLICTS RULES

The categorization of legal rules is a method of inquiry that facilitates further discussion of matters involving legal theory.³¹ Without doubt, the precise definition and resulting scope of any category so constructed may be

also Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act – Accomplishments, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/spotlight/dodd-frank/accomplishments.shtml> (last modified Sept. 7, 2012) (“[Dodd-Frank] contains more than 90 provisions that require SEC rulemaking, and dozens of other provisions that give the SEC discretionary rulemaking authority. Of the mandatory rulemaking provisions, the SEC has proposed or adopted rules for about three-quarters of them.”).

27. In arguing for the primacy of ethical rules in this instance, I do not argue for the relative unimportance of other categories of conflicts rules – i.e., activity rules, liability rules, and disclosure rules. Indeed, the federal securities regulatory scheme can be viewed as including *all* of the categories of conflicts rules as discussed herein. Nevertheless, the argument made will be that ethical rules should be of primary consideration because of their implications on the other categories of conflicts rules. Accordingly, the extent to which one may be able to determine the nature and quality of ethical rules may illuminate further discussion of activity rules, liability rules, and disclosure rules as part of the ongoing scholarship in this area of law.

28. Here, this Article keeps in mind the discussion amongst Professors Geoffrey Hazard, David Luban, and Michael Millemann with respect to the theoretical foundations of the Model Rules of Professional Conduct. *See, e.g.*, Geoffrey C. Hazard, Jr., *The Future of Legal Ethics*, 100 YALE L.J. 1239 (1991) [hereinafter Hazard, *The Future of Legal Ethics*]; David Luban & Michael Millemann, *Good Judgment: Ethics Teaching in Dark Times*, 9 GEO. J. LEGAL ETHICS 31 (1995).

29. *See* Dodd-Frank § 952.

30. *See infra* Part III.A.2.

31. *See, e.g.*, ARISTOTLE, *Categories*, in THE COMPLETE WORKS OF ARISTOTLE: THE REVISED OXFORD TRANSLATION 3, 3-24 (Jonathan Barnes ed., 1984).

challenged,³² which may ultimately lead to a negative thesis that the categorization itself is meaningless.³³ Nevertheless, any categorization of legal rules should ultimately be assessed as to whether it facilitates inquiry into matters under consideration.³⁴ The question, therefore, is not whether the categories are true or correct in an absolute sense, but rather, whether such categories inform the argument being presented.³⁵

Part II of this Article presents one possible categorization of legal rules concerning conflicts of interest within the context of corporate and securities law.³⁶ Specifically, this Part sets forth a framework for further discussion by

32. With respect to the categories set forth in this Article, for instance, one might argue that the distinction between disclosure rules and liability rules is without difference, as a matter of practice. For does not the public company in the United States follow the particular disclosure rules of federal securities regulation in the shadow of its potential liability under the general anti-fraud liability rule? *See, e.g.*, 15 U.S.C. § 78j(b) (2006); 17 C.F.R. §§ 229.10-.1016 (2012). Indeed, much of this makes sense. Nevertheless, the intended purpose of this categorization is to argue in favor of the primacy of ethical rules within the context of corporate and securities law where the corporate gatekeeper is an actor. *See supra* note 27 and accompanying text.

33. This does not mean to imply, however, that any negative thesis is without merit as part of scholarly discussion. Indeed, a compelling critique of longstanding opinions and beliefs is often the first step toward more enlightened discussion of legal rules and their effects. *See, e.g.*, Duncan Kennedy, *The Structure of Blackstone's Commentaries*, 28 BUFF. L. REV. 205, 210 (1979) (“[T]he activity of categorizing, analyzing, and explaining legal rules has a double motive. On the one hand, it is an effort to discover the conditions of social justice. On the other, it is an attempt to deny the truth of our painfully contradictory feelings about the actual state of relations between persons in our social world.”).

34. *See, e.g.*, Paul Studtmann, *Aristotle's Categories*, STAN. ENCYCLOPEDIA OF PHIL. (Sept. 7, 2007), <http://plato.stanford.edu/entries/aristotle-categories/> (“The set of doctrines in the *Categories*, which I will henceforth call *categorialism*, provides the framework of inquiry for a wide variety of Aristotle's philosophical investigations, ranging from his discussions of time and change in the *Physics*, to the science of being *qua* being in the *Metaphysics*, and even extending to his rejection of Platonic ethics in the *Nicomachean Ethics*.”).

35. *See supra* notes 27, 33 and accompanying text; *infra* Part III.A.1; *see also* Hans Smit, *Common and Civil Law Rules of In Personam Adjudicatory Authority: An Analysis of Underlying Policies*, 21 INT'L & COMP. L.Q. 335, 336-340 (1972) (distinguishing, by definition, *in personam*, *in rem*, and *quasi in rem* adjudicatory authority).

36. Although the number of possible categories of legal rules is infinite, the most influential remains the fundamental distinction between property rules and liability rules as part of the law and economics literature. *See, e.g.*, Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1106-10 (1972); Jonathan R. Macey & Geoffrey P. Miller, *An Economic Analysis of Conflict of Interest Regulation*, 82 IOWA L. REV. 965, 979-80 (1997) (“A property rule gives the holder of the right the legal power to prevent any other party from infringing on that right. A liability rule does not give the holder of the right the legal power to prevent another party from infringing, but instead gives the holder the right to obtain compensatory damages from the

first defining and then elaborating on four categories of conflicts rules—namely, activity rules, liability rules, disclosure rules and ethical rules.³⁷

A. Activity Rules

The first category of legal rules concerning conflicts of interest within the context of corporate and securities law is called *activity rules*.³⁸ In this context, activity rules will be defined as rules of law that prescribe the permitted activity that the corporate gatekeeper may engage in as part of her professional representation of her chosen client.³⁹ Activity rules, therefore, are fundamentally negative rules in that they prohibit certain activities that the corporate gatekeeper may undertake.⁴⁰ In this sense, activity rules can be viewed as the most stringent of conflicts rules because their mandate is (or at least should be) rather clear – *you can do X, but you cannot do Y*.⁴¹ In many cases, however, activity rules will be even more straightforward – *you cannot do X, Y, and Z*.⁴² Accordingly, one would naturally be inclined to conclude that any activities that are not specifically prohibited by the given activity rule

infringing party. In operational terms, courts typically enforce property rights through injunctive relief, whereas liability rules are typically enforced through monetary damages.”).

37. See *infra* Parts II.A-D.

38. Admittedly, one could fashion a different taxonomy for the conflicts rules in question. For instance, *conduct rules* could be an alternative phrasing of the rules that I have in mind. As a means, however, of avoiding any confusion with the Attorney Conduct Rules, I adopt the term *activity rules* to provide the necessary distinction.

39. With respect to the corporate gatekeepers that are within the purview of this discussion, as a preliminary matter we may consider auditors, corporate attorneys, securities analysts, and the rating agencies. See, e.g., COFFEE, *supra* note 14, at 103-07.

40. On this prohibitory aspect of activity rules, there are similarities with ethical rules as discussed herein. See *infra* Part II.D. In particular, I have in mind the requirements of Rule 1.8 of the Model Rules, which prohibit certain activity between attorneys as their clients. See MODEL RULES OF PROF'L CONDUCT R. 1.8(j) (2012) (“A lawyer shall not have sexual relations with a client unless a consensual sexual relationship existed between them when the client-lawyer relationship commenced.”). This said, the specific requirements of Rule 1.8 of the Model Rules read to certain representations that operate as *de facto* violations of the more general ethical rule on conflicts of interest, i.e., Model Rule 1.7. See MODEL RULES R. 1.7. For purposes of this Article, therefore, Model Rule 1.8 may be considered as an ethical rule that *in its effects* also operates as an activity rule. See *supra* note 27; *infra* Part II.D.

41. On such points, activity rules often raise questions of statutory construction and interpretation. Given the scope of this Article, however, such questions must remain without the realm of inquiry.

42. See, e.g., 15 U.S.C. § 78j-1(g) (2006).

are permissible, provided that they are not otherwise prohibited by other activity rules.⁴³

Given this prohibited/permissible nature of activity rules, it is understandable that they will likely become a point at issue amongst competing interest groups during the political enactment process.⁴⁴ This effect results because the activity rule will delineate clear costs for those market actors who previously profited in the absence of such activity rules.⁴⁵ And, presumably, such market actors will not accept the enactment of the activity rule without some measure of a political contest.⁴⁶

With this overview of activity rules in mind, what examples are there of activity rules that affect the conduct of corporate gatekeepers? Although other examples of activity rules may provide insight into the manner in which they operate,⁴⁷ perhaps the most notable instance of activity rules affecting

43. See *supra* note 41 and accompanying text.

44. On such points, the longstanding and influential scholarship on public choice theory provides additional discussion and illumination. See generally RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 19.3 (8th ed. 2011).

45. See *id.* § 19.3, at 718 (“All this makes interest groups sound pretty bad. But the real economic objection is not to interest groups but to the use of the political process to make economic decisions.”).

46. A more recent example of such a political process is the proposed “Volcker Rule” – named after former chairman of the Federal Reserve, Paul Volcker – as part of the Dodd-Frank Reforms. See, e.g., Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376 (2010) (codified as amended at 12 U.S.C. §§ 5301-5641). By its terms, the Volcker Rule seeks to prohibit “proprietary trading and certain relationships with hedge funds and private equity funds.” *Id.* As one might imagine, however, the devil remains in the details of the forthcoming regulation. See FIN. STABILITY OVERSIGHT COUNCIL, *STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS* 4 (2011), <http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf>.

47. See, e.g., *SEC Fact Sheet on Global Analyst Research Settlements*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/news/speech/factsheet.htm> (last modified Apr. 28, 2003) (“Investment bankers will have no role in determining what companies are covered by the analysts. Research analysts will be prohibited from participating in efforts to solicit investment banking business, including pitches and roadshows.”). Note, however, that the Global Analyst Research Settlements included other mandates, including what for purposes of this Article may be deemed disclosure rules. See *id.* (“Each firm will include a disclosure on the first page of each research report stating that it ‘does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report.’”); see also *infra* Part II.C.

the conduct of a gatekeeper is the prescribed activities of auditors as set forth in Sarbanes-Oxley.⁴⁸

An important part of the reforms set forth in Sarbanes-Oxley,⁴⁹ section 201 provides that certain services are outside the scope of practice of auditors.⁵⁰ Subject to certain restrictions,⁵¹ section 201 mandates that it is unlawful for a registered public accounting firm that performs an audit of an issuer,⁵² to contemporaneously offer to such an issuer any non-audit services, including the following:

- (1) “[B]ookkeeping or other services related to the accounting records or financial statements of the audit client;
 - (2) [F]inancial information systems design and implementation;
 - (3) [A]ppraisal or valuation services, fairness opinions, or contribution-in-kind reports;
 - (4) [A]ctuarial services;
 - (5) [I]nternal audit outsourcing services;
 - (6) [M]anagement functions or human resources;
 - (7) [B]roker or dealer, investment adviser, or investment banking services;
 - (8) [L]egal services and *expert services unrelated to the audit*;
- and

48. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 201, 116 Stat. 745 (2002) (codified as amended at 15 U.S.C. §§ 7201-66).

49. For additional discussion regarding the enactment of the Sarbanes-Oxley, see THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 22.1 (6th ed. 2009) (“From a long-term perspective, perhaps the most significant aspect of Sarbanes-Oxley is not the enhanced disclosure requirements or criminal penalties, but rather that the Sarbanes-Oxley Act goes further than any of the earlier federal securities laws and amendments in dealing directly with corporate governance – an area that had traditionally been reserved to the states.”).

50. Sarbanes-Oxley Act of 2002, § 201 (codified at 15 U.S.C. § 78j-1(g)).

51. See 15 U.S.C. § 78j-1(h) (permitting the rendering of tax services when such “activity is approved in advance by the audit committee of the issuer”).

52. This may be required under federal securities law and regulation.

(9) [A]ny other services that the [Public Company Accounting Oversight] Board determines, by regulation, is impermissible.”⁵³

As part of this enumerated list of prohibited activities, section 201 notably prohibits the offering of services that may otherwise have been provided by a financial advisor or consultant.⁵⁴ And, these aforementioned specific *activity rules* were designed to address what – in the aftermath of the accounting scandals that preceded passage of Sarbanes Oxley – was perceived as a failing of the regulatory apparatus.⁵⁵ Namely, auditors did not pay close enough attention to their audits,⁵⁶ and became compromised by the allure of consulting fees from their clients.⁵⁷

As Professor John Coffee recounts in his important treatment on the subject, “the growth of consulting revenue as a proportion of accounting firms’ overall revenues during the 1990s was dramatic In short, consulting revenues more than doubled over this period and had come to exceed auditing revenues by a healthy 10 percent.”⁵⁸ It is within this context that the economic effect of the activity rules, as set forth in section 201, should be considered.⁵⁹ Prior to the passage of Sarbanes-Oxley, the accounting firms could engage in financial advisory and consulting services. After passage,

53. 15 U.S.C. § 78j-1(g)(1)-(9) (emphasis added).

54. *Id.* § 78j-1(g)(7)-(8).

55. See generally BETHANY MCLEAN & PETER ELKIND, *THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON* (2003).

56. See *id.* at 322 (“[In an interview with *Fortune* magazine, Former Enron CFO Andrew] Fastow’s explanation of Enron’s business did not exactly provide the promised clarity. On the contrary. Here’s how Fastow explained Enron’s business model: ‘We create optionality. Enron is so much more valuable – hence our stock price – because we have so much more optionality embedded in our network than anyone else.’”).

57. Although the available empirical scholarship on the effects of the rise of consulting fees is not dispositive, nevertheless the perception remains that the accounting industry changed in a fundamental manner. See, e.g., COFFEE, *supra* note 14, at 150-51. The problem, therefore, became one of culture and the often discussed “tone at the top.” *Id.* at 151 (“In some cases, audit services may have been provided on such a discounted basis that auditing in effect became a ‘loss leader.’ Inherently, few things are more destructive to a watchdog culture that demands professional skepticism than to learn that is serves are so little valued as to be given away below cost.”).

58. *Id.* at 147. As Professor Coffee notes, accounting and auditing revenue from all clients at the “Big Five” accounting firms stood at 53% in 1990, and thereafter declined to 34% in 1999. *Id.* In contrast, consulting revenues at these same firms started at 20% in 1990 and rose to 40% by 1999. *Id.*

59. See, e.g., Hines, *supra* note 1, at 41 n.41 (noting the importance of viewing the law in a historical context).

they could not.⁶⁰ Additionally the new activity rules – that is to say, the prohibitions on the enumerated services as set forth in section 201 – came at the cost of lost business opportunities for the accounting firms.⁶¹

In this sense, activity rules can be viewed as a rather drastic (or Draconian, depending on one's perspective) form of rulemaking that seeks to curtail the activity in question.⁶² In the realm of conflict of interest rules, therefore, activity rules are typically used to define – or more aptly stated, to *re-define* – the realm of conduct for the corporate gatekeeper.⁶³ Prior to the accounting scandals of Enron, Worldcom, and the rest, the public auditor increasingly came to be seen as both auditor and consultant. When this fundamental tension between the auditor and consultant roles came to light, and the fallout from the accounting fraud scandals became a matter of political interest, the necessary political will was achieved in order to push the activity rules through the political process.⁶⁴ Activity rules, therefore, are frequently en-

60. Thus, these financial advisory and consulting services – those purported occasions of sin – are thrown into the bonfire. *See supra* note 4.

61. As a practical matter, this “bottom line” of the economic effect of activity rules is an important consideration as to whether the activity rule in question is efficient. *See, e.g.*, Interview by Charlie Rose with Lloyd Blankfein, CEO, Goldman Sachs (Apr. 30, 2010), *available at* http://www.charlierose.com/view/interview/10989#frame_top (“ROSE: What would happen to Goldman Sachs if you could no longer engage in proprietary trading? BLANKFEIN: I think that if we eliminated all the activity that's unrelated to client activity of Goldman Sachs we would probably do away with about 10% of our revenue.”).

62. Perhaps the most notable example of an activity rule in modern U.S. financial history is the famous Glass-Steagall Act of 1933, which separated commercial and investment banking and ultimately came undone by the Gramm-Leach-Bliley Act of 1999. *See, e.g.*, RICHARD SCOTT CARNELL, JONATHAN R. MACEY, GEOFFREY P. MILLER, *THE LAW OF BANKING AND FINANCIAL INSTITUTIONS* 27 (4th ed. 2009) (“The once formidable wall between commercial and investment banking fell after long bombardment.”).

63. *See, e.g.*, *SEC Fact Sheet on Global Analyst Research Settlements*, *supra* note 47.

64. The final vote in favor of passage of Sarbanes-Oxley was 423-3 in the House and 99-0 in the Senate. *See Final Vote Results for Roll Call 348*, U.S. HOUSE OF REPRESENTATIVES (July 25, 2002, 12:09 PM), <http://clerk.house.gov/evs/2002/roll348.xml>; *U.S. Senate Roll Call Votes for 107th Congress – 2nd Session*, U.S. SENATE (July 25, 2002, 4:30 PM), http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=107&session=2&vote=00192. In contrast, Dodd-Frank passed the House by a margin of 237-192, and in the Senate on a 60-39 vote. *Final Vote Results for Roll Call 413*, U.S. HOUSE OF REPRESENTATIVES (June 30, 2010, 6:54 PM), <http://clerk.house.gov/evs/2010/roll413.xml>; *U.S. Senate Roll Call Votes 11th Congress – 2nd Session*, U.S. SENATE (July 15, 2010, 2:29 PM), http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=111&session=2&vote=00208. Based solely on these numbers, the relative lack of political consensus in the case of Dodd-Frank suggests that the appetite for activity

acted at moments of heightened political power, because in their effects they are inherently structural.⁶⁵ Given that such moments of political power are an infrequent occurrence, however, additional categories of conflicts rules must be considered.

B. Liability Rules

A second category of legal rules that addresses matters of conflicts of interest in corporate and securities law is the category of *liability rules*.⁶⁶ Although the consideration of liability rules remains a foundational element of scholarly discourse,⁶⁷ for purposes of this discussion I will limit the definition of liability rules to those legal rules that attach liability to the actions (or lack thereof) of the corporate gatekeeper.⁶⁸ In this context, therefore, liability rules raise the essential question – in which circumstances should we hold the corporate gatekeeper liable for its actions, or failure to act, in connection with alleged misconduct by its client under the federal securities laws?⁶⁹ While a definitive answer to this question is beyond the scope of this Article, and

rules – for instance, in the form of the Volcker Rule – was not as prevalent as was the case with Sarbanes-Oxley.

65. Although the structure or overall form of corporate law and its intersection with legal ethics merits additional inquiry, such matters will be reserved for the third article in this series.

66. Again, one could argue for a different taxonomy in relation to such legal rules. See *supra* note 38. However, given that the term *liability rules* is frequently used in the literature, I adopt such language for purposes of this discussion. See, e.g., Calabresi & Malamed, *supra* note 36, at 1092. This said, the question that necessarily arises with liability rules is *who* owes the liability to *whom*. Liability rules in this broader context, while certainly worthy of further discussion, are not what is intended for consideration in this Article. Rather, in invoking the term *liability rules*, I speak to *gatekeeper liability rules* – that is, the legal rules that attach liability to the actions or inactions of the corporate gatekeeper.

67. See, e.g., Calabresi & Malamed, *supra* note 36, at 1110 (“[O]nce a liability rule is decided upon, perhaps for efficiency reasons, it is then employed to favor distributional goals as well.”).

68. See *supra* note 66.

69. In public discourse, this question is often phrased – *where were the gatekeepers?* See, e.g., John C. Coffee, Jr., *Understanding Enron: “It’s About the Gatekeepers, Stupid”*, 57 BUS. LAW. 1403, 1408-09 (2002) [hereinafter Coffee, *Understanding Enron*]. The implicit premise in posing such a question is that the gatekeepers were not there – a place they should have been – and therefore were in some manner absent or derelict in their duties. One means of ensuring that the gatekeepers are appropriately engaged (as one may define) in the next case is to incentivize such behavior by enacting a liability rule. *Id.* at 1405 (“[T]he starting point for responding to the Enron debacle begins with asking the right question. That question is not: Why did some managements engage in fraud? But is rather: Why did the gatekeepers let them?”).

indeed remains a highly debated point in case law and scholarship,⁷⁰ nevertheless an exploration of liability rules as a category of conflicts rules will further illuminate the discussion that surrounds such a difficult question.⁷¹

Liability rules are, in their essential function, a method of compensating an aggrieved party for the damages caused by another.⁷² For instance, if you are a corporate executive and engage in securities fraud,⁷³ presumably your malfeasance will damage your stockholders through a depressed stock price.⁷⁴ Accordingly, existing law makes such executives liable to their shareholders in a state derivative suit⁷⁵ and federal securities class action.⁷⁶ The instances in which such liability attaches are matters, therefore, that are further addressed in the relevant federal and state statutes and regulations,⁷⁷ as well as under applicable decisional law.⁷⁸ Thus, it is unsurprising to find that any possible changes to liability rules are points of contention that – in a manner similar to activity rules – will cause the political debate to be joined.⁷⁹ In such cases, the interest group that may classify as an aggrieved party would

70. See, e.g., *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 158 (2008); *Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 166-67 (1994); Robert A. Prentice, *Scheme Liability: Does It Have a Future After Stoneridge?*, 2009 WIS. L. REV. 351 (2009); Joseph Grundfest, *Is There an Express Section 10(b) Private Right of Action? A Response to Professor Prentice* (Stanford Law & Econ. Olin, Working Paper No. 352, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1077437; Robert A. Prentice, *Scheme Liability: A Reply to Grundfest* (McCombs Research Paper Series No. IROM-03-07, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1030525; Joseph Grundfest, *Scheme Liability: A Question for Congress, Not for the Court* (Rock Ctr. for Corporate Governance Stanford Univ. Working Paper No. 12, Stanford Univ. Law & Econ. Olin Working Paper No. 344, Stanford Univ. Pub. Law & Legal Theory Working Paper No. 1005524, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1005524.

71. See *infra* Part III.A.

72. See, e.g., Macey & Miller, *supra* note 36, at 979-80.

73. See HAZEN, *supra* note 49, §§ 12.3, 12.4 (describing remedies for fraud in the sale or trade of securities).

74. See, e.g., *Basic Inc. v. Levinson*, 485 U.S. 224, 241-42 (1988) (“The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company’s stock is determined by the available material information regarding the company and its business Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements The causal connection between the defendants’ fraud and the plaintiffs’ purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.”) (citation omitted).

75. See DEL. CODE ANN. tit. 8, § 327 (West, Westlaw through 2012 Laws).

76. See HAZEN, *supra* note 49, §§ 7.17, 12.15.

77. See *id.* §1.2 (reviewing the history and scope of federal and state regulations).

78. See, e.g., *SEC v. W.J. Howey Co.*, 328 U.S. 293, 301 (1946).

79. See *supra* note 44 and accompanying text.

more naturally be in favor of the liability rule, while the potential compensating party will be decidedly opposed to the rule because it will necessarily increase its cost of doing business.⁸⁰ In this sense, liability rules present a struggle between two competing interest groups as to *who* should compensate for *what* and to *whom*.⁸¹

An example of this extended contest that often surrounds liability rules is the longstanding debate regarding the availability of a private cause of action for secondary liability under section 10(b) of the Exchange Act.⁸²

As a matter of legal history, the current debate over secondary liability under section 10(b) of the Exchange Act began in earnest in 1994 with the Court's decision in *Central Bank v. First Interstate Bank of Denver*.⁸³ Further, the debate continued with the more recent 2008 decision of the Court regarding "scheme" liability in *Stoneridge Investment Partners v. ScientificAtlanta*.⁸⁴ Taken together, these cases provide the doctrinal context⁸⁵ in which one may further explore liability rules as a category for conflicts rules in the area of corporate and securities law.⁸⁶

80. In connection with such increased costs, the question of a possible increase in agency costs remains an important area of inquiry. See, e.g., George M. Cohen, *When Law and Economics Met Professional Responsibility*, 67 *FORDHAM L. REV.* 273, 280 (1998) ("Law and economics scholars have used agency theory to analyze the client-lawyer relationship. Examples of lawyer conduct that have been traced to agency cost problems include misusing client confidential information for the lawyer's personal gain, favoring one client's interests over another's, and increasing or skewing the demand for legal services in ways that benefit the lawyer but not the client."). But see Deborah A. DeMott, *The Lawyer as Agent*, 67 *FORDHAM L. REV.* 301, 301 (1998) ("Lawyers are more than their client's agents. Lawyers are officers of the court, thus subjecting themselves to the court's supervision and to duties geared to protect the vigor, fairness, and integrity of processes of litigation. Furthermore, as members of a profession, lawyers are subject to duties not neatly captured by the consequences of agency.").

81. As a matter of practice, this would be more generally recognized as the somewhat unfortunate but all together common human behavior of *pointing the finger* at another. See, e.g., WILLIAM SHAKESPEARE, *Othello*, in *THE RIVERSIDE SHAKESPEARE* 1251, 1279 (G. Blakemore Evans & J.J. M. Tobin eds., Houghton Mifflin Company 1997) (1622) ("[A]las, to make me [t]he fixed figure for the time of scorn [t]o point his slow [unmoving] finger at!").

82. See 15 U.S.C. § 78j(b) (2006).

83. 511 U.S. 164 (1994).

84. 552 U.S. 148 (2008).

85. Thus, while the particular facts of *Central Bank* and *Stoneridge* do not directly concern corporate gatekeepers as previously defined, nevertheless the doctrinal rules that result from such cases illustrate the nature and quality of liability rules in this context.

86. Although one could argue that *Central Bank* and *Stoneridge* are not cases that specifically or perhaps even necessarily implicate issues of conflicts of interest, this category of liability rules, as defined, seeks to facilitate discussion of not only conflicts of interest rules, in and of themselves, but also the principles of independ-

1. *Central Bank v. First Interstate Bank of Denver*

The facts in *Central Bank* concerned certain bonds issued by the Colorado-Springs-Stetson Hills Public Building Authority in the amount of \$26 million in order to “finance public improvements at Stetson Hills, a planned residential and commercial development in Colorado Springs.”⁸⁷ Pursuant to the financing papers, Central Bank of Denver served as indenture trustee for the bonds in question, which were secured by certain real estate interests.⁸⁸ As part of the financing, AmWest, the developer of Stetson Hills, covenanted to provide an annual report that such real estate interests had value of at least 160% of the outstanding principal and interest on the bonds.⁸⁹ In light of a decline in real estate values, Central Bank performed an in-house appraisal of the real estate interests in question.⁹⁰ The in-house appraisal determined that the stated values for such interests were “optimistic.”⁹¹ After exchanging letters with AmWest, Central Bank agreed to a delay of an independent review of the real estate appraisal, which permitted a second tranche of the bond issues to close.⁹² In due time, however, the Colorado-Springs Stetson Hills Public Building Authority defaulted on this second tranche of bonds.⁹³

In such circumstances, the question before the Court was whether Central Bank was “secondarily liable under [Section] 10(b) for its conduct in aiding and abetting the fraud.”⁹⁴ In light of Central Bank’s role as indenture trustee, the issue of secondary liability became a critical point of concern. In other words, Central Bank did not issue the bonds, but rather operated in a facilitating role per the terms of the indenture.⁹⁵ Accordingly, a claim for a primary violation of section 10(b) by Central Bank would be difficult to sub-

ence that serve as the theoretical foundation for such rules. *See, e.g.*, MODEL RULES OF PROF’L CONDUCT R. 1.7 cmt. 1 (2012). Accordingly, by fashioning this category of liability rules, I seek to further explore the manner in which conflicts rules, broadly considered, may be addressed within the space of corporate and securities law.

87. *Cent. Bank of Denver, N.A.*, 511 U.S. at 167.

88. *Id.*

89. *Id.*

90. *Id.* at 167-68.

91. *Id.* at 167.

92. *Id.* at 168.

93. *Id.*

94. *Id.*

95. *See, e.g.*, Steven L. Schwarcz & Gregory M. Sergi, *Bond Defaults and the Dilemma of the Indenture Trustee*, 59 ALA. L. REV. 1037, 1040 (2008) (“Absent default, the indenture trustee’s duties to bondholders are straightforward and, indeed, even ministerial. In the event of default, however, those duties are governed by a ‘prudent man’ standard.”).

stantiate.⁹⁶ But could investors in the bonds sue Central Bank on a theory of aiding and abetting liability?

The Court responded in the negative in a 5-4 decision.⁹⁷ In particular, the Court primarily relied upon the argument that Congressional intent was lacking in this instance. Accordingly, the Court reasoned that “there would be no logical stopping point to this line of reasoning”⁹⁸ of inferring private causes of action from the federal criminal statutory provision on aiding and abetting liability. Both the public and scholarly reaction to *Central Bank* was mixed at best.⁹⁹ Nevertheless, could an alternative theory of “scheme” liability prevail where the aiding and abetting liability claimed in *Central Bank* had failed?

2. *Stoneridge Investment Partners v. Scientific-Atlanta*

In *Stoneridge*, investors in Charter Communications, Inc. filed suit against the company for falsely reporting financial information in order to meet Wall Street expectations for cable subscriber growth and operating cash flow.¹⁰⁰ In particular, the investors alleged that Charter Communications engaged in transactions of no economic substance (i.e., sham transactions) in order to create the appearance of increased revenues.¹⁰¹ Indeed, the investors

96. As an elaboration, this would be so due to the fact that indenture trustees customarily do not actively engage in the marketing of bonds in a manner which would satisfy the requirement that such indenture trustee made a material misstatement or omission in connection with the purchase and sale of the bonds. See 17 C.F.R. § 240.10b-5 (2012).

97. *Cent. Bank of Denver, N.A.*, 511 U.S. at 185 (“In sum, it is not plausible to interpret the statutory silence as tantamount to an implicit congressional intent to impose [section] 10(b) aiding and abetting liability.”).

98. *Id.* at 190-91.

99. As part of the Private Securities Litigation Reform Act of 1995, Congress provided that the SEC may bring actions against persons on an aiding and abetting liability theory. See Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended at 15 U.S.C. §§ 77-78); 15 U.S.C. § 78t (2006). However, this left unaddressed the possibility of a private right of action by investors, which remains an issue within the scholarship. See, e.g., Susan Koniak, *When the Hurlyburly's Done: The Bar's Struggle with the SEC*, 103 COLUM. L. REV. 1236, 1279 (2003) (“Aiding and abetting liability for lawyers must be restored, and the level of scienter necessary for liability should be returned to recklessness for private suits and for actions brought by the SEC.”); Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, 58 BUS. LAW. 143, 182 (2002) (“The *Central Bank* case should be overruled by legislative action.”).

100. 552 U.S. 148, 152-53 (2008).

101. *Id.* at 154 (“The transactions, it is alleged, had no economic substance; but, because Charter would then record the advertising purchases as revenue and capitalize its purchase of the set top boxes, in violation of generally accepted accounting princi-

alleged that Scientific-America and Motorola, each of whom were counterparties to contracts with Charter Communications, actively engaged in these sham transactions.¹⁰² For instance, the investors alleged that Scientific-America falsely indicated an increase in its production costs,¹⁰³ while both Scientific-America and Motorola backdated certain advertising agreements in order to hide from the company's auditor that these transactions had no economic value.¹⁰⁴

Unlike the facts in *Central Bank*, therefore, the plaintiffs in *Stoneridge* appeared to have a stronger case against the secondary actors – in this case, the counterparties to contract, Scientific-America and Motorola.¹⁰⁵ However, the problem for the investors was that neither Scientific-America nor Motorola had misstated the financial information of Charter Communications.¹⁰⁶ The question, therefore, was whether the investors could impose “scheme liability” on Scientific-America and Motorola in the absence of either company making specific disclosure in respect of the relevant transactions.¹⁰⁷ Once again, the Court responded in the negative.¹⁰⁸ In particular, the Court held that the reliance requirement for a section 10(b) action was not satisfied because “it was Charter, not [Scientific-America and Motorola], that misled its auditor and filed fraudulent financial statements; nothing [Scientific-America and Motorola] did made it necessary or inevitable for Charter to record the transactions as it did.”¹⁰⁹

When considered together, the Court's rulings in *Central Bank* and *Stoneridge* illustrate how difficult it is to define – or, once again, to *redefine* – the liability that attaches to secondary actors to the corporation.¹¹⁰ And while both *Central Bank* and *Stoneridge* involved entities that are not typically considered within the definition of the corporate gatekeeper, the liability rules set forth in each of these cases apply to each of the corporate attorney, auditor, securities analyst, and ratings agency.¹¹¹ Therefore, it appears that liability rules are quite similar to activity rules in that they are rules enacted, in some

ples, the transactions would enable Charter to fool its auditor into approving a financial statement showing it met projected revenue and operating cash flow numbers.”).

102. *Id.* at 154-55.

103. *Id.* at 154.

104. *Id.* at 154-55.

105. *See id.* at 168-69 (Stevens, J., dissenting).

106. *Id.* at 155 (majority opinion).

107. *Id.* at 159-160.

108. *Id.* at 159-161.

109. *Id.* at 161.

110. *See, e.g.,* JAMES M. BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY* 112 (1962) (“The expected costs of organizing decisions, *under any given rule*, will be less in the smaller unit than in the larger, assuming that the populations of each are roughly comparable.”); POSNER, *supra* note 44, § 19.3.

111. *See supra* note 85.

sense, in a moment of political violence.¹¹² One side will prevail, and the other side will fail.¹¹³ And to the winner go the spoils – that is, the damages mandated by the new liability rule that will compensate for the alleged wrongs.¹¹⁴ In such circumstances, the possibility of enacting new activity rules and/or liability rules without the necessary political will appears remote at best.¹¹⁵ Other categories of conflicts rules must therefore be discussed.

C. Disclosure Rules

The third category of legal rules on conflicts of interest in the context of corporate and securities law is the category of *disclosure rules*.¹¹⁶ For purposes of this discussion, I will broadly define disclosure rules as those legal rules concerning the registration and reporting process for publicly traded companies under federal securities law and regulation.¹¹⁷ Disclosure rules, therefore, are legal rules that are best captured in the famous remarks of Justice Brandeis: “Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.”¹¹⁸ As a matter of legal history, such an approach to securities regulation was the hallmark of President Franklin D. Roosevelt’s thinking toward federal legislation in respect of such business activities.¹¹⁹ Accordingly, in discussing disclosure rules, we concern our-

112. Gerald F. Seib, *In Crisis, Opportunity for Obama*, WALL ST. J., Nov. 21, 2008, <http://online.wsj.com/article/SB122721278056345271.html> (“‘You never want a serious crisis to go to waste,’ Rahm Emanuel, Mr. Obama’s new chief of staff, told a Wall Street Journal conference of top corporate chief executives this week.”).

113. Anglo-American legal history provides the antecedents for such an approach to dispute resolution. See, e.g., DANIEL R. COQUILLETTE, *THE ANGLO-AMERICAN LEGAL HERITAGE: INTRODUCTORY MATERIALS* 159 (2nd ed. 2004) (“‘Battle’ was the original mode of proof for the writ of right. It also fell from favor after the Fourth Lateran Council (1215). Battle, like oaths, technically survived into the 19th century. Indeed, it was only abolished in 1819 by statute after a party tried to use it to bring an appeal of felony in the case of *Ashford v. Thornton* (1818), 1 B. & Ald. 405.”).

114. See Macey & Miller, *supra* note 36, at 979.

115. See *supra* notes 44, 78 and accompanying text.

116. For purposes of this Article, I do not address matters of state securities or “blue sky” laws. See, e.g., HAZEN, *supra* note 49, § 8.1 (“Section 18(b) of the 1933 Act, as enacted by the [National Securities Markets Improvement Act of 1996], provides that a number of securities offerings will be exempted from state law regulation in terms of registration and reporting requirements. Notwithstanding the curtailing of state law regulatory jurisdiction, state antifraud provisions are preserved.”).

117. See, e.g., 15 U.S.C. §§ 77a-78pp (2006); 17 C.F.R. §§ 229.10-.1016 (2012).

118. LOUIS D. BRANDEIS, *OTHER PEOPLE’S MONEY AND HOW THE BANKERS USE IT* 92 (1914) [hereinafter BRANDEIS, *OTHER PEOPLE’S MONEY*].

119. See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* 41 (3rd ed. 2003) (“[President Franklin D. Roosevelt] approached the problem of securi-

selves with foundational rules of the federal securities regulatory regime.¹²⁰ Moreover, while in recent years federal securities law and regulation may have encroached into the historical role of states in respect of corporate governance,¹²¹ the fact remains that the federal securities regulatory system is primarily a system that mandates and enforces disclosure rules.¹²²

As noted previously, the distinction between disclosure rules and liability rules has a tendency to blur in practice.¹²³ For purposes of this categorization, however, this distinction will be preserved in order to facilitate consideration of these different species of legal rules.¹²⁴ For instance, suppose that Corporation X discloses in its proxy statement that CEO Y will receive \$50 million in aggregate compensation.¹²⁵ Suppose further that, in point of fact, CEO Y will receive \$50 million and one cent in aggregate compensation.¹²⁶ In each case, the amount of aggregate compensation must be disclosed pursuant to a disclosure rule, as defined previously.¹²⁷ But is the difference in disclosed compensation – that is, the lonely cent that did not make it into the final draft for the printers – a matter that will also trigger a liability rule?¹²⁸ One thinks not, because the misstatement of one cent will probably not con-

ties regulation with the instincts of a progressive politician in the Wilson and Brandeis tradition, rather than of an economist concerned with the larger questions of capital allocation and economic recovery. Rarely did Roosevelt speak about the stock market without invoking the title of Louis Brandeis's celebrated study, *Other People's Money*. Like Brandeis, Roosevelt viewed the need to reform securities sales practices primarily as stemming from the self-interest of investment bankers, primarily the House of Morgan. Like Brandeis, Roosevelt believed the moral delicts of the bankers would be curbed when fully exposed to public scrutiny.”).

120. See *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/about/whatwedo.shtml> (last modified Jan. 24, 2013) (“The laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it. To achieve this, the SEC requires public companies to disclose meaningful financial and other information to the public.”).

121. See HAZEN, *supra* note 49, § 22.1 (giving an overview of the intersection of many state and federal securities regulation laws).

122. See *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, *supra* note 120.

123. See *supra* note 32.

124. But see Kennedy, *supra* note 33, at 210 (discussing the act of categorizing legal rules as a method of inquiry).

125. See 17 C.F.R. § 229.402 (2012).

126. See *id.*

127. See *id.*

128. See, e.g., 15 U.S.C. § 78j(b) (2006).

stitute a *material* misstatement of executive compensation for purposes of section 10(b) liability.¹²⁹

Thus, while disclosure rules and liability rules are undoubtedly connected – indeed, they may be seen as two sides of the same coin under federal securities law and regulation – the difference in their fundamental nature remains.¹³⁰ Disclosure rules mandate disclosure. Liability rules mandate liability.¹³¹ And, therefore, disclosure rules, in and of themselves, should be further explored as part of this categorization. In particular, the proxy disclosure of codes of ethics for senior financial officers¹³² as well as the proposed disclosure rules for compensation committee independence standards¹³³ provide us with examples of disclosure rules in practice.¹³⁴

1. Code of Ethics for Senior Financial Officers

The first example of a disclosure rule, for purposes of this discussion,¹³⁵ is the requirement that companies subject to Regulation S-K must disclose their ethical codes.¹³⁶ Specifically, section 406 of Sarbanes-Oxley mandated that the SEC issue rules to “require each issuer . . . to disclose whether or not,

129. *See, e.g.*, *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988); 17 C.F.R. § 240.10b-5; SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150, 45,152 (Aug. 12, 1999) (codified at 17 C.F.R. pt. 211 (2011)).

130. *See supra* note 32. A more recent example of the interconnection of disclosure rules and liability rules is the historic \$550 million settlement between the SEC and Goldman Sachs in relation to certain trading in subprime mortgage collateralized debt obligations (“CDOs”). *See* Sec. & Exchange Comm’n v. Goldman, Sachs & Co., SEC Litigation Release No. 21595, No. Civ. 3229 (Jul. 15, 2010). In particular, Goldman Sachs acknowledged that marketing materials for a certain CDO transaction “contained incomplete information” in that it failed to disclose that Paulson & Co., Inc., a noted hedge fund, engaged in the selection process for the referenced portfolio. *See id.*

131. *See, e.g.*, Hines, *supra* note 1, at 40 n.37.

132. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 406, 116 Stat. 745 (2002) (codified as amended at 15 U.S.C. §§ 7201-66).

133. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 124 Stat. 1376 (2010) (codified as amended at 12 U.S.C. §§ 5301-5641).

134. Although there are numerous examples of disclosure rules under federal securities law and regulation, I have selected the proxy disclosure related to codes of ethics for senior financial officers and the newly enacted compensation committee independence standards in that they provide us with useful examples of the intersection of corporate law with legal ethics. *See supra* note 13.

135. Again while this particular disclosure rule does not read to the corporate gatekeeper but to her client – here, the senior financial officers – nevertheless the illustration of this disclosure rule provides context for purposes of this categorization. *See supra* note 85.

136. *See* 17 C.F.R. § 229.406 (2012).

and if not, the reason therefor, such issuer has adopted a code of ethics for senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions”.¹³⁷

In response to this Congressional mandate, the SEC promulgated Item 406 of Regulation S-K that requires, *inter alia*, the disclosure of such a code of ethics.¹³⁸ Further, the SEC defined the term “code of ethics” as meaning:

[W]ritten standards that are reasonably designed to deter wrongdoing and to promote: (1) Honest and ethical conduct, *including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships*; (2) Full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant; (3) Compliance with applicable governmental law, rules and regulations; (4) The prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and (5) Accountability for adherence to the code.¹³⁹

Here, therefore, is an example of the intersection of corporate law with legal ethics in the form of a disclosure rule.¹⁴⁰ More specifically, Item 406 provides for the disclosure of a code of ethics that addresses the issue of conflicts of interest.¹⁴¹

But what information in respect of conflicts of interest is being disclosed by registrants pursuant to this disclosure rule?¹⁴² And further to such consid-

137. Sarbanes-Oxley Act § 406(a).

138. *See* 17 C.F.R. § 229.406(a) (2012).

139. *See id.* § 229.406(b) (emphasis added).

140. For purposes of this Article, however, I use the term “corporate law” in a wider sense to include matters that are more specifically addressed in federal securities law and regulation. While the interrelation of state corporation law and federal securities law remains an important area of inquiry in the scholarship, such matters are without the scope of this Article. *See, e.g.*, STEPHEN M. BAINBRIDGE, *CORPORATE LAW* § 1.2, at 8 (2d ed. 2009) (“Indeed, publicly held corporations can be said to function in a dual regulatory scheme: federal securities law and state corporate law.”). As for a possible definition of legal ethics, I will adopt a wider meaning as well. *See, e.g.*, GEOFFREY C. HAZARD JR. & ANGELO DONDI, *LEGAL ETHICS: A COMPARATIVE STUDY 3* (2004) [hereinafter HAZARD & DONDI, *LEGAL ETHICS*] (“‘Legal Ethics’ includes not only ethical conventions of the legal profession but also legal regulations prescribed by the authority of the state.”).

141. *See* 17 C.F.R. § 229.406(b).

142. *See, e.g.*, Usha Rodrigues & Mike Stegemoller, *Placebo Ethics: A Study in Securities Disclosure Arbitrage*, 96 VA. L. REV. 1, 5 (2010) (“[A]t least for related-party transactions, firms regularly engage in a kind of ‘disclosure arbitrage,’ neglecting to disclose ethics waivers at the time when transactions occur (in violation of

erations, are there other disclosure rules that we might consider as examples of the intersection of corporate law and legal ethics?

2. Compensation Committee Independence Standards

A second example of a disclosure rule that lies at the intersection of corporate law and legal ethics is the newly enacted independence standards for compensation committees and related proxy disclosure to such standards.¹⁴³ In particular, section 952 of Dodd-Frank requires the SEC to issue by rule, or direct the national securities exchanges and national securities associations to promulgate such rules, whereby certain independence standards will apply for compensation committees.¹⁴⁴ Further, section 952 requires the SEC to define by rule certain factors that may affect the “independence”¹⁴⁵ of the relevant compensation consultant, legal counsel, or other adviser to a compensation committee of an issuer:

(A) the provision of other services to the issuer by the person that employs the compensation consultant, legal counsel, or other adviser; (B) the amount of fees received from the issuer by the person that employs the compensation consultant, legal counsel, or other adviser . . . ; (C) *the policies and procedures of the person that employs the compensation consultant, legal counsel, or other adviser that are designed to prevent conflicts of interest*; (D) any business or personal relationship of the compensation consultant, legal counsel, or other adviser with a member of the compensation committee; and (E) any stock of the issuer owned by the compensation consultant, legal counsel, or other adviser.¹⁴⁶

Here, once again, we find a legal rule that touches upon both corporate law and legal ethics in its requirement that conflicts of interest policies and procedures must preserve the independence of the compensation consultant, legal counsel, or other adviser.¹⁴⁷

Section 406 of Sarbanes-Oxley), but disclosing related-party transactions in their year-end proxy statements as required by Item 404 of Regulation S-K.”)

143. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 124 Stat. 1376 (2010) (codified as amended at 12 U.S.C. §§ 5301-5641).

144. See *id.* § 952(a).

145. See generally Christopher T. Hines, Tatsuya Tanigawa & Andrew P. Hughes, *Doing Deals in Japan: An Analysis of Recent Trends and Developments for the U.S. Practitioner*, 2006 COLUM. BUS. L. REV. 355, 413 n.144 (2006).

146. Dodd-Frank Act § 952(b)(2) (emphasis added).

147. *Id.*

While this independence rule is not a disclosure rule as such,¹⁴⁸ section 952 of Dodd-Frank later provides for the disclosure in corporate proxy materials of whether:

(A) the compensation committee of the issuer retained or obtained the advice of a compensation consultant; and (B) *the work of the compensation consultant has raised any conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed.*¹⁴⁹

Here, therefore, is an additional disclosure rule that implicates matters of both corporate law and legal ethics.

In addition, the SEC has issued a final rule pursuant to the mandates of section 952.¹⁵⁰ However, since the relevant disclosure in proxy statements pursuant to such rule is currently unavailable, as of present it is not completely clear what specific information will be provided by means of this new disclosure rule.¹⁵¹ Nevertheless, for the purpose of the present categorization, the definition of disclosure rules becomes clearer.

D. Ethical Rules

The fourth and final category of legal rules in the area of corporate and securities law is *ethical rules*.¹⁵² In many ways, this last category of ethical

148. Indeed, the independence rule would more properly be considered as a corporate governance rule. *See, e.g.*, BAINBRIDGE, *supra* note 140, § 5.7(B).

149. Dodd-Frank Act § 952(c).

150. Listing Standards for Compensation Committees, 77 Fed. Reg. 38,422 (June 27, 2012) (to be codified at 17 C.F.R. pts. 229, 240).

151. Comments to the SEC proposed rule identified a number of points that required additional consideration. *See, e.g.*, Letter from Jeffrey W. Rubin, Chair of the Fed. Regulation of Sec. Comm., ABA Bus. Law Section, to U.S. Sec. & Exch. Comm'n 12 (Jun. 29, 2011), *available at* <http://www.sec.gov/comments/s7-13-11/s71311-57.pdf> (“We do not believe that it is appropriate for the Commission to expand the Section 10C(c)(2) disclosure requirement to cover both actual and potential conflicts of interest.”); Letter from Robert J. Jackson, Jr., Assoc. Professor, Columbia Law Sch., to U.S. Sec. & Exch. Comm'n 4 (May 19, 2011), *available at* <http://www.sec.gov/comments/s7-13-11/s71311-52.pdf> (“While the exact design of the disclosure is beyond the scope of these preliminary comments, companies should at least be required to disclose which attorneys advised the compensation committee on executive pay – and any potential conflict of interest these lawyers may face.”).

152. Although this category of ethical rules undoubtedly and perhaps even necessarily touches upon the prior categories of activity rules, liability rules, and disclosure rules, I believe that there is merit in distinguishing ethical rules from these other categories for reasons that will be made clear. *See infra* Part III.A.

rules presents the greatest challenge as a matter of taxonomy.¹⁵³ What is an ethical rule under law?¹⁵⁴ Is it necessarily a moral rule, and if so, what then are the connections (if any) between law, ethics and morality?¹⁵⁵ Further, what of the notion of professionalism or professional ethics as such terms are commonly used in scholarship?¹⁵⁶ What then do we mean to say when employing such language in scholarly discourse, or perhaps more tellingly what do we not mean?¹⁵⁷

As a means of facilitating further discussion on such points, this Article seeks to adopt a more neutral phraseology in relation to these fundamental questions.¹⁵⁸ Thus, I employ the term *ethical rule* as a conscious effort to

153. Indeed, the definition of one's "ethics" may be viewed as the normative act itself. For once certain behavior or other relevant thought or action becomes *by definition* unethical, then *by necessity* it will not be ethical. In this sense, the categorization of ethics brings substance to the form. *See, e.g.,* Kennedy, *supra* note 33, at 210 (discussing the act of categorizing legal rules as a method of inquiry).

154. *See, e.g.,* Geoffrey C. Hazard, Jr., *Law, Morals, and Ethics*, 19 S. ILL. U. L.J. 448, 453 (1995) ("By 'ethics,' I mean norms shared by a group on a basis of mutual and usually reciprocal recognition. Ethics, as thus defined, is essentially a two-party transaction The term 'ethics' comes to us from the Greek *ethikos*, a word which signified a custom or usage. Thus, the term refers to a norm having the characteristic of being understood in a community [E]thics entails a dimension of outward manifestation resulting in communication within the relevant community and a dimension of historical sequence through which an idea manifested at one period is remembered at a subsequent period.").

155. In answering such a question, of course, lies the fundamental distinction between natural law and legal positivist approaches to law. *See, e.g.,* ROBERT L. HAYMAN, JR., NANCY LEVIT & RICHARD DELGADO, *JURISPRUDENCE CLASSICAL AND CONTEMPORARY: FROM NATURAL LAW TO POSTMODERNISM* 1-10, 74-80 (2d ed. 2002).

156. *See, e.g.,* COMM'N ON PROFESSIONALISM, AM. BAR. ASS'N, ". . . IN THE SPIRIT OF PUBLIC SERVICE": A BLUEPRINT FOR THE REKINDLING OF LAWYER PROFESSIONALISM 10 (1986) ("'Professionalism' is an elastic concept the meaning and application of which are hard to pin down. That is perhaps as it should be. The term has a rich, long-standing heritage, and any single definition runs the risk of being too confining."); Geoffrey C. Hazard, Jr., *Personal Values and Professional Ethics*, 40 CLEV. ST. L. REV. 133, 134 (1992) ("The term 'professional ethics' can be understood to refer to at least three different but related normative sources: first, the profession's rules of ethics; second, ethical tradition including professional myths, lore and narrative; and, third, the standards of conduct that an observing anthropologist would describe as the profession's conventions of actual practice. The last source may also be captured by the term 'habit' which at one time was used to describe a group's regular pattern of conduct.").

157. *See supra* note 156. Definition is, therefore, a decision – that is to say, a decision as to the precise ambit of the ethics under consideration. This said, the interpretation of such definitions is a matter beyond the scope of inquiry in this article.

158. Without doubt, alternative terms may be used by those with a contrary perspective to the conclusions that I draw in this Article. Nevertheless, the intention is to

provide common language that may be utilized when forming arguments from numerous perspectives on law.¹⁵⁹ Further, I make the initial distinction between first-order ethical rules and second-order ethical rules.¹⁶⁰ In this respect, the intention is once again to provide such language that may be useful in furthering scholarly discussion on such points.¹⁶¹ But before turning to the distinction between first-order ethical rules and second-order ethical rules, it is helpful to more fully enunciate the meaning of the term *ethical rule* as used for the purposes of the present discussion.

The more frequently used phrase in modern discourse is the word *professionalism* or *professional ethics*.¹⁶² But what does this phrase mean? As Professors Geoffrey Hazard and Deborah Rhode explain, “‘Profession’ comes from the Latin, *professionem*, meaning to make a public declaration. The term evolved to describe occupations that required new entrants to take an oath professing their dedication to the ideals and practices associated with a learned calling.”¹⁶³ While the origins of the term profession may be clear, however, the manner in which it is employed has not been entirely consistent over time.¹⁶⁴ Nevertheless, a consistency in the usage of the term professional or its variants (i.e., professionalism, professional ethics) is, in some fashion, an effort to achieve greater virtue on the part of the profession in question.¹⁶⁵

make the language employed as neutral as may be possible, given the inherent limitations of the written word. Accordingly, one may view this taxonomy as placeholders of sorts for the concepts that are being explored in developing the lines of argumentation as set forth herein. See, e.g., WILLIAM R. BISHIN & CHRISTOPHER D. STONE, LAW, LANGUAGE AND ETHICS: AN INTRODUCTION TO LAW AND LEGAL METHOD vii (1972) (“[E]very legal problem – whether it concern the ‘great issues’ of civil disobedience or the hum-drum matters of Offer and Acceptance and Last Clear Chance – has its roots and perhaps its analog in traditionally ‘philosophical’ realms. Strip away the technical terms, plumb the debate’s assumptions, and a host of implicit philosophical positions will be found.”).

159. See *id.* at 403.

160. See *infra* Parts II.D.1-2.

161. Without some measure of agreement as to the language being employed, one imagines that further discussion as to areas of disagreement cannot be fully explored. We must, therefore, first agree on the language being used prior to any disagreement as to subsequent argumentation. See *supra* note 157 and accompanying text.

162. See, e.g., Hazard, *Doing the Right Thing*, *supra* note 11, at 691 (“In the most recent decade, the call [to ‘do the right thing’] has been expressed in terms of ‘professionalism.’ In earlier years, the call was expressed as a demand that lawyers dedicate themselves to ‘serving the public interest’ and in Victorian times it was expressed in terms of the ‘honor of the legal profession.’”).

163. GEOFFREY C. HAZARD, JR. & DEBORAH L. RHODE, THE LEGAL PROFESSION: RESPONSIBILITY AND REGULATION 2 (3d ed. 1994).

164. See Hazard, *Doing the Right Thing*, *supra* note 11, at 691-92.

165. See *id.* at 691 (“[T]he quest is for greater virtue on the part of lawyers, both individually and as a member of the profession.”); Heidi Li Feldman, *Codes and*

Perhaps the most comprehensive definition of “profession” is found in Professor Wasserstrom’s influential article on the subject matter.¹⁶⁶ Given its importance within the scholarship, it may be helpful to quote at length:

Because of the significance for my analysis of the closely related concepts of a profession and professional, it will be helpful to indicate at the outset what I take to be the central features of a profession. . . .

. . . There are, I think, at least six that are worth noting.

(1) The professions require a substantial period of formal education – at least as much if not more than that required by any other occupation. . . .

(2) The professions require the comprehension of a substantial amount of theoretical knowledge and the utilization of a substantial amount of intellectual ability

(3) *The professions are both an economic monopoly and largely self-regulating.* Not only is the practice of the profession restricted to those who are certified as possessing the requisite competencies, but the questions of what competencies are required and who possesses them are *questions that are left to the members of the profession to decide for themselves.*

(4) The professions are clearly among the occupations that possess the greatest social prestige in the society. They also typically provide a degree of material affluence substantially greater than that enjoyed by most working persons. . . .

(5) *The professions are almost always involved with matters which from time to time are among the greatest personal concerns that humans have: physical health, psychic well-being, liberty, and the like.* As a result, persons who seek the services of a professional

Virtues: Can Good Lawyers Be Good Ethical Deliberators?, 69 S. CAL. L. REV. 885, 940 (1996) (arguing that “highly technocratic lawyers” cannot be good ethical deliberators).

166. See Richard Wasserstrom, *Lawyers as Professionals: Some Moral Issues*, 5 HUM. RTS. 1 (1975). But see Susan P. Koniak & George M. Cohen, *In Hell There Will Be Lawyers Without Clients or Law*, 30 HOFSTRA L. REV. 129, 131 (2001) (“The questions articulated by Wasserstrom and accepted by so many legal scholars as central to legal ethics do not fit the patterns of later lawyer scandals any better than they fit Watergate.”).

are often in a state of appreciable concern, if not vulnerability, when they do so. . . .

(6) The professions almost always involve at their core a significant inter-personal relationship between the professional, on the one hand, and the person who is thought to require the professional's services: the patient or the client.¹⁶⁷

Professions, therefore, are an elite of sorts within society with certain prescribed privileges and responsibilities that are obtained upon the completion of rigorous academic training and achievement.¹⁶⁸ As Tocqueville famously observed: "Hidden at the bottom of the souls of lawyers one therefore finds a part of the tastes and habits of aristocracy. They have its instinctive penchant for order, its natural love of forms; they conceive its great disgust for the actions of the multitude and secretly scorn the government of the people."¹⁶⁹

This notion of the professional as a class that is separate and distinct from others in society is a reality that is often at odds with fundamental principles of American culture.¹⁷⁰ Such tension between the necessity for profes-

167. Wasserstrom, *supra* note 166, at 1-2 n.1 (emphasis added).

168. *See id.*

169. ALEXIS DE TOCQUEVILLE, *DEMOCRACY IN AMERICA* 252 (Harvey C. Mansfield & Delba Winthrop eds., University of Chicago Press 2000) (1835). Although this quotation from Tocqueville is often cited, its precise meaning is frequently lost or misunderstood. *See, e.g.*, Hazard, *The Future of Legal Ethics*, *supra* note 28, at 1272 ("It is important to contrast Tocqueville's view of aristocracy with what seems to be a widely shared contemporary misinterpretation of that concept. In present-day American usage, 'aristocracy' signifies a class constituted by inheritance, endowed with unearned wealth and income, and privileged to remain in idleness. Its members enjoy their status by an accident of history and interject themselves in serious matters only occasionally and then merely as a matter of personal choice. This concept of an aristocracy calls up images of the English country house dilettantes of the Victorian era . . . Yet Tocqueville assumes that an 'aristocratic element' must exist even in a democracy, and finds it in the legal profession and in 'those who have turned to industry.' In Jeffersonian terms – perhaps compatible with democratic ideology – members of the legal profession would be a 'natural aristocracy,' as distinct from an inherited one.").

170. *See, e.g.*, U.S. CONST. pmb. ("We the People of the United States, in Order to form a more perfect Union, establish Justice, insure domestic Tranquility, provide for the common defence, promote the general Welfare, and secure the Blessings of Liberty to ourselves and Posterity, do ordain and establish this Constitution for the United States of America."); Hazard, *The Future of Legal Ethics*, *supra* note 28, at 1241 ("The bar's ambiguous standards of competence, for example, can be attributed to such external realities as the wide variety of constituencies seeking legal services, the diversity of aspirants for legal careers, and – above all – fundamental tendencies in the American social environment: its unacknowledged social stratification, disdain for elitism, and aversion to regulatory controls on personal behavior.").

sions within the greater political economy and the tendencies of an anti-establishment culture often leads to the most natural of results – professionals, and lawyers in particular, are not exceedingly popular in the United States.¹⁷¹ But such cultural phenomena aside, the reality remains that the task must be completed – and, therefore, the professions must seek to complete their appointed task.¹⁷²

One of the most important tasks of professions is their self-regulation.¹⁷³ While reasonable minds may disagree as to whether such an approach is natural or whether alternatives may be desired,¹⁷⁴ this is the current state of affairs

171. See, e.g., Hazard, *Doing the Right Thing*, *supra* note 11, at 701 (“I submit that the opprobrium is essentially what psychiatrists call ‘projection.’ . . . The lawyer’s vocation is living testimony to the discrepancy between the community’s ethical aspirations and its merely human condition. It may also be that the availability of lawyers to deal with some of these discrepancies permits other members of the community to imagine themselves above such unpleasantness and allows them to live in an imaginary world.”); Robert C. Post, *On the Popular Image of the Lawyer: Reflections in a Dark Glass*, 75 CALIF. L. REV. 379, 380 (1987) (“Lawyers, it seems, can’t win for trying. They are simultaneously praised and blamed for the very same actions.”). This said, the interrelationship of the professions with greater society need not always be this strained. For instance, in Japan the notion that there is a legal elite is an accepted reality for the larger society in question. See generally Curtis J. Milhaupt & Mark D. West, *Law’s Dominion and the Market for Legal Elites in Japan*, 34 L. & POL’Y INT’L BUS. 451, 459-477 (2003). But what one culture may accept, another may freely deny as a matter of choice or, more likely, historical path dependence. And therein lies the difference for the professions when properly considering their ethical rules within the fabric of larger social discourse. Or, to put the question plainly, to which culture are you fashioning the ethical rule? See ISAIAH BERLIN, *THE CROOKED TIMBER OF HUMANITY: CHAPTERS IN THE HISTORY OF IDEAS* 38 (Henry Hardy ed., 1990) (“In order to understand a culture, one must employ the same faculties of sympathetic insight with which we understand one another, without which there is neither love nor friendship, nor true human relationships.”); HAZARD & DONDI, *LEGAL ETHICS*, *supra* note 140, at 2 (“Every legal system has a distinct cultural character, and there is much variance in legal systems even among the Western regimes.”).

172. See Wasserstrom, *supra* note 166, at 1-2 n.1. Here, Professor Wasserstrom’s observations ring true that “[t]he professions are almost always involved with matters which from time to time are among the greatest personal concerns that humans have: physical health, psychic well-being, liberty, and the like.” *Id.* Some measure of opprobrium is, one must imagine, a small price to pay in the face of such important responsibilities. See Charles Fried, *The Lawyer as Friend: The Moral Foundations of the Lawyer-Client Relation*, 85 YALE L.J. 1060, 1071-72 (1976) (“To be sure, the lawyer’s range of concern is sharply limited. But within that limited domain the intensity of identification with the client’s interests is the same.”).

173. See Wasserstrom, *supra* note 166, at 1 n.1.

174. See, e.g., John C. Coffee, Jr., *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293, 1316 (2003) [hereinafter Coffee, *The Attorney as Gatekeeper*] (“The blunt truth is that private self-regulation of attorneys through bar

of the professions.¹⁷⁵ This Article, therefore, addresses the professions in their current state and not necessarily in their desired form.¹⁷⁶ More specifically, this Article considers the professional *qua* gatekeeper¹⁷⁷ in a manner consistent with the ongoing scholarship on corporate gatekeepers.¹⁷⁸ In taking such an approach, the intersection of corporate law and legal ethics will be further explored.¹⁷⁹ And as a means to further such lines of inquiry, the initial distinction between first-order ethical rules and second-order ethical rules becomes necessary.¹⁸⁰

1. First-Order Ethical Rules

A first-order ethical rule is, for purposes of this discussion, a rule of ethics as may be prescribed by the relevant profession.¹⁸¹ Accordingly, the first-

associations means the continued government of the guild, by the guild, and for the guild.”).

175. See, e.g., MODEL RULES OF PROF’L CONDUCT Preamble: A Lawyer’s Responsibilities ¶ 10 (2012) (“The legal profession is largely self-governing. Although other professions also have been granted powers of self-government, the legal profession is unique in this respect because of the close relationship between the profession and the processes of government and law enforcement. This connection is manifested in the fact that ultimate authority over the legal profession is vested largely in the courts.”).

176. This said, I do not intend to provide a purely descriptive argument, but also include some possible prescriptions in federal securities law and regulation. See *infra* Part III.A.2.

177. See Wasserstrom, *supra* note 166, at 21 (“The lawyer *qua* professional is, of necessity, only centrally interested in that part of the client that lies within his or her special competency.”).

178. See, e.g., Reiner H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53 (1986); see generally COFFEE, *supra* note 14.

179. See *supra* note 13.

180. See *infra* Parts II.D.1-2. Notably, this distinction between first-order ethical rules and second-order ethical rules should not be confused with the distinction of primary and secondary rules. See H.L.A. HART, *THE CONCEPT OF LAW* 81 (2d ed. 1994) (“Rules of the first type impose duties; rules of the second type confer powers, public or private.”).

181. In using the phrase *first-order* ethical rule, I do not mean to suggest that such rules are necessarily more important or in some fashion superior to what will later be described as a *second-order* ethical rule. The effort, once again, is to provide a taxonomy of ethical rules that will facilitate further discussion. Indeed, the distinction between a first-order ethical rule and second-order ethical should be considered as primarily one of logic. See Herbert B. Enderton, *Second-Order and Higher-Order Logic*, STAN. ENCYCLOPEDIA OF PHIL. (MAR. 4, 2009), <http://plato.stanford.edu/entries/logic-higher-order/> (“Second-order logic is an extension of first-order logic where, in addition to quantifiers such as ‘for every object (in the universe of discourse),’ one has quantifiers such as ‘for every *property* of objects (in the universe of discourse).’ This augmentation of the language increases its expressive strength, without adding

order ethical rule is an ethical rule of the first-order precisely because it is enunciated by the relevant profession as matter of self-regulation.¹⁸² Again, while reasonable minds may disagree as to whether first-order ethical rules should be promulgated in the current fashion or whether alternatives may be desirable,¹⁸³ nevertheless the reality remains that first-order ethical rules do exist for the professional *qua* gatekeeper.¹⁸⁴ More specifically, the first-order ethical rules for corporate attorneys are those model rules of legal ethics as drafted by the American Bar Association (“ABA”),¹⁸⁵ and as further enunciated and enforced by the bar associations and courts in the various states.¹⁸⁶ Therefore, the ABA rules on the ethics of the legal profession and the historical development thereof are the focus of this discussion.¹⁸⁷

As a matter of legal history, it may be helpful to first recall the precise manner in which the self-regulation of attorneys commenced in the United States.¹⁸⁸ Although the antecedents of the professional regulation of attorneys read back to the nineteenth century in the United States,¹⁸⁹ and even as far back as the thirteenth century in England,¹⁹⁰ the first comprehensive ethi-

new non-logical symbols, such as new predicate symbols. For classical extensional logic (as in this entry), properties can be identified with sets, so that second-order logic provides us with the quantifier ‘for every *set* of objects.’”).

182. See MODEL RULES OF PROF'L CONDUCT Preamble: A Lawyer's Responsibilities ¶ 10 (2012); Wasserstrom, *supra* note 166, at 1-2 n.1.

183. See, e.g., Coffee, *The Attorney as Gatekeeper*, *supra* note 174, at 1316.

184. See MODEL RULES Scope ¶ 19 (“Failure to comply with an obligation or prohibition imposed by a Rule is a basis for invoking the disciplinary process.”).

185. See MODEL RULES R. 1.7-1.13; MODEL CODE OF PROF'L RESPONSIBILITY Canons 5, 9 (1981).

186. See, e.g., DEBORAH L. RHODE & GEOFFREY C. HAZARD, JR., PROFESSIONAL RESPONSIBILITY AND REGULATION 8-9 (2d ed. 2007).

187. See generally CTR. FOR PROF'L RESPONSIBILITY, AM. BAR ASSOC., A LEGISLATIVE HISTORY: THE DEVELOPMENT OF THE ABA MODEL RULES OF PROFESSIONAL CONDUCT, 1982-2005 143-318 (2006).

188. See COFFEE, *supra* note 14, at 199-202 (detailing the historical evolution of the modern MODEL RULES).

189. See Allison Marston, *Guiding the Profession: The 1887 Code of Ethics of the Alabama State Bar Association*, 49 ALA. L. REV. 471, 471 (1998) (“[T]he Model Code of Professional Responsibility and the Model Rules of Professional Conduct owe much of their content to the first code of ethics for lawyers officially adopted in the United States: the 1887 code of ethics of the Alabama State Bar Association.”). In this effort at codification, the prior work of George Sharswood and David Hoffman were particularly influential. See *id.* at 493-97.

190. See, e.g., Jonathan Rose, *The Legal Profession in Medieval England: A History of Regulation*, 48 SYRACUSE L. REV. 1, 4 (1998) (“In the late thirteenth century, three critical regulations were adopted: the Statute of Westminster I, chapter 29 (1275), the London Ordinance of 1280, and the Ordinance of 1292, *de Attornatis et Apprenticiis*.”).

cal “code”¹⁹¹ for attorneys in the United States took the form of the ABA Canons of Professional Ethics.¹⁹² The impetus for such codification of ethical rules came from a speech by President Theodore Roosevelt given in 1905, where he made the following observation:

Every man of great wealth who runs his business with cynical contempt for those prohibitions of the law which by hired cunning he can escape or evade is a menace to our community; and the community is not to be excused if it does not develop a spirit which actively frowns on and discountenances him. *The great profession of the law should be that profession whose members ought to take the lead in the creation of just such a spirit.* We all know that, as things actually are, many of the most influential and most highly remunerated members of the bar in every centre of wealth make it their special task to work out bold and ingenious schemes by which their very wealthy clients, individual or corporate, can evade the laws which are made to regulate in the interest of the public the use of great wealth.¹⁹³

In response to this call for action, the ABA adopted the Canons of Professional Ethics in 1908.¹⁹⁴ In comparison to the current rules of professional ethics the Canons of Professional Ethics are somewhat antiquated.¹⁹⁵ The adoption of these Canons meant the Rubicon had been crossed; there now

191. See generally UGO A. MATTEI, TEEMU RUSKOLA & ANTONIO GIDI, SCHLESINGER'S COMPARATIVE LAW 384 (7th ed. 2009) (discussing the historical evolution of legal codification).

192. See ABA CANONS OF PROF'L ETHICS (1908).

193. Theodore Roosevelt, U.S. President, Address at Harvard University (June 28, 1905), available at <http://www.theodore-roosevelt.com/images/research/txtspeeches/143.txt> (emphasis added). In addition to his comments on the legal profession, President Roosevelt also championed the cause of scholarship in this address. See *id.* (“The ideal for the graduate school and for those undergraduates who are to go into it must be the ideal of high scholarly production, which is to be distinguished in the sharpest fashion from the mere transmittal of ready-made knowledge without adding to it. If America is to contribute its full share to the progress not alone of knowledge, but of wisdom, then we must put ever-increasing emphasis on university work done along the lines of the graduate school.”).

194. See ABA CANONS OF PROF'L ETHICS.

195. See *id.* Preamble (“The future of the Republic, to a great extent, depends upon our maintenance of Justice pure and unsullied. It cannot be so maintained unless the conduct and the motives of the members of our profession are such as to merit the approval of all just men.”); see also Luban & Millemann, *supra* note 28, at 45 (“The term ‘canon’ derives initially from biblical studies, where ‘the canon’ referred to those sacred texts officially included in the Bible (the antonym was ‘apocrypha’).”).

existed a formal ethical code for attorneys in the United States.¹⁹⁶ Despite the fact that the specific rule on conflicts of interest was rather terse,¹⁹⁷ it did provide the beginnings for the further development of first-order ethical rules in the form of the Model Code of Professional Responsibility and the Model Rules of Professional Conduct.¹⁹⁸

a. Model Code of Professional Responsibility

In 1969, the ABA enacted the Model Code of Professional Responsibility, which constituted a significant revision – indeed, perhaps one can even say a redrafting – of the first-order ethical rules for attorneys in the United States.¹⁹⁹ Notably, the Model Code reorganized the rules in question into a three-fold structure: canons, ethical considerations, and disciplinary rules.²⁰⁰ The canons continued to provide general direction to attorneys,²⁰¹ while the ethical considerations provided aspirational rules.²⁰² Further, the disciplinary rules²⁰³ provided the first step in what Professor Hazard calls the “legalization” process of the norms of professional conduct.²⁰⁴ Accordingly, while the Model Code may be viewed as an intermediate step between the 1908 Canons and the Model Rules, on closer inspection the Model Code provided a clear break from the past in that first-order rules for attorneys now took the form, at least in part, of what is now frequently known as *professional regulation*.²⁰⁵

Nevertheless, the Model Code did maintain some elements of the 1908 Canons through the vehicle of the canons and, more specifically, the ethical

196. See ABA CANONS OF PROF'L ETHICS.

197. See CANONS OF PROF'L ETHICS Canon 6 (“It is unprofessional to represent conflicting interests, except by express consent of all concerned given after a full disclosure of the facts.”).

198. See MODEL RULES OF PROF'L CONDUCT R. 1.7-1.13 (2012); MODEL CODE OF PROF'L RESPONSIBILITY Canons 5, 9 (1981).

199. See MODEL CODE OF PROF'L RESPONSIBILITY Preliminary Statement.

200. See *id.*

201. See *id.* (“The Canons are statements of axiomatic norms, expressing in general terms the standards of professional conduct expected of lawyers in their relationships with the public, with the legal system, and with the legal profession.”).

202. See *id.* (“The Ethical Considerations are aspirational in character and represent the objectives toward which every member of the profession should strive.”).

203. See *id.* (“The Disciplinary Rules, unlike the Ethical Considerations, are mandatory in character. The Disciplinary Rules state the minimum level of conduct below which no lawyer can fall without being subject to disciplinary action.”).

204. See Hazard, *The Future of Legal Ethics*, *supra* note 28, at 1251 (“In retrospect, it is clear that the crucial step in the ‘legalization’ process occurred in the change from the 1908 Canons to the 1970 code, rather than from the Code to the 1983 Rules.”).

205. See *id.* (“The Code’s Disciplinary Rules formed the baseline of the 1983 Rules; indeed, many of the DR’s were carried over intact into the Rules.”).

considerations.²⁰⁶ And the reasons for this division between the aspirational and the mandatory, as Professor David Luban explains in his important work on the subject matter,²⁰⁷ was in part due to the scholarship of Professor Lon Fuller.²⁰⁸ In this sense, therefore, the ethical considerations provide a means by which one may explore the “inner morality” of a profession that an otherwise mandatory rule may not achieve.²⁰⁹ Accordingly, the Model Code presents us with this bifurcated approach to first-order ethical rules – those that are aspirational, and those that are mandatory.²¹⁰

Of particular note for the present discussion on conflicts of interest, the Model Code provides, under the rubric of an Ethical Consideration, a rule on the appearance of impropriety, which may be helpful to consider at length:

Every lawyer owes a solemn duty to uphold the integrity and honor of his profession; to encourage respect for the law and for the courts and the judges thereof; to observe the Code of Professional Responsibility; to act as a member of a learned profession, one dedicated to public service; to cooperate with his brother lawyers in supporting the organized bar through the devoting of his time, efforts, and financial support as his professional standing and ability reasonably permit; to conduct himself so as to reflect credit on the legal profession and to inspire the confidence, respect, and trust

206. See MODEL CODE Preliminary Statement.

207. See David Luban, *Rediscovering Fuller's Legal Ethics*, 11 GEO. J. LEGAL ETHICS 801 (1998).

208. See *id.* at 806-07 (“Fuller was not only an important philosopher of legal ethics, he was also, for a period of time, quite an influential one [T]he *Model Code* divided its rules into aspirational ‘Ethical Considerations’ and mandatory ‘Disciplinary Rules.’ This structure was partly inspired by Fuller’s distinction between the moralities of aspiration and duty in *The Morality of Law*.”). As Professor Owen Fiss further observes, Fuller’s theoretical approach to law has its foundation in the law of contract. Owen M. Fiss, *Foreward: The Forms of Justice*, 93 HARV. L. REV. 1, 44 (1979); see also Luban, *supra* note 207, at 805 (“As Owen Fiss perceptively notes, Fuller was a contracts scholar who was not only more interested in private law than in public law, but who regarded private law as the template to which public law should mold itself.”). Fuller’s contributions to contract law scholarship remain considerable. See, e.g., L. L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages*, 46 YALE L.J. 52 (1936); Lon L. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799 (1941) [hereinafter Fuller, *Consideration and Form*].

209. See Luban, *supra* note 207, at 807 (“One knows a priori, so to speak, how a Fullerian analysis of legal ethics should run. There should be an outer morality concerned with the content of legal representations, and perhaps with issues such as a lawyer’s honesty. *But the interesting part of the analysis would be an effort to discover an inner morality of the legal profession, that is, a morality that makes law practice possible.* The inner morality, professional ethics in the proper sense of the term, would consist of functional virtues and duties.” (emphasis added)).

210. See MODEL CODE Preliminary Statement.

of his clients and of the public; *and to strive to avoid not only professional impropriety but also the appearance of impropriety.*²¹¹

The Model Code, therefore, provides first-order ethical rules that came in an almost binary fashion – what one *must* do under the Disciplinary Rules, and what one *should* do under the Ethical Considerations.²¹² In this manner, conflicts of interest under the Model Code should be considered under both the mandatory rule, as to whether a conflict of interest in point of fact exists as enunciated in the Disciplinary Rules,²¹³ as well as the possibility of an *appearance of impropriety* in the given case.²¹⁴ This approach evolved, however, under the present formulation of first-order ethical rules for the legal profession – that is, the Model Rules of Professional Conduct.²¹⁵

b. Model Rules of Professional Conduct

In 1983, the ABA replaced the Model Code of Professional Responsibility with the Model Rules of Professional Conduct, which remain the primary source of first-order ethical rules for attorneys in the United States.²¹⁶ In their formulation, the Model Rules had the intended purpose of “legalizing” the rules of legal ethics.²¹⁷ In this sense, therefore, the Model Rules completed the task that the Model Code initiated – that is, a concerted effort to remove the rules of legal ethics from the vestiges of canonical prose, or the language of professional scripture.²¹⁸ Such a development, while not inevitable,²¹⁹ was

211. MODEL CODE EC 9-6 (emphasis added).

212. See MODEL CODE Preliminary Statement.

213. See MODEL CODE DR 5-102 to 5-107.

214. See MODEL CODE EC 9-6; *infra* Part III.A.

215. See MODEL RULES OF PROF'L CONDUCT Preamble: A Lawyer's Responsibilities, Scope (2012).

216. See MODEL RULES Preface.

217. See Hazard, *The Future of Ethics*, *supra* note 28, at 1241 (“[O]ver the last twenty-five years or so the traditional norms have undergone important changes. One important development is that those norms have become ‘legalized.’ The rules of ethics have ceased to be internal to the profession; they have instead become a code of public law enforced by formal adjudicative disciplinary process.”).

218. See *id.* at 1250-51.

219. See Luban & Millemann, *supra* note 28, at 46 (“Geoffrey Hazard’s views of the transformation are particularly significant, because, as the Kutak Commission’s reporter who drafted the Model Rules, he occupies the dual role of chronicler and prime mover of the final stage of the transition.”). Further, Daniel Reynolds served as Assistant Reporter to the Kutak Commission, and I especially thank Professor Reynolds for his thoughtful comments on the arguments presented herein. See *infra* note 234.

nevertheless an improvement in the self-regulation of the legal profession.²²⁰ In lieu of what may be considered as rather vague notions of “ethics” and “professionalism” that arguably obtained under the Model Code and certainly were set forth in the 1908 Canons, the Model Rules brought clarity and focus to the regulation of attorneys as a profession.²²¹ The clarity brought by the Model Rules meant that vague notions of “ethics” and “professionalism” were no longer the criteria upon which one would determine whether particular conduct by an attorney was permissible or not.²²²

As an example of the increased clarity, consider the manner in which the Model Rules addressed the issue of an “appearance of impropriety” in comparison to the approach taken under the Model Code, as discussed previously.²²³ In keeping with the aim of legalizing the rules of legal ethics, the Model Rules take the direct approach in that they discard the ethical consideration of an appearance of impropriety from the conflict of interest rules.²²⁴ The reasons for such an approach are persuasively explained in the commentary to the Model Rules:

The other rubric formerly used for dealing with disqualification is the appearance of impropriety proscribed in Canon 9 of the ABA Model Code of Professional Responsibility. This rubric has a two-fold problem. First, the appearance of impropriety can be taken to include any new client-lawyer relationship that might make a former client feel anxious. If that meaning were adopted, disqualification would become little more than a question of subjective judgment by the former client. Second, since “impropriety” is undefined, the term “appearance of impropriety” is question-begging. It therefore has to be recognized that the problem of disqualification cannot be properly resolved either by simply analogy to a lawyer practicing alone or by the very general concept of appearance of impropriety.²²⁵

Accordingly, the “appearance of impropriety” criterion is subject to compelling criticism in that it makes the test a subjective one where the opinion of a former client will, more often than not, be decisive.²²⁶ Moreover, if the effort behind the Model Rules is to legalize legal ethics, then the appear-

220. See Hazard, *The Future of Legal Ethics*, *supra* note 28, at 1249 (“What were fraternal norms issuing from an autonomous professional society have now been transformed into a body of judicially enforced regulations.”).

221. See *id.*

222. See Luban & Millemann, *supra* note 28, at 46-47.

223. See MODEL CODE OF PROF’L RESPONSIBILITY EC 9-6 (1981); *supra* Part II.D.1.a.

224. See MODEL RULES OF PROF’L CONDUCT R. 1.7-1.13 (2012).

225. MODEL RULES OF PROF’L CONDUCT R. 1.9 cmt. 5 (1995).

226. See *id.*

ance of impropriety test could not remain in the manner set forth in the Model Code.²²⁷ The criterion *necessarily* needed revision in order to move the test from a subjective to an objective one.²²⁸ As a consequence, the Model Rules in a certain sense reified the Disciplinary Rules of the Model Code.²²⁹ This change, then, is the current state of affairs of the first-order ethical rules for the legal profession.²³⁰

2. Second-Order Ethical Rules

In contrast to first-order ethical rules, for purposes of this discussion a second-order ethical rule is defined as a rule of ethics as may be prescribed by the competent authority.²³¹ In this sense, the distinction between first-order and second-order ethical rules is primarily one of the rule-giver.²³² In the case of first-order ethical rules, the relevant profession provides the ethical rules as a matter of self-regulation.²³³ As for second-order ethical rules, a

227. See Luban & Millemann, *supra* note 28, at 46-47. To be sure, the assessment on such points will necessarily change when considering the important issues that concern conflict of interest scenarios for judges. See MODEL CODE OF JUDICIAL CONDUCT Canon 1 (2011) (“A judge shall uphold and promote the independence, integrity, and impartiality of the judiciary, and shall avoid impropriety and the appearance of impropriety.”); ABA Comm. on Prof’l Ethics, Formal Op. 322 (1969) (“The public is rightfully concerned with the interests of legislators, of lawyers, of businessmen and the basis on which their decisions are made. The public rightfully is interested in the appearance of impropriety on the part of its judges, and the public’s judges should conform to the standards set forth many years ago by the thoughtful members of the legal profession and codified in the Canons of Judicial Ethics.”).

228. This struggle between subjective and objective criteria under law is not without precedent. Indeed, such a debate was the essential question in respect of the modern law of contractual formation. E. ALLAN FARNSWORTH, CONTRACTS § 3.6, at 115 (4th ed. 2004) (“By the end of the nineteenth century, the objective theory had become ascendant and courts universally accept it today.”).

229. See Hazard, *The Future of Legal Ethics*, *supra* note 28, at 1254; Luban & Millemann, *supra* note 28, at 46-47.

230. See MODEL RULES OF PROF’L CONDUCT Scope ¶ 14 (2012) (“The Rules of Professional conduct are rules of reason. They should be interpreted with reference to the purposes of legal representation and of the law itself.”).

231. With respect to an additional definition as to what may constitute a competent authority, I adopt such language in an effort to provide neutral language in furtherance of additional discussion. See *supra* note 158 and accompanying text.

232. This additional quantifier of the rule-giver that is not the relevant profession is what transforms the first-order ethical rule into a second-order ethical rule. See Enderton, *supra* note 181. This is to say, for instance, that an attorney will always be subject to first-order ethical rules in connection with their licensure requirements with the relevant bar association. However, such an attorney may or may not be subject to certain second-order ethical rules, depending on the areas in which she may or may not practice law.

233. See, e.g., MODEL RULES Preamble: A Lawyer’s Responsibilities ¶ 10.

competent authority in some sense *imposes* rules of legal ethics onto the profession.²³⁴ The difference, therefore, is largely one of governance.²³⁵ With respect to first-order ethical rules, the professions, to some extent, decide what ethical rules will bind them.²³⁶ First-order ethical rules, therefore, can be seen as an effort by the professions to tie themselves to the mast, in a manner of speaking, when approaching the Sirens.²³⁷ On the other hand, second-order ethical rules are, by their very nature, imposed on the professions.²³⁸ And while the professions may or may not consent to such an imposition of ethical rules, the critical distinction is that while such consent may be desired, it is by no means necessary.

234. *See, e.g.*, 17 C.F.R. §§ 205.1-205.7 (2012). As a matter of legal history, however, it is important to note that the interplay between the relevant profession and a competent authority is often much more complex. For instance, much of the content of the Attorney Conduct Rules was previously offered by the SEC prior to the adoption of the Model Rules. *See* Daniel S. Reynolds, *Wrongful Discharge of Employed Counsel*, 1 GEO. J. LEGAL ETHICS 553, 581 (1988) (“The [SEC], for example, solicited comments a number of years ago with respect to a rulemaking proposal initiated by the Georgetown Institute for Public Representation. The proposal would have required annual certification by corporations of a certain size to the effect: (1) that its board of directors had instructed each lawyer employed or retained by the corporation to report any probable law violations of a certain qualitative or quantitative seriousness; (2) that the attorneys had done so; and (3) that the board had taken appropriate action with respect to the lawyer reports. The response of the organized corporate bar was ferocious and directly attacked the SEC’s authority for such rulemaking, as well as certain specifics of the proposal itself. These attacks, however, did not question the fundamental *legal* correctness of the proposal’s view of the lawyer-management role. In fact, however inadequately put, the proposal seems to have gotten it basically right. This was in 1979. Soon thereafter, the Kutak Commission’s original version of Rule 1.13 appeared.” (emphasis added)). In this sense, therefore, much of what was right in 1979 did not come to fruition until 2002 with the passage of Sarbanes-Oxley and associated promulgation of the Attorney Conduct Rules.

235. *See generally* JONATHAN R. MACEY, *CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN* 2 (2008) (“Corporate governance is a broad descriptive term rather than a normative term. Corporate governance describes all of the devices, institutions, and mechanisms by which corporations are governed.”).

236. *See, e.g.*, MODEL RULES Preamble: A Lawyer’s Responsibilities ¶ 12 (“The legal profession’s relative autonomy carries with it special responsibilities of self-government. The profession has a responsibility to assure that its regulations are conceived in the public interest and not in furtherance of parochial or self-interested concerns of the bar.”).

237. *See* Roosevelt, *supra* note 193 (“It shall not help us if we avoid the Scylla of baseness of motive, only to be wrecked on the Charybdis of wrong-headedness, of feebleness and inefficiency.”).

238. *See, e.g.*, 17 C.F.R. §§ 205.1-205.7.

The occurrence of second-order ethical rules for the professions has particular salience for the corporate attorney.²³⁹ Indeed, it is in the case of the corporate attorney that we find in sharp relief the distinction between first-order ethical rules and second-order rules.²⁴⁰ Accordingly, in considering the manner in which corporate attorneys concern themselves with second-order ethical rules, one may further explore the precise manner in which such rules may operate.²⁴¹ The most notable example of second-order ethical rules for the corporate attorney remains, by general consensus, the Attorney Conduct Rules as enacted pursuant to the mandates of Sarbanes-Oxley.²⁴²

a. Attorney Conduct Rules

Although the Attorney Conduct Rules are a matter deserving of extended discussion, for purposes of this categorization an overview of the notable provisions of such rules will be sufficient.²⁴³ Adopted by the SEC in 2003 pursuant to section 307 of Sarbanes-Oxley,²⁴⁴ the Attorney Conduct Rules have the stated purpose of “set[ting] forth minimum standards of professional conduct for attorneys appearing and practicing before the SEC in the representation of an issuer.”²⁴⁵ A key limitation, therefore, in the scope of the Attorney Conduct Rules is whether the attorney in question is

239. See Milton C. Regan, Jr., *Professional Responsibility and the Corporate Lawyer*, 13 GEO. J. LEGAL ETHICS 197, 204 (2000) [hereinafter Regan, *Professional Responsibility*] (“Corporate lawyers also tend to be in the vanguard of another emerging trend in legal practice: the subjection of lawyers to multiple sources of ethical governance.”).

240. See MILTON C. REGAN, JR. & JEFFREY D. BAUMAN, LEGAL ETHICS AND CORPORATE PRACTICE 729-30 (2005).

241. See *id.* at v (“The behavior of corporations and the professionals who advise them are now the object of a searching scrutiny. Why, critics ask, didn’t the lawyers stop the looting, the fraud, and the manipulations of loopholes?”); Coffee, *Understanding Enron*, *supra* note 69, at 1405.

242. See 17 C.F.R. §§ 205.1-205.7. See generally Simon M. Lorne, *An Issue-Annotated Version of the Sox Rules for Lawyer Conduct* (2005), reprinted in REGAN & BAUMAN, *supra* note 240, at 712, 712-31.

243. For a more detailed discussion of the Attorney Conduct Rules, including the discussions that took place in connection with the passage of Section 307 of Sarbanes-Oxley and the regulations promulgated thereunder, see COFFEE, *supra* note 14, at 216-23; HAZEN, *supra* note 49, § 9.8; Koniak, *supra* note 99, at 1269-78.

244. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745 (2002) (codified as amended at 15 U.S.C. §§ 7201-66).

245. 17 C.F.R. § 205.1 (“These standards supplement applicable standards of any jurisdiction where an attorney is admitted or practices and are not intended to limit the ability of any jurisdiction to impose additional obligations on an attorney not inconsistent with the application of this part. Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this part, this shall govern.”).

“[a]ppearing and practicing before the [SEC].”²⁴⁶ Further, the Attorney Conduct Rules read in a manner similar to the Disciplinary Rules under the Model Code,²⁴⁷ or the various rules provided in the Model Rules.²⁴⁸ In other words, the Attorney Conduct Rules are not drafted in a strictly aspirational sense as seen in the case of the 1908 Canons²⁴⁹ and the ethical considerations set forth in the Model Code.²⁵⁰ Rather, the Attorney Conduct Rules are more closely related to the Model Rules in that they seek to provide minimum standards of professional conduct that will apply in the case of an attorney that is appearing and practicing before the SEC.²⁵¹

In particular, the Attorney Conduct Rules set forth the now famous “up the ladder” reporting requirements for covered attorneys that become aware of “evidence of a material violation”²⁵² by their corporate client.²⁵³ Importantly, the Attorney Conduct Rules provide that the duty to report evidence of a material violation is mandatory and thus is not a matter of personal discretion.²⁵⁴ Further, this reporting duty remains mandatory in instances in which the attorney in question “reasonably believes”²⁵⁵ that the chief legal officer or chief executive officer has not provided an “appropriate response”²⁵⁶ to such

246. *Id.* § 205.2(a). Notably, this defined term of “appearing and practicing before the [SEC]” does not include a “non-appearing foreign attorney.” *Id.* § 205.2(a)(2)(ii). In turn, the phrase “non-appearing foreign attorney” has its own defined term. *Id.* § 205.2(j).

247. *Compare id.* § 205.3(b), with MODEL CODE OF PROF’L RESPONSIBILITY DR 5-101 (1981).

248. *Compare* 17 C.F.R. § 205.3(b), with MODEL RULES OF PROF’L CONDUCT R. 1.7 (2012).

249. *Compare* 17 C.F.R. § 205.3(b), with ABA CANONS OF PROF’L ETHICS Canon 6 (1908).

250. *Compare* 17 C.F.R. § 205.3(b), with MODEL CODE EC 5-1.

251. *See* 17 C.F.R. § 205.1; MODEL RULES Scope ¶ 14.

252. 17 C.F.R. § 205.2(e) (“Evidence of a material violation means credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.”). Further, the term “material violation” has its own definition. *Id.* § 205.2(i) (“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.”).

253. More specifically, the Attorney Conduct Rules employ the term “issuer” as further defined under federal securities laws. *See id.* § 205.2(h).

254. *Id.* § 205.3(b).

255. *See id.* § 205.2(m) (“Reasonably believes means that an attorney believes the matter in question and that the circumstances are such that the belief is not unreasonable.”); *see also id.* § 205.2(l) (“Reasonable or reasonably denotes, with respect to the actions of an attorney, conduct that would not be unreasonable for a prudent and competent attorney.”).

256. *See id.* § 205.2(b) (providing an enumerated definition of what constitutes an “appropriate response”).

evidence of material violation. In such cases, therefore, the attorney must report such evidence of material violation to the board of directors, the audit committee, or another uninterested committee of the board of directors in order to satisfy her duties under the Attorney Conduct Rules.²⁵⁷ Alternatively, the attorney may be subject to a separate reporting procedure in cases where there is a “qualified legal compliance committee.”²⁵⁸ In either case, however, the Attorney Conduct Rules provide mandatory rules of professional conduct that operate in the fashion of second-order ethical rules.²⁵⁹

Of note, the Attorney Conduct Rules specifically provide that they do not create a private right of action.²⁶⁰ Nevertheless, the Attorney Conduct Rules do provide that a violation thereof will subject an attorney to civil penalties and remedies that apply in the case of a violation of federal securities laws.²⁶¹ As one might imagine, therefore, attorneys appearing and practicing before the SEC must carefully consider their responsibilities under both first-order and second-order ethical rules.²⁶² Such considerations are without the scope of this Article.²⁶³ For the purposes of the present categorization, however, the nature and extent of ethical rules becomes clear – in both their first-order and second-order formulations.

III. THE PRIMACY OF ETHICAL RULES OF THE CORPORATE GATEKEEPER

With the foregoing categorization of conflicts of interest rules now complete, the discussion may now turn to the argument in favor of the primacy of ethical rules for the corporate gatekeeper.²⁶⁴ This argument will be

257. *Id.* § 205.3(b)(3).

258. *Id.* § 205.3(c).

259. *See id.* § 205.3(b)-(c).

260. *Id.* § 205.7(a). Additionally, the final rules promulgated by the SEC did not include the controversial “noisy withdrawal” provisions that were included in the proposed rule. *See* Koniak, *supra* note 99, at 1274-78.

261. 17 C.F.R. § 205.6(a).

262. *Compare id.* § 205.3(b), with MODEL RULES OF PROF’L CONDUCT R. 1.13 (2012).

263. *See, e.g.*, MODEL RULES OF PROF’L CONDUCT R. 1.13, in PROFESSIONAL RESPONSIBILITY STANDARDS, RULES & STATUTES (John S. Dzienkowski ed., 2011-2012 ed.) (“In August 2003, the ABA House of Delegates modified Model Rule 1.13 to respond to the claims that the old rule did not permit lawyers to prevent corporate fraud which had a significant impact on their client’s financial wellbeing.”); Arnold Rochvarg, *Enron, Watergate and the Regulation of the Legal Profession*, 43 WASHBURN L.J. 61, 68-70 (2003) (discussing the Kutak Commission’s recommendation with respect to Model Rule 1.13).

264. As noted previously, the intended scope of this argument in favor of the primacy of ethical rules of the corporate gatekeeper is in its potential application in the areas of corporate and securities law. In this sense, therefore, ethical rules of the

made in two-parts: (a) by comparing the previously defined categories of conflicts rules,²⁶⁵ and (b) by arguing for an ethical perspective as to the corporate gatekeeper.²⁶⁶

A. Ethical Rules and the Corporate Gatekeeper

Reputation has long been an important factor in approaches to law.²⁶⁷ Indeed, the inclusion of reputation in the form of *reputational capital* in legal theory has a long history within the law and economics schools of thought,²⁶⁸ which inform to a considerable degree the important work in the area of gatekeeper scholarship.²⁶⁹ Further, the application of reputation as a more specific criterion upon which to assess law has been explored in such varied ar-

corporate gatekeeper can be viewed as standing at the intersection of corporate law and legal ethics. See *supra* note 13.

265. See *infra* Part III.A.1.

266. See *infra* Part III.A.2.

267. See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* 395-96 (1985) (“Reputation effects will deter defection from the letter and the spirit of an agreement in the degree to which (1) defections can be made public knowledge, (2) the consequences of defection can be fully ascertained (which will permit, among other things, real versus contrived claims of defection to be distinguished), and (3) parties who experience or observe defection penalize the offender and/or his successors in ‘full measure.’”).

268. See, e.g., Cohen, *supra* note 80, at 287 (“The theory is that the law firm protects clients against the lawyer-client agency problem by posting a bond in the form of its reputation for client service and then monitoring the conduct of its member lawyers to prevent forfeiture of the reputational bond.”); Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615, 616 (1981); Larry E. Ribstein, *Ethical Rules, Agency Costs, and Law Firm Structure*, 84 VA. L. REV. 1707, 1714 (1998) (“By posting reputational ‘bonds,’ large law firms help ensure that their lawyers serve client interests, including in ways that are not addressed by ethical rules. The reputational bond is not only critical to an understanding of the large law firm’s role in reducing agency costs, but it also helps explain some otherwise puzzling aspects of law firm organization.”); Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519, 529, 532 n.29 (1983).

269. See COFFEE, *supra* note 14, at 2-3; Ronald J. Gilson, *The Devolution of the Legal Profession: A Demand Side Perspective*, 49 MD. L. REV. 869, 915 (1990) (“Here, then, is my best (and only) candidate for the next generation of private gatekeeper: the inside lawyer.”); Frank Partnoy, *Strict Liability for Gatekeepers: A Reply to Professor Coffee*, 84 B.U. L. REV. 365, 367 (2004) (“The central theoretical point is that reputational arguments related to gatekeepers are complex and reputation alone is not necessarily a viable constraint on gatekeeper certification.”); Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1614 (2010) (“All this suggests that reputations may not be well-calibrated to the quality of gatekeeper performance in past transactions and are thus noisy, or crude, indicators of gatekeeper performance.”).

eas of law such as international law,²⁷⁰ corporate law²⁷¹ and international financial law.²⁷²

While invoking the usage of the term “reputation” no doubt strongly suggests that important issues of law and policy are raised, the initial question that must be asked is – *what is reputation?*²⁷³ As a matter of etymology, the word “reputation” derives from the Latin *reputatio*, which means “the action of thinking about, consideration; a subject of thought, reflection.”²⁷⁴ Accordingly, the word reputation may properly be considered as a term that connotes some manner of introspection.²⁷⁵ Contrasted with the modern usage of the word reputation, which is more typically associated with one’s regard within a community,²⁷⁶ this ancient and perhaps more precise definition of reputation has resonance in the ethical context. For, in the words of Warren Buffett, if you *think* about your reputation as something that takes twenty years to build and five minutes to ruin, you will do things differently.²⁷⁷ With this definition of reputation in mind, we may now turn to the comparison of the categories of conflicts as has been set forth in the preceding pages of this Article.²⁷⁸

270. See, e.g., Andrew T. Guzman, *Reputation and International Law* 15 (UC Berkeley Pub. Law Research Paper No. 1112064, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1112064 (“The reputation of a state is contingent on its past behavior but it is the knowledge that today’s conduct will affect tomorrow’s reputation that gives reputational sanctions their force.”).

271. Karl S. Okamoto, *Reputation and the Value of Lawyers*, 74 OR. L. REV. 15, 46 (1995) (“What can be said with certainty is that the reputation model provides a powerful lens for examining the practice of corporate law.”).

272. Chris Brummer, *How International Financial Law Works (and How It Doesn’t)*, 99 GEO. L.J. 257, 286 (2011) (“As a result, noncompliance with key international standards, if discovered, will cause other countries to rethink or reevaluate their expectations concerning the regulator’s future behavior (or ‘reputation’).”).

273. See *supra* notes 153, 157.

274. OXFORD LATIN DICTIONARY 1624 (1982).

275. See *id.* One may also consider the additional meaning of *reputatio* as being “a consideration to be taken into account when drawing up a financial statement.” *Id.*; see *infra* Part III.A.2.

276. See *Reputation Definition*, OXFORD ENGLISH DICTIONARY, <http://www.oed.com/view/Entry/163228> (last visited Jan. 29, 2013) (defining reputation as “the condition, quality, or fact of being highly regarded or esteemed; credit, fame, distinction; respectability, good report.”).

277. See Editorial, *supra* note 2; see also Macey & Miller, *supra* note 36, at 1003 (“The rules of legal ethics do in fact impose such an additional level of sanctions, as the attorney found to have engaged in an impermissible conflict of interest is subject to serious penalties, including loss of reputation, license suspension, or even disbarment – sanctions sufficient to make attorneys think twice about engaging in inappropriate conflicts of interest or disclosing client secrets or confidences to third parties.”).

278. See *supra* Parts II.A-D.

1. Comparison of the Categories of Conflicts Rules

As a means of further developing the notion of the primacy of ethical rules of the corporate gatekeeper, it will be helpful to consider the manner in which the previously defined categories of conflicts rules interrelate.²⁷⁹ More specifically, a comparison of the categories of conflicts rules in respect of the positive and negative interests at issue for each of the professional *qua* gatekeeper and the corporate client itself will be instructive.²⁸⁰ For when considering conflicts rules, the tension often lies with the respective responsibilities assumed by the professional *qua* gatekeeper and her corporate client.²⁸¹ One might imagine an instance where the corporate client may wish to engage in certain illegal and perhaps even immoral conduct,²⁸² but the professional *qua* gatekeeper must intervene as a matter of professional ethics.²⁸³ Cases of conflict of interest, therefore, are necessarily – in a phrase – *conflicted*. And they are conflicted precisely in the sense that the interest of one party is set against the interest of another party.²⁸⁴

Much of this makes intuitive sense, and indeed is reflected in the applicable first-order ethical rules.²⁸⁵ But what does this import when comparing the various species of conflicts rules? Are some conflicts rules more properly designed to address certain issues in law and policy than others? And if so, what are the comparative advantages and disadvantages of each of these species of conflicts rules? In attempting to answer such questions, the rule maker will need to consider, at least to some degree, the precise manner of rule that will be employed.²⁸⁶ The rule maker, in this sense, must know what rules she

279. *See supra* Parts II.A-D.

280. The comparative approach remains an important method of inquiry in law and other disciplines. *See generally* Roscoe Pound, *What May We Expect From Comparative Law?*, 22 A.B.A. J. 56, 59 (1936).

281. Under the Model Rules of Professional Conduct, such tension is aptly captured with the language of adversity between the attorney and her client. *See* MODEL RULES OF PROF'L CONDUCT R. 1.7(a)(1) (2012).

282. In making such an observation, we need not address the possible connection of law with morals. *See, e.g.*, H. L. A. Hart, *Positivism and the Separation of Law and Morals*, 71 HARV. L. REV. 593, 629 (1958); Lon L. Fuller, *Positivism and Fidelity to Law – A Reply to Professor Hart*, 71 HARV. L. REV. 630, 630-31 (1958). Suffice it to note that cases involving conflicts of interest will often raise questions that will implicate both law and morality, regardless of their connection with one another.

283. *See* MODEL RULES R. 1.13 (stating the up the ladder reporting requirement for attorneys of corporate clients); 17 C.F.R. § 205.3(b) (2012) (referencing a duty to report evidence of an issuer-client's material violations).

284. *See* MODEL RULES R. 1.7(a)(1).

285. *See id.* R. 1.7-1.13.

286. This said, the reality may well be that the rule maker has other more pressing considerations in mind, such as the need of a reelection. Nevertheless, the point to be made is that if the law is to have any coherence, then some notion of the rule of law must obtain. *See generally* LON L. FULLER, *THE MORALITY OF LAW* 38-41 (revised

is writing.²⁸⁷ And if this is indeed the case, then a categorization of conflicts rules will provide some structure through which the decision as to the particular rule that will be employed can be made.²⁸⁸ Here, therefore, is the intended purpose of the aforementioned categorization of conflicts rules.

But prior to a specific consideration of each of the aforementioned categories, it may be helpful to first compare the positive and negative interests of each of the professional *qua* gatekeeper and her corporate client. For the purpose of such a comparison, I will adopt a broad notion of “interest” for each of the parties in question.²⁸⁹ Thus, for the professional *qua* gatekeeper, the positive interest will be defined as matters that fall within the self-interest of such gatekeeper as a member of her chosen profession.²⁹⁰ The negative interest for such gatekeeper, therefore, will be the logical opposite – matters that fall *without* the self-interest of such gatekeeper as a member of her chosen profession.²⁹¹ Further to such descriptions, the positive interest of the corporate client will be defined as matters that fall within the self-interest of the corporate enterprise, broadly considered. In turn, the negative interest of the corporate client will also be the logical opposite – that is to say, those matters that fall *without* the self-interest of the corporate enterprise, again in the broadest sense.²⁹²

Here, the effort remains to provide both the reader and the author with a common language with which to engage in discussion.²⁹³ And while there may be other terms that would be seen as more attractive to the particular

ed. 1969) [hereinafter . FULLER, *THE MORALITY OF LAW*]; HART, *supra* note 180, at 80-81.

287. See generally David Luban, *Epistemology and Moral Education*, 33 J. LEGAL EDUC. 636, 650-54 (1983) (exploring the development of moral epistemology); Matthias Steup, *Epistemology*, STAN. ENCYCLOPEDIA PHIL. (DEC. 14, 2005), <http://plato.stanford.edu/entries/epistemology/>.

288. See ARISTOTLE, *supra* note 31, at 3-24.

289. See, e.g., MODEL RULES R. 1.7-1.13.

290. In this sense, the definition of the “positive interest” of the gatekeeper may be read to include the Brandeisian notion of the attorney acting in the public interest. See LOUIS D. BRANDEIS, *The Opportunity in the Law, in BUSINESS: A PROFESSION* 313, 321 (1914). However, such a reading cannot be read to the point that the gatekeeper disappears as an entity that is separate and distinct from the public. Accordingly, the positive interest as defined herein can be viewed in the Brandeisian sense of being the public interest as may be expressed by the professional *qua* gatekeeper.

291. To be sure, there are an infinite number of cases where the positive interest and negative interest may blend into one another. As a means, however, of developing the argument presented this distinction becomes necessary. Accordingly, the distinction between the positive interest and negative interest can be viewed as applying in the marginal sense.

292. See *supra* notes 290-91.

293. See BISHIN & STONE, *supra* note 158, at vii (noting that the study of law is an “effort of the human mind to make ‘reality’ comprehensible and manageable” through language and philosophy).

reader, I ask that such reader take this proffered terminology in light of its intended purpose.²⁹⁴ I will note, however, that in using the term “self interest” I do not mean to imply that such interests be considered in the narrow sense. By this definition I mean that when invoking such language I am not making a particular claim for a normative ethical position.²⁹⁵ Rather, I seek to use the term “self interest” in a more specific sense – that is, the specific sense to the professional as a member of her chosen profession.²⁹⁶ Accordingly, the self-interest in question is not solely a personal one. Indeed, when considered as such, the self-interest in question is the interest of the profession itself as may be *channeled* through the particular professional under consideration.²⁹⁷ This definition is a preferred approach to consider interests of the profession because this approach is how – one must imagine – professional ethics actually works.²⁹⁸ This is to say, while the first-order and second-order ethical rules provide guidance, in the final analysis the ethical decision remains an individual one.²⁹⁹ Thus, the ethical choice for the professional *qua* gatekeeper is to consider her ethical duties and responsibilities *as a member of her chosen profession*.

When considering the positive and negative interests of each of the professional *qua* gatekeeper and her corporate client as such, the following description emerges:

294. See *supra* note 27.

295. See WILLIAM K. FRANKENA, *ETHICS* 15 (2d ed. 1973) (“*Ethical egoism* holds that one is always to do what will promote his own greatest good – that an act or rule of action is right if and only if it promotes at least as great a balance of good over evil for him in the long run as any alternative would, and wrong if it does not.”).

296. See MODEL RULES OF PROF’L CONDUCT Preamble: A Lawyer’s Responsibilities ¶ 1 (2012) (“A lawyer, as a member of the legal profession, is a representative of clients, an officer of the legal system and a public citizen having special responsibility for the quality of justice.”).

297. Cf. Fuller, *Consideration and Form*, *supra* note 208, at 802 (“One who wishes to communicate his thoughts to others must force the raw material of meaning into defined and recognizable channels; he must reduce the fleeting entities of wordless thought to the patterns of conventional speech.”).

298. See Regan, *Professional Responsibility*, *supra* note 239, at 214 (“[T]he transformative character of corporate enterprise virtually guarantees that corporate lawyers perpetually will be facing dilemmas for which our existing professional responsibility framework provides imperfect guidance.”).

299. See *id.*

Figure 1: Comparison of Positive and Negative Interests

		<u>CORPORATION</u>	
		NEGATIVE INTEREST	POSITIVE INTEREST
<u>GATEKEEPER</u>	NEGATIVE INTEREST	Gatekeeper Negative / Corporation Negative	Gatekeeper Negative / Corporation Positive
	POSITIVE INTEREST	Gatekeeper Positive / Corporation Negative	Gatekeeper Positive / Corporation Positive

In every case, therefore, there will be four possible outcomes.³⁰⁰ There may be instances where the conflict rule in question can be seen as reading to the negative interest of the gatekeeper and the negative interest of the corporation. This “double negative” circumstance is illustrated in the upper left quadrant of the matrix.³⁰¹ Alternatively, the conflict rule may remain in the gatekeeper’s negative interest but may more properly be viewed as in the corporation’s positive interest. Here, then, is the upper right quadrant.³⁰² But, of course, the “mixed” interest circumstance can turn on its head, whereby the conflict rule reads to the gatekeeper’s positive interest and the corporation’s negative interest. This will be the lower left quadrant of the

300. *But see supra* note 291.

301. As a matter of optics, the “double negative” is written in shorthand as “Gatekeeper Negative / Corporation Negative.”

302. This “mixed” interest circumstance is noted as “Gatekeeper Negative / Corporation Positive.”

matrix.³⁰³ And, finally, there will be those instances where the conflict rule in question reads to the positive interest of both the gatekeeper and the corporation. This is the lower right quadrant.³⁰⁴

But this may all be seen as somewhat of an abstraction.³⁰⁵ Indeed, the close reader may say, although this structure is consistent in and of itself, it is merely that – a structure without substance. I will concede that, at least in its initial outlines, such criticism has some merit. Nevertheless, it is in bringing substance to such a form that we may more intensely consider the theoretical foundations of conflicts rules.³⁰⁶ And when applying the aforementioned categorization to such a substance, the following illustration comes into view:

Figure 2: Comparison of Categorized Conflicts Rules

		CORPORATION	
		NEGATIVE INTEREST	POSITIVE INTEREST
GATEKEEPER	NEGATIVE INTEREST	Activity Rules	Liability Rules
	POSITIVE INTEREST	Disclosure Rules	Ethical Rules

303. Accordingly, this “mixed” circumstance carries the label “Gatekeeper Positive / Corporation Negative.”

304. This final quadrant is described as “Gatekeeper Positive / Corporation Positive.”

305. See RONALD DWORKIN, LAW’S EMPIRE 93 (1986) (“[W]e might understand law better if we could find a similar abstract description of the point of law most legal theorists accept so that their arguments take place on the plateau it furnishes [J]urisprudence [does not] depend on finding an abstract description of that sort.”).

306. See Hines, *supra* note 1, at 42 n.46 (noting the importance of examining a theory in order to understand its problem-solving capabilities).

Activity rules occupy the upper left quadrant because they are, by definition, rules of limitation.³⁰⁷ Thus, the corporation cannot receive certain consulting services from its auditor, even though the auditor might provide the most desirable consulting services on such matters in the market.³⁰⁸ Such a rule will benefit neither party – the auditor will lose the business of such consulting services, and the corporation will not receive the services it seeks from its auditor.³⁰⁹ In turn, liability rules rests in the upper right quadrant in that the corporation would prefer to place the blame on the gatekeeper by *pointing the finger*.³¹⁰ Understandably, the gatekeeper would rather not have this finger pointed in her direction, and will therefore view such liability rules from a negative perspective. Disclosure rules sit in the lower left quadrant for similar reasons. The gatekeeper would likely prefer the corporation to clear the air by going public with, for instance, a press release that would correct any continuing fraud that may exist within the market.³¹¹ In contrast, the corporation will understandably be reluctant to make such disclosure because it will bring to light an otherwise hidden wrong.

But what then of the lower right hand quadrant? Here, I argue, is where ethical rules lie. For it is in the clear interest of the gatekeeper to maintain her status within the market as a professional, and in so doing she must uphold the stated ethical requirements of her chosen profession.³¹² Further, the corporation seeks the services of the gatekeeper *precisely because* she is a professional – she provides a specialized service that the corporation cannot obtain solely on its own.³¹³ Ethical rules are, in this sense, a *necessity* for both the gatekeeper and the corporation.³¹⁴ As a consequence, ethical rules occupy a primary position within the constellation of conflicts rules.³¹⁵ This is not to say, of course, that activity rules, liability rules, and disclosure rules have no relevance when assessing conflicts of interest rules within the ambit of corporate and securities law.³¹⁶ Quite the contrary – the rule maker, when

307. See *supra* Part II.A.

308. See 15 U.S.C. § 78j-1(g)(1)-(9) (2006).

309. See generally COFFEE, *supra* note 14, at 146-52 (examining changes within the auditing profession that increase conflicts with clients).

310. See *supra* Part II.B; *supra* note 81 and accompanying text.

311. See *supra* Part II.C; see generally *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

312. See MODEL RULES OF PROF'L CONDUCT Scope ¶ 19 (2012).

313. See Gilson, *supra* note 269, at 889.

314. See Regan, *Professional Responsibility*, *supra* note 239, at 214 (“Directives must have an aspirational, rather than merely descriptive, character. This unavoidably requires reflection upon the roles we believe lawyers should play and the normative commitments they should seek to realize.”).

315. See *supra* note 27.

316. See *supra* note 27.

considering possible alternatives in federal securities law, must consider such rules.³¹⁷ But it must first begin with the ethical rules. For without the ethical rules, the entire structure of gatekeeper enforcement in the various professions will collapse like so many houses of cards.³¹⁸ The primacy of ethical rules, therefore, obtains in the context of corporate and securities law where the gatekeeper is an actor.³¹⁹

2. The Corporate Gatekeeper in Ethical Perspective

If we may then agree that ethical rules occupy a primary position within the various categories of conflicts rules, what ethical rule should be under consideration in the present state of affairs in corporate and securities law?³²⁰ Here, I argue that an ethical perspective within the context of corporate and securities law is necessary.³²¹ More specifically, by providing additional legal rules that will build upon the notion of an ethical perspective as to the corporate gatekeeper, the landscape within corporate and securities law will, hopefully, improve for the better.³²² And in facilitating the process by which the gatekeeper *thinks, considers, and reflects* upon her actions, the intention is that better decisions will ultimately be made.

Although one can imagine a host of potential changes in law that will build upon this notion of the primacy of ethical rules of the corporate gatekeeper, at the present time perhaps further analysis of forthcoming proxy disclosures may provide additional information of interest.³²³ Here, I have in

317. *See supra* note 27.

318. *See generally* SORKIN, *supra* note 6.

319. Further to this notion of the primacy of ethical rules, the potential benefits of such an approach can be more specifically enunciated within the context of federal securities law enforcement. For instance, imagine that in the given case that the gatekeeper or her client engages in certain conduct that arguably may be in violation of an ethical rule, in either its first-order or second-order formulations. In such a case, the violation of such an ethical rule could have probative value in assessing whether the gatekeeper or her client engaged in conduct sufficient to satisfy the state of mind requirement in Section 10(b) actions. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (holding that allegations of intent to deceive, manipulate, or defraud are required for a private right of action in a Section 10(b) action). Accordingly, the violation of an ethical rule can provide additional information and context to the determination of a possible violation of a liability rule. In this sense, an incentive-based approach to ethical rules – and in particular the assessment of penalties for the violation thereof – can be seen as the interplay between ethical rules and liability rules. *See generally* POSNER, *supra* note 44, § 12.4.

320. *See* Regan, *Professional Responsibility*, *supra* note 239, at 204.

321. *See generally* Koniak, *supra* note 99, at 1278-80.

322. *See generally id.*

323. More specifically, such analysis would be of disclosure rules in the first instance, as such category has been defined for purposes of this article. *See supra* Part II.C.

mind the final rule on Compensation Committee independence standards as part of the Dodd-Frank reforms.³²⁴ If the effort is to facilitate an ethical perspective as to the corporate gatekeeper, then perhaps encouraging such an approach by means of the disclosure rules may be a helpful way to start.³²⁵ Accordingly, in reviewing the forthcoming proxy disclosure as mandated by the final rule, we may be able to achieve a better understanding as to how such issues are addressed by market actors.³²⁶

On this point, one can imagine that careful consideration of conflicts already takes within the practice of law. For instance, imagine a partners' meeting at a leading law firm in the United States.³²⁷ Assume, for the moment, that a potential engagement raises a conflict of interest. At some point, the discussion may turn to the questions – *do we really want to take on this representation? Is this who we are? How will this affect our reputation?* And if such discussion already takes place within the practice of law,³²⁸

324. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 124 Stat. 1376 (2010) (codified as amended at 12 U.S.C. §§ 5301-5641).

325. See BRANDEIS, OTHER PEOPLE'S MONEY, *supra* note 118, at 92 (“Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.”). *But see* Daylian M. Cain, George Loewenstein & Don A. Moore, *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest*, 34 J. LEGAL STUD. 1, 22 (2005).

326. See generally Dodd-Frank Act § 952. In considering additional ethical rules along such lines, the action – that is, the manifested behavior – of the professional *qua* gatekeeper could be constructed in such fashion as to constitute a formality of sorts. See Fuller, *Consideration and Form*, *supra* note 208, at 805 (“Forms must be reserved for relatively important transactions. We must preserve a proportion between means and end; it will scarcely do to require a sealed and witnessed document for the effective sale of a loaf of bread.”). Although the focus of the discussion will likely then turn to the nature and quality of the formality in question, the specifics of any such formality will undoubtedly be subject to the political process. See POSNER, *supra* note 44, § 19.3. Nevertheless, one senses that – as a matter of legal theory – the key move in the extended discussion of doctrine will have been made. The question, therefore, will become one of competing formalities. See, e.g., Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 302, 116 Stat. 745 (2002) (codified as amended at 15 U.S.C. §§ 7201-66) (chief executive officer and chief financial officer certification of financial statements of reporting companies).

327. See, e.g., RHODE & HAZARD, *supra* note 186, at 32-35.

328. Within the practice of law, this brief hypothetical will admittedly be much more complex. For instance, one imagines that the respective ethical concerns for actors within the law firm will be quite different. Senior Partner W with equity in the firm will stand in a different position from Junior Partner X, who may have little or no equity at all. Further, Senior Associate Y may have a different perspective than Junior Associate Z. However, one supposes that both will stand in a different position from legal assistants and staff who are not subject to rules of professional ethics in connection with state bar licensure requirements. Moreover, the respective risk to reputation as opposed to opportunity of an optimum of professional performance –

should not the applicable federal regulations further reflect the concerns that are raised by ethical rules?³²⁹ The potential benefits of such revisions can be seen as four-fold: (i) the relevant profession will more proactively address matters of conflicts of interest through individual cases;³³⁰ (ii) the professional *qua* gatekeeper will be reminded of the importance of preserving her reputational capital;³³¹ (iii) a potential collective action problem will be addressed in that an ethical perspective as to the corporate gatekeeper will be universally applied to the gatekeepers in question;³³² and (iv) the normative ends of justice, such as they are, may be more fully achieved by focusing the attention of both the professional *qua* gatekeeper and her corporate client.³³³

In taking such steps to facilitate introspection by the professional *qua* gatekeeper, we may then achieve some measure of consideration of ethical rules in the difficult case.³³⁴ While it is far from clear that this will in fact occur, at the least the law will have provided an additional method by which

that is to say, a “happy” client – will necessarily be different for attorneys within the law firm, given their level of involvement in the relevant case or transaction. Thus, an attorney with no part in an engagement that subsequently ruins the reputation of the firm in five minutes will in this sense lose the reputation of the firm that she may have helped build over twenty years. Here, recall the accounting fraud scandals – Enron, Worldcom and the rest – as well as the most notable instances from the financial crisis – Lehman Brothers, Bear Stearns, etc. See Hines, *supra* note 1, at 34-38. In the case of the large firm, therefore, this asymmetry of reputational effects will be an important issue to consider as a matter of firm governance and, more broadly, by the professions as a matter of their self-regulation. My thanks to Professor Hazard in providing me with these insightful thoughts.

329. By definition, such an ethical rule would constitute a second-order ethical rule. See *supra* Part II.D.2. Further, such a second-order ethical rule can be viewed as the means by which ethical decision, such as it is, may be channeled by the professional *qua* gatekeeper. See, e.g., Fuller, *Consideration and Form*, *supra* note 208, at 802.

330. See, e.g., EMILE DURKHEIM, *PROFESSIONAL ETHICS AND CIVIL MORALS* 13 (Cornelia Brookfield trans., Greenwood Press 1983) (1950) (“A system of ethics, however, is not to be improvised. It is the task of the very group to which they are to apply.”); GEOFFREY C. HAZARD, JR., *ETHICS IN THE PRACTICE OF LAW* 67 (1978) (“[A]cting as lawyer for the situation can be thought of as similar to a doctor’s ‘authority’ to terminate the life of a hopeless patient: It can be properly undertaken only if it will not be questioned afterwards.”).

331. See *supra* notes 267-78 and accompanying text.

332. See, e.g., Steven Kuhn, *Prisoner’s Dilemma*, STAN. ENCYCLOPEDIA PHIL. (Oct. 22, 2007), <http://plato.stanford.edu/entries/prisoner-dilemma/>. Here, the issue of reputational asymmetry remains an important issue for consideration. See *supra* note 328.

333. See, e.g., Calabresi & Melamed, *supra* note 36, at 1102-05.

334. In this sense, the law may then approach the Fullerian notion of an inner morality in cases where the professional *qua* gatekeeper undertakes such a meditation on her professional responsibilities. See FULLER, *THE MORALITY OF LAW*, *supra* note 286, at 41-44; Luban, *supra* note 207, at 807.

such consideration may take place – *from an ethical perspective*.³³⁵ And the specific manner in which such consideration takes place will be in the assessment by the professional *qua* gatekeeper of her reputation – that fleeting thing that takes twenty years to build and five minutes to ruin.³³⁶

IV. CONCLUSION

The classification of conflicts of interest remains one of the enduring challenges in both corporate law and legal ethics in that it raises fundamental questions as to the proper role of the professional *qua* gatekeeper.³³⁷ And while such a classification can never truly be complete,³³⁸ an attempt to consider the ethical implications of such conflicts does, in a certain sense, engage with both the burdens and responsibilities of professional practice.³³⁹ As the Model Rules note in their Preamble on a Lawyer's Responsibilities:

In the nature of law practice, however, conflicting responsibilities are encountered. Virtually all difficult ethical problems arise from conflict between a lawyer's responsibilities to clients, to the legal system and to the lawyer's own interest in remaining an ethical person while earning a satisfactory living. The Rules of Professional Conduct often prescribe terms for resolving such conflicts. Within the framework of these Rules, however, many difficult issues of professional discretion can arise. Such issues must be resolved through the exercise of sensitive professional and moral judgment guided by the basic principles underlying the Rules. These principles include the lawyer's obligation zealously to protect and pursue a client's legitimate interests, within the bounds of the law, while maintaining a professional, courteous and civil attitude toward all persons involved in the legal system.³⁴⁰

The foregoing discussion of the primacy of ethical rules of the corporate gatekeeper hopefully furthers the discussion on the professional, ethical, and moral dilemmas that may be encountered by the professional in practice.³⁴¹ Moreover, in this Article's review of the recent changes to proxy disclosures

335. See MODEL CODE OF PROF'L RESPONSIBILITY Preliminary Statement (1981).

336. See Editorial, *supra* note 2.

337. See COFFEE, *supra* note 14, at 365 ("In principle, the professions should be uniquely sensitive to the dangers surrounding conflicts of interest. Still, the 1990s revealed little, if any, evidence of self-restraint.").

338. See Kennedy, *supra* note 33, at 210.

339. See Fried, *supra* note 172, at 1061.

340. MODEL RULES OF PROF'L CONDUCT Preamble: A Lawyer's Responsibilities ¶ 9 (2012).

341. See Wasserstrom, *supra* note 166, at 1-2 n.1.

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rules³⁴² – that is, ethical rules of the second-order – the corporate gatekeeper may be reconsidered from the perspective of those rules prescribed by the professions themselves – that is to say, ethical rules of the first-order.

342. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 124 Stat. 1376 (2010) (codified as amended at 12 U.S.C. §§ 5301-5641).