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## SARBANES-OXLEY 307: TRUSTED COUNSELORS OR INFORMERS?

M. PETER MOSER\* &amp; STANLEY KELLER\*\*

IN this paper we review Section 307 of the Sarbanes-Oxley Act of 2002 (the "Act")<sup>1</sup> and rules the Securities and Exchange Commission (SEC or the "Commission") has adopted or proposed to govern the professional conduct of lawyers who appear and practice before the Commission. The up-the-ladder reporting and permissive reporting-out provisions in the Final Rules adopted by the SEC are seen as having a beneficial impact, in part because they are generally consistent with prevailing state ethics standards. Our main thesis is, however, that those proposed rules still under consideration, which would mandate lawyers to withdraw from representing issuers followed by either the lawyer or the company reporting outside the company, should not be adopted, at least for now. Those rules threaten to change the role of lawyers who advise public companies on securities matters from trusted counselors to informers. Inevitably, public companies would be impeded from obtaining legal advice when it is most needed. Lawyers' ability to promote client legal compliance also would be jeopardized. Most significantly, the rules tend to shift corporate decision-making from the directors, who are charged with corporate governance responsibility, to the company's lawyers.<sup>2</sup>

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1. Pub. L. No. 107-204, 116 Stat. 745 (2002).

2. See Letter from Alfred P. Carlton, Jr., President, American Bar Association, to the Securities and Exchange Commission (Dec. 18, 2002), available at <http://www.sec.gov/rules/proposed/s74502/apcarlton1.htm> [hereinafter ABA Letter of Dec. 18, 2002] (commenting on originally proposed Part 205 Rules and, among other suggestions, urging that mandatory noisy withdrawal provisions not be adopted or, alternatively, be accorded extended comment period); see also Letter from Alfred P. Carlton, Jr., President, American Bar Association, to the Securities and Exchange Commission (Apr. 2, 2003), available at <http://www.sec.gov/rules/proposed/s74502/aba040203.htm> [hereinafter ABA Letter of Apr. 2, 2003] (urging against adopting mandatory withdrawal proposals requiring either noisy withdrawal by lawyer or company reporting lawyer's withdrawal because changes already adopted should prove effective so that adverse consequences of mandatory withdrawal and reporting out are unwarranted).

In Part I we summarize the purposes and major provisions of Section 307 of the Act. We demonstrate in Part II how the SEC's Final Rules, in force since August 2003, should, with clarifications, prove acceptable and effective in achieving the purposes of the Act. In contrast, in Parts III and IV we describe why we believe that the mandatory withdrawal and reporting-out rules the SEC is still considering would be more likely to harm than protect companies and their investors from management fraud, and hence undercut the purposes of the Act. In Part V we discuss several challenges to the Commission's authority under Section 307 to adopt regulations that would override state rules prohibiting disclosure of client confidences. Finally, in Part VI we propose an appropriate regulatory response regarding the mandatory withdrawal and reporting-out proposals.

### I. ENACTMENT OF SARBANES-OXLEY SECTION 307

As is well known, early in 2002, public attention focused on the enormous losses that investors, employees and pensioners were experiencing as a consequence of widespread accounting irregularities and flagrant management misconduct involving numerous public companies. One of the questions persistently asked has been why the lawyers who represented these companies and handled their transactions did not question management's conduct and the propriety of the transactions that have garnered notoriety.<sup>3</sup> Following revelation of these accounting irregularities and instances of mismanagement, a practically unanimous Congress adopted the

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3. See Allison Frankel, *No Confidence*, AM. LAW., Dec. 2002, at 78, 102 (questioning whether allegedly fraudulent deals would not have happened if Enron's outside counsel had asked more questions about deals they documented); see also *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 598-611 (S.D. Tex. 2002) (discussing duty of attorneys to disclose nonmisleading information to nonclients and third parties, and concluding that attorneys have established duty to third parties not to make material misrepresentations on which attorney knows or has reason to expect that third parties will rely); *In re Global Crossing Ltd.*, 295 B.R. 726, 739 (Bankr. S.D.N.Y. 2003) (noting that Global Crossing consulted with its legal counsel prior to entering into amendment of its Purchase Agreement); SEC v. HealthSouth Corp., Litig. Release No. 18044 (Mar. 20, 2003), available at <http://www.sec.gov/litigation/litreleases/lr18044.htm> (declaring that HealthSouth overstated its earnings to meet Wall Street's earning expectations); SEC v. WorldCom Inc., Litig. Release No. 17866 (Nov. 26, 2002), available at <http://www.sec.gov/litigation/litreleases/lr17866.htm> (announcing permanent injunction entered against WorldCom and noting investigation into adequacy of WorldCom's code of ethics and business conduct and WorldCom's safeguards to prevent violations of federal securities laws); Floyd Norris, *In U.S. Eyes, a Notably Bold Case of Health Care Fraud*, N.Y. TIMES, Mar. 20, 2003, at C4 (noting that lawyer for Richard Scrushy, HealthSouth officer alleged to have directed accounting fraud, was "shocked and surprised" by allegation). See generally Final Report of Neal Batson, *In re Enron Corp.*, No. 03 Civ. 1727 (LTS), 2003 U.S. Dist. LEXIS 19543 (Bankr. S.D.N.Y. Nov. 4, 2003) [hereinafter Batson Report] (discussing, in detail in Appendix C to Final Report, role of Enron's attorneys in certain of Enron's SPE transactions and in Enron's disclosures concerning these transactions); Indep. Exam'r Report, SEC v. Spiegel, Inc., No. 03C-1685, 2003 U.S. Dist. LEXIS 17933 (N.D. Ill. Sept. 5, 2003).

Sarbanes-Oxley Act in July 2002 “to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws,” and thus restore public confidence in the financial markets.<sup>4</sup>

Although most of the Act focuses on improving the integrity and timeliness of financial reporting, Section 307 directs the Commission to issue rules “in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission.”<sup>5</sup> Section 307 specifies that these rules shall include a requirement that an attorney for a public company must report evidence of a “material violation of securities law or breach of fiduciary duty or similar violation” up the ladder within the corporation and, if necessary, to the board, the audit committee or another committee composed of “independent” directors.<sup>6</sup> Section 307 was Congress’s response to the question: “Where were the lawyers?”

## II. ADOPTION OF PART 205 “UP-THE-LADDER” RULES

As directed by Section 307, the SEC adopted the Part 205 Rules, effective August 5, 2003, to provide for up-the-ladder reporting.<sup>7</sup> The Final Rules also included provisions for permissive disclosure of client confidences by attorneys in certain circumstances.<sup>8</sup>

In general, the up-the-ladder reporting rules provide that when a lawyer who is “appearing and practicing before the Commission” on behalf of

4. Sarbanes-Oxley Act of 2002 pmbl.

5. *Id.* § 307.

6. *Id.* The full text of Section 307 states:

Not later than 180 days after the date of enactment of this Act, the Commission shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule—

(1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and

(2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

*Id.*

7. See Implementation of Standards of Professional Conduct for Attorneys, Release No. 33-8185, 68 Fed. Reg. 6296, 6296 (Feb. 6, 2003), available at <http://www.sec.gov/rules/final/33-3185.htm> (noting that Section 307 requires SEC to prescribe minimum standards of professional conduct for attorneys appearing and practicing before Commission in any way in representation of issuers); see also 17 C.F.R. § 205.3(b), (c) (2004) (stating rules for up-the-ladder reporting).

8. See 17 C.F.R. § 205.3(d) (stating rules of disclosure).

an issuer “becomes aware” of credible evidence of a “material violation,” the lawyer ordinarily must:

(1) report the evidence to the issuer’s chief legal officer (CLO) or the issuer’s CLO and chief executive officer (CEO); and

(2) if the lawyer does not reasonably believe that the CLO or the CEO has provided an appropriate response within a reasonable period of time, then report the evidence to the audit committee or, if there is none, to a board committee of independent directors or, if there is no applicable committee, to the issuer’s board of directors.<sup>9</sup>

The SEC permissive disclosure rules, much like ABA Model Rules of Professional Conduct 1.6(b)(2) and (3),<sup>10</sup> allow an attorney representing a public company to:

[R]eveal to the Commission . . . confidential information related to the representation to the extent the attorney reasonably believes necessary:

- (i) To prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors; . . . or
- (iii) To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney’s services were used.<sup>11</sup>

Observers have suggested that information which might have prevented some of the recent corporate failures was not reported to the companies’ boards or even to the CEOs. Mandating lawyers to report up the ladder to boards of directors when necessary helps ensure that boards do receive and can act on evidence of material violations of which the company’s lawyers have become aware.

Others have criticized the SEC’s up-the-ladder reporting rules because they attempt to force public company lawyers to become “information intermediaries” with the false notion that “mandated disclosure will qualitatively increase information flow to corporate boards and to securi-

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9. See *id.* § 205.3(b), (c) (setting forth process for attorney to report material violations by issuer or by any officer, director, employee or agent of issuer). Under the rules, if the lawyer believes reporting to the CLO and CEO would be futile (if, for example, those officers are implicated in the violation), the lawyer may report directly to the committee or board of directors. See *id.* § 205.3(b)(4) (stating disclosure rules for instances in which reporting to CLO and CEO are futile). Also, if the issuer has a “qualified legal compliance committee,” the lawyer may report directly to that committee. See *id.* § 205.3(c) (explaining what lawyer should do when issuer had qualified legal compliance committee).

10. MODEL RULES OF PROF’L CONDUCT R. 1.6 (2004), available at [http://www.abanet.org/cpr/mrpc/mrpc\\_toc.html](http://www.abanet.org/cpr/mrpc/mrpc_toc.html) (last visited Mar. 30, 2004). For a further discussion of the exceptions to confidentiality provided in Rule 1.6(b), added to the Model Rules in August 2003, see *infra* note 27 and accompanying text.

11. 17 C.F.R. § 205.3(d)(2).

ties markets.”<sup>12</sup> A better approach, they say, would be to provide incentives to board members and managers to seek additional guidance, information and advice from their advisers, including lawyers.<sup>13</sup>

Those who criticize the SEC’s up-the-ladder rules also are concerned that the rules will cause company employees to limit the information their lawyers should have in order to counsel the company properly. This might occur because public company lawyers must report material violations up the ladder even in matters totally removed from their representation of the client. Thus, lawyers could be deprived of information they need to properly advise the client.

Despite these criticisms and continuing concern over their breadth, interpretive uncertainty and highly rigid structure, the up-the-ladder rules have found general acceptance among lawyers and their company clients. This is because the rules do not depart significantly from prevailing state ethics standards and are recognized as having accomplished some clear benefits.<sup>14</sup>

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12. Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons?*, 48 VILL. L. REV. 1097, 1101, 1112-13 (2003) (noting value of reporting up). Fisch and Rosen make the point that directors at Enron had information regarding many of the transactions. *See id.* at 1116-23 (describing ties of Enron directors). According to Fisch and Rosen, not only did the directors not question the transactions’ legitimacy, they in fact approved the transactions, including waivers of the company’s ethics code when necessary to permit its CFO to participate in at least one of the special purpose entities. *See id.* at 1119 n.85 (addressing multiple waivers of Enron’s code of conduct).

13. *See id.* at 1097-98, 1131-33 (stating demand side approach to reform). Fisch and Rosen argue that Section 307 of the Act would have had little impact on the conduct of the lawyers most closely advising the Enron board because the directors already knew the risks involved in many transactions the board approved; no one had shown, moreover, that the lawyers were aware of evidence that company principals were engaged in fraudulent conduct; and in any subsequent similar situation, lawyers likely will lack credible evidence of a material violation that corporate officials refuse to remedy, or the lawyers will be complicit in the fraud. *See id.* at 1114-17 (noting applicability of Section 307 to Enron). The authors argue that in either case the lawyers will have nothing to report, and in the latter case, i.e., if the lawyers are complicit in the fraud, the lawyers can be sanctioned by the SEC and subjected to civil and, possibly, criminal liability, “rendering the additional threat posed by Section 307 inconsequential.” *Id.* at 1117 (noting potential ineffectiveness of reporting-up provisions); *see also* Batson Report, *supra* note 3.

14. The up-the-ladder reporting standards are only slightly broader than ABA Model Rule 1.13 provisions and, although somewhat ambiguous and rigid, are less intrusive on the client-lawyer relationship than the rules the SEC originally proposed in November 2002. In its April 2, 2003 Comment Letter to the Commission, the ABA noted the clarifications necessary for the Final Rules to operate effectively. *See* ABA Letter of Apr. 2, 2003, *supra* note 2, at 10-12. For example, the duty to report evidence of a material violation up the ladder ought to be based on “information relating to the representation” of the company as it is in ABA Model Rule 1.13.

## III. PROPOSED MANDATORY WITHDRAWAL RULES

As noted above, the SEC has addressed reporting out by permitting lawyers to report evidence of serious client crimes to the SEC, notwithstanding any inconsistent state rules. This permissive reporting rule resembles exceptions in the ABA Model Rules and lawyer conduct rules that apply in all but eight states. Nevertheless, the Commission continues to consider additional rules that would increase the obligations of lawyers far beyond reporting up the ladder and permissive reporting outside of the company. The rules currently being considered might force lawyers to inform against their own clients.

Since their proposal last November, the Commission continues to consider rules that would require a lawyer, if (1) after reporting evidence of a material violation up the ladder the lawyer fails to receive an "appropriate response" within a reasonable time, and (2) the lawyer reasonably believes that a material violation is ongoing or about to occur and is likely to result in substantial injury to the financial interest of the company or investors, to withdraw forthwith from representing the issuer based on "professional considerations," so notify the company and, within one business day, also notify the Commission and promptly disaffirm to the Commission any materially false or misleading document or representation.<sup>15</sup>

Most of those commenting on the November 2002 proposal described serious problems with the so-called "noisy withdrawal."<sup>16</sup> In response, the Commission proposed for consideration, along with noisy withdrawal, an

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15. See 17 C.F.R. § 205.3(d)(1) (defining standards of conduct); Implementation of Standards of Professional Conduct for Attorneys, Release No. 33-8185, 68 Fed. Reg. 6296, 6296 (Feb. 6, 2003) (explaining that in-house employed lawyers would be excused from mandatory withdrawal but must cease working on particular matter).

16. See generally SEC, *Comments on Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys*, at <http://www.sec.gov/rules/proposed/s74502.shtml> (last visited Mar. 30, 2004) (providing comment letters on all proposed and final Part 205 Rules). Nearly all object to the noisy withdrawal proposal. For example, the letter signed by former SEC Commissioner Edward H. Fleischman on behalf of himself and other prominent securities lawyers objects to mandatory noisy withdrawal as "substituting the lawyer's legal judgment (on, for example, materiality) for that of the client's chief internal reviewing officer or organ and equally substituting the lawyer's business judgment . . . for that of the client's audit committee or its board of directors." Letter from Edward Fleischman, former SEC Commissioner, to the Securities and Exchange Commission (Nov. 25, 2002), available at <http://www.sec.gov/rules/proposed/s74502/ehfleischman1.htm>. The letter argues against impairment of "public company lawyers' willingness to render independent legal advice on [matters of compliance and disclosure on novel issues that may disagree with SEC views] and to afford independent legal advice in those matters and to afford independent legal representation in those contexts." *Id.* Among those supporting the concept of noisy withdrawal were forty law professors, most of whom in March 2002 joined in a letter urging the SEC to mandate up-the-ladder reporting within the company. See, e.g., Letter from Susan Koniak et al., to the Securities and Exchange Commission (Dec. 17, 2002), available at <http://www.sec.gov/rules/proposed/s74502/skoniak1.htm> (stating reasons for advocating noisy withdrawal).

alternative that would require the lawyer to withdraw in circumstances similar to those just described. Under the alternative, the company (rather than the reporting lawyer) would have to publicly report the lawyer's withdrawal from representing the company for "professional considerations."<sup>17</sup>

This alternative would not, however, eliminate the fundamental policy concerns regarding harm to the client-lawyer relationship and interference with effective corporate governance. Mandating lawyer withdrawal would still deny lawyers the flexibility they need to counsel clients effectively on compliance with complex securities laws. It would, for example, encourage lawyers to withdraw prematurely, rather than continue to counsel legal compliance regarding difficult issues, when companies most need

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17. See Implementation of Standards of Professional Conduct for Attorneys, Release No. 33-8186 (Jan. 29, 2003), available at <http://sec.gov/rules/proposed/33-8186.htm> [hereinafter January 2003 Proposed Rules] ("Requiring issuers to report attorney withdrawals in a public filing with the Commission may also provide protection to investors by alerting them to the possibility of ongoing material violations by issuers."). The Commission also extended until April 7, 2003, the time for commenting on the mandatory noisy withdrawal provisions. See *id.* at 6-10. Proposed alternative § 205.3(d)(1) sets forth the lawyer's reporting-out requirement:

- (d) Actions required where there is no appropriate response within a reasonable time.
  - (1) Where an attorney who has reported evidence of a material violation under paragraph (b) of this section rather than paragraph (c) of this section (i) does not receive an appropriate response, or has not received an appropriate response in a reasonable time, and (ii) has followed the procedures set forth in paragraph (b)(3) of this section, and (iii) reasonably concludes that there is substantial evidence of a material violation that is ongoing or about to occur and is likely to cause substantial injury to the financial interest or property of the issuer or of investors:
    - (A) An attorney retained by the issuer shall withdraw from representing the issuer, and shall notify the issuer, in writing, that the withdrawal is based on professional considerations.
    - (B) An attorney employed by the issuer shall cease forthwith any participation or assistance in any matter concerning the violation and shall notify the issuer, in writing, that he or she believes that the issuer has not provided an appropriate response in a reasonable time to his or her report of evidence of a material violation under paragraph (b) of this section.

Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6324, 6328 (proposed Feb. 6, 2003) (to be codified at 17 C.F.R. pt. 205) (explaining duties of attorneys when company does not respond to evidence of violation). Proposed Section 205.3(e) provides the company's reporting-out requirement:

- (e) Duties of an issuer where an attorney has given notice pursuant to paragraph (d).
  - (1) Where an attorney has provided an issuer with a written notice pursuant to paragraph (d)(1), (d)(2), or (d)(3) of this section, the issuer shall, within two business days of receipt of such written notice, report such notice and the circumstances related thereto on Form 8-K, 20-F, or 40-F, as applicable.

*Id.* at 6329 (requiring company to file with Commissioner when attorney has withdrawn).



the lawyer's advice. If the lawyer withdraws prematurely, the damage to the company and its stockholders could have serious adverse consequences.<sup>18</sup> Even worse, because of the serious consequences that would flow from identifying a possible material violation, a mandatory withdrawal requirement might prompt some lawyers to avoid asking the hard questions that enable them to counsel legal compliance.

Requiring that the lawyer withdraw followed by immediate mandatory reporting by the company could, in addition, severely damage companies and their investors through public disclosure of a withdrawal that might have been unwarranted. The company's board might feel forced to disclose damaging information, despite justifiably believing that no material violation has occurred, solely to avoid the lawyer's withdrawal, a public report of the lawyer's withdrawal and the consequences of these events, i.e., a full-scale SEC investigation and a private class action lawsuit. Many feel that creating such a situation is not in the public interest.

While an SEC mandatory noisy withdrawal requirement might make a difference in the rare situation in which it would be invoked, the mere existence of such a requirement going beyond traditional lawyer obligations would likely make clients reluctant to confide in their lawyers, and it may cause lawyers to avoid asking hard questions or to withdraw prematurely. For these and other reasons, it seems clear to many that either of the SEC's pending proposals would be more likely to harm than protect companies and their investors.<sup>19</sup>

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18. See, e.g., Letter from Thomas Morgan, Professor, George Washington University Law School, to the Securities and Exchange Commission (Dec. 17, 2002), available at <http://www.sec.gov/rules/proposed/s74502/tdmorgan1.htm> (opining that attorney disclosure to client company or CLO does not violate attorney-client privilege, while reporting outside corporation may result in injury to corporation and shareholders); ABA Letter of Apr. 2, 2003, *supra* note 2, at 4-8 (citing negative effects of withdrawal as including destroying client trust in attorneys, clients avoiding consultation with attorneys, premature withdrawal of attorneys and risk of destruction of market value of company's securities). Premature withdrawal risks suit by the company against the attorney for allegedly withdrawing in breach of the attorney's duty of loyalty to the client. To be sure, Section 205.6(c) purports to exonerate an attorney from disciplinary or other liability under inconsistent state standards when the attorney complies in good faith with the Part 205 Rules. See Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6296-6301, 6323 (proposed Feb. 6, 2003) (to be codified in 17 C.F.R. pt. 205) (establishing sanctions and discipline for attorneys). Section 205.1 also provides that where state standards conflict with the Commission's rules, the latter shall govern, but that a jurisdiction may impose additional obligations that are not inconsistent with the Commission's standards. See *id.* at 6319 (establishing minimum standards for attorney conduct, but allowing states to supplement, not override such standards). Nevertheless, in the absence of a definitive judicial determination, the effectiveness of the Commission's attempt to preempt state standards is uncertain. See ABA Letter of Dec. 18, 2002, *supra* note 2, at 31-34 (discussing legal challenges to this issue). For a further discussion of the legal challenges to this issue, see *infra* Part V.

19. In this respect, the pending standards for lawyer conduct would not be "in the public interest and for the protection of investors," as Section 307 requires. See

## IV. DEVIATIONS FROM TRADITIONAL LAWYER DISCLOSURE OBLIGATIONS

Manifestly, an SEC mandated noisy withdrawal rule would deviate from traditional lawyer obligations and set up direct conflicts of interest with the lawyer's primary duty of loyalty to the company client. Mandatory noisy withdrawal also would establish a federal legal standard in sharp conflict with rules of professional conduct applicable in virtually every state, thus creating serious dilemmas for lawyers regarding which standards to follow.<sup>20</sup> No state rule requires, as would the Commission's proposal, that a lawyer withdraw from representing the client merely because (1) an "appropriate response"<sup>21</sup> to reported evidence of a material violation of securities laws is not received within a reasonable time and (2) there is merely a "likelihood" (as opposed to reasonable certainty or clear proof) that financial injury to others will occur, and without such violation bearing any relationship to the representation or the lawyer's rendering of services.

When representing a client as an adviser, the lawyer's main function is to provide the client with an informed understanding of the client's

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Sarbanes Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 768 (2002) (defining standards for attorneys appearing before Commission).

20. Even where reporting to prevent a crime is mandatory, the clearest evidence is required. *See, e.g.,* VA. RULES OF PROF'L CONDUCT R. 1.6(c)(1) cmt. 13 (2004), *available at* <http://www.vsb.org/profguides/rules.pdf> (requiring mandatory reporting when client states intention to commit crime); *see also* MODEL RULES OF PROF'L CONDUCT R. 1.6(b)(2)-(3) (2004) (stating that lawyer may disclose confidential information to "prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services," or to prevent, mitigate or rectify such substantial injury); REPORT OF ABA TASK FORCE ON CORPORATE RESPONSIBILITY 48-50, 50 n.89 (Mar. 31, 2003), *available at* <http://www.acca.com/public/policy/corpresp/aba.pdf> [hereinafter ABA CORPORATE RESPONSIBILITY REPORT] (describing state disclosure rules).

21. Some of the quoted terms are defined or explained in the Part 205 Rules, *supra* note 6. For example, Proposed Rule 205.2(b) provides that an "appropriate response" is a response, as a result of which, the attorney reasonably believes (i) no material violation has occurred, is ongoing or is about to occur; or (ii) the company has adopted appropriate remedial measures to stop or prevent any material violation or minimize the likelihood of recurrence; or (iii) the company, with board approval, directed an attorney to review the evidence, has substantially implemented remedial recommendations made by the attorney after investigation or has been advised by the attorney that a colorable defense may be asserted in any investigation or proceeding. *See* Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6296 (proposed Feb. 6, 2003) (to be codified in 17 C.F.R. pt. 205) (calling for consideration of attorney's evaluation, issuer's response and material evidence). "Reasonable or reasonably" means conduct that would not be unreasonable for a prudent and competent attorney. *See id.* (defining term). "Reasonably believes" means that an attorney believes the matter in question and that the circumstances are such that the belief is not unreasonable. *See id.* (same).

legal rights and obligations and to explain their practical implications.<sup>22</sup> Therefore, reporting within the company up the ladder to the board of directors, if necessary, is appropriate to fulfill the lawyer's obligation to protect the corporation because the board has the ultimate responsibility to take appropriate action on behalf of the company.<sup>23</sup> Once the lawyer makes a recommendation to the company's board, however, those officials—and not the lawyer—should make the ultimate decisions.<sup>24</sup>

Of course, when a lawyer knows the lawyer's services are being or will be used to assist the client in a crime or fraud, the lawyer must terminate assistance and, if necessary, withdraw from representing the client.<sup>25</sup> When it becomes clear, for example, that a client is using its lawyer's services to make loans from banks based upon the security of fake equipment leases, the lawyer who continues to assist at closings not only would violate

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22. See MODEL RULES OF PROF'L CONDUCT pmb. ¶ 2 (2004) (stating that as adviser "a lawyer provides a client with an informed understanding of the client's legal rights and obligations and explains their practical implications"); see also ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 375 (1993) (stating that lawyer assisting client in regulatory matter must not lie to or mislead agency or assist client's fraud, but has no duty to reveal confidential information protected under Rule 1.6 and does not assume client's legal disclosure obligations at least so long as agency continues to have access to client and its employees); ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 346 (1982) (explaining that in providing tax shelter opinion, lawyer, *inter alia*, must not accept as true any facts lawyer reasonably should know further inquiry would prove untrue, but has no duty to "audit" client's affairs); RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 95 cmt. c (2000) (noting that lawyer undertaking evaluation at request of client for benefit of third person owes that person duty to be fair and objective, but absent express undertaking does not guarantee accuracy of facts stated).

23. See generally ABA CORPORATE RESPONSIBILITY REPORT, *supra* note 20 (explaining obligations of lawyers). An enhanced role for lawyers is advocated in order to diminish the occurrence of material violations of law. See *id.* at 34-61 (advocating methods to facilitate more communication between lawyers and corporations). This report also establishes nine general practices for improving corporate responsibility. See *id.* at 62-73 (suggesting means to improve effectiveness of boards of directors). Measures recommended by the Corporate Responsibility Task Force and adopted by the ABA's House of Delegates in August 2003 (House Reports 119A, 119B and 119C) effectively balance the need of corporate managers to exchange information with their lawyers and to receive and act upon lawyers' advice with the responsibility of lawyers to help achieve legal compliance, including permission to report outside the corporation in certain circumstances when all other measures fail. See *id.* (same).

24. To illustrate, suppose that the independent directors, after being informed of the anticipated loss of a major customer and counsel's view that this circumstance needs to be disclosed in an impending SEC filing, determine to withhold that disclosure based on the prospects for retaining or replacing that customer and the irreparable harm that would be caused the company if the disclosure were made out of context. The lawyer should not be put in the position of substituting the lawyer's judgment for that of the directors in this situation.

25. See MODEL RULES OF PROF'L CONDUCT R. 1.16(a) (2004) (stating that "a lawyer shall not represent a client or, where representation has commenced, shall withdraw from the representation of a client if: (1) the representation will result in violation of the rules of professional conduct or other law").

ethical obligations,<sup>26</sup> but would engage in illegal and possibly criminal conduct.

Under traditional standards, such as ABA Model Rule 1.6(b)<sup>27</sup> and the ALI's Restatement of the Law Governing Lawyers Section 67,<sup>28</sup> when a

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26. *See id.* (stating that “[a] lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent”).

27. *See id.* (stating exceptions to client confidentiality). Specifically, these exceptions are as follows:

- (b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:
  - (1) to prevent reasonably certain death or substantial bodily harm;
  - (2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;
  - (3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;
  - (4) to secure legal advice about the lawyer's compliance with these Rules;
  - (5) to establish a claim or defense on behalf of the lawyer in a controversy between the lawyer and the client, to establish a defense to a criminal charge or civil claim against the lawyer based upon conduct in which the client was involved, or to respond to allegations in any proceeding concerning the lawyer's representation of the client; or
  - (6) to comply with other law or a court order.

*Id.*

28. RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 67 (2000). Section 67 provides:

- § 67. Using or Disclosing Information to Prevent, Rectify, or Mitigate Substantial Financial Loss.
- (1) A lawyer may use or disclose confidential client information when the lawyer reasonably believes that its use or disclosure is necessary to prevent a crime or fraud, and:
    - (a) the crime or fraud threatens substantial financial loss;
    - (b) the loss has not yet occurred;
    - (c) the lawyer's client intends to commit the crime or fraud either personally or through a third person; and
    - (d) the client has employed or is employing the lawyer's services in the matter in which the crime or fraud is committed.
  - (2) If a crime or fraud described in Subsection (1) has already occurred, a lawyer may use or disclose confidential client information when the lawyer reasonably believes its use or disclosure is necessary to prevent, rectify, or mitigate the loss.
  - (3) Before using or disclosing information under this Section, the lawyer must, if feasible, make a good-faith effort to persuade the client not to act. If the client or another person has already acted, the lawyer must, if feasible, advise the client to warn the victim or to take other action to prevent, rectify, or mitigate the loss. The lawyer must, if feasible, also advise the client of the lawyer's ability to use or disclose information as provided in this Section and the consequences thereof.

lawyer learns a client is using the lawyer's services to commit a fraud, the lawyer has discretion to reveal client information to the extent the lawyer reasonably believes necessary: (1) to prevent the crime or fraud when it is "reasonably certain" to result in substantial financial loss to another, and (2) to prevent, mitigate or rectify the substantial financial loss when it is reasonably certain to result or has occurred.

These traditional standards, substantially similar to the SEC's Part 205 Rules that provide for permissive reporting out, allow lawyers sufficient flexibility to dissuade clients from criminal or fraudulent activities where the lawyer is likely to be implicated and, if that fails, to protect innocent third parties against substantial financial injury, as well as avoid personal liability themselves. Moreover, the SEC previously has indicated in *In re Carter*<sup>29</sup> that the best way to ensure compliance is to encourage lawyers to continue counseling clients to comply with the law, rather than to provide incentives for withdrawing prematurely because of concern for their own liability.<sup>30</sup> *In re Carter* recognized that, short of assisting fraud, a lawyer's continuing to counsel compliance with the law serves both the public interest and the interests of the company and its investors.

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- (4) A lawyer who takes action or decides not to take action permitted under this Section is not, solely by reason of such action or inaction, subject to professional discipline, liable for damages to the lawyer's client or any third person, or barred from recovery against a client or third person.

*Id.* These exceptions closely resemble the crime-fraud exception to the attorney-client privilege, although the latter generally is applied by court decision. *See id.* §§ 67 cmt. c, 82 cmt. d (noting similarity to crime-fraud exceptions); GEOFFREY C. HAZARD, JR. & W. WILLIAM HODES, *THE LAW OF LAWYERING* § 9.10 (3d ed. & 2003 Supp.) (explaining crime-fraud exception to attorney-client privilege).

29. 47 S.E.C. 471, 512 (1981), 1981 SEC LEXIS 1940 ("Premature resignation serves neither the end of an effective lawyer-client relationship nor, in most cases, the effective administration of the securities laws.").

30. *See id.* (supporting continued counseling role). A lawyer's concern about the lawyer's own liability when advising a client on a close question whether to disclose significant detrimental information or not can, as recognized in *In re Carter*, alter the balance of the lawyer's professional judgment just as surely as subservience to the wishes of clients. *See id.* at 504 (stating how concern about liability can alter decision to disclose just as likely as "unseemly obeisance" to wishes of client). It serves no public purpose to disclose nonmaterial information, adverse though it may be, or to encourage the timid to withdraw from representing a client with the belief the lawyer could be charged with assisting in a fraud "just to be safe." *See id.* (stating that neither result is truly in public's interest). Moreover, securities law concepts such as whether a matter is material or information constitutes evidence of a securities law violation or breach of fiduciary duty are complex and all the facts rarely are known when decisions need to be made. These practical considerations are given no weight by those who urge adoption of noisy withdrawal. *See, e.g.*, Letter from Susan P. Koniak et al., to the Securities and Exchange Commission (Apr. 7, 2003), available at <http://www.sec.gov/rules/proposed/s74502/lawprofs040703.htm> (listing academics in general agreement).

## V. LEGAL CHALLENGES TO PART 205 RULES

Two state bar associations are already challenging the SEC's authority to preempt conflicting state professional conduct rules that prohibit disclosure of client confidences. The Part 205 Rules flatly state: "Where the standards of a state or other United States jurisdiction where an attorney is admitted or practices conflict with this Part, this Part shall govern."<sup>31</sup> In order to protect lawyers who comply with the Part 205 Rules, they also provide:

An attorney who complies in good faith with the provisions of this Part shall not be subject to discipline or otherwise liable under inconsistent standards imposed by any state or other United States jurisdiction where the attorney is admitted or practices.<sup>32</sup>

Nevertheless, in a recent ethics opinion, the Washington State Bar Association warned Washington lawyers against disclosing client information when it is *permitted* under the Part 205 Rules, but *prohibited* by the state's rules.<sup>33</sup> Accordingly, the SEC's safe harbor for good faith compliance with the Part 205 Rules might not protect a lawyer from state discipline for disclosing client confidences when the state's Rule 1.6 prohibits such disclosure.

In response, SEC General Counsel Prezioso, on behalf of the Commission, in a public letter to the Washington State Bar, has asserted the authority of the SEC under the Act to preempt conflicting state standards, including a state's rules that would discourage lawyers from making a disclosure that is permitted under the SEC's Part 205 Rules.<sup>34</sup>

A committee of the California State Bar Business Law Section also has taken issue with the Commission and asserted that California has an obligation, notwithstanding the Part 205 Rules, to enforce its near absolute

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31. Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205.1 (2003), available at <http://www.sec.gov/rules/final/33-8185.htm>.

32. *Id.* § 205.6(c).

33. See WASHINGTON STATE BAR ASS'N, INTERIM FORMAL ETHICS OPINION RE: THE EFFECT OF THE SEC'S SARBANES-OXLEY REGULATIONS ON WASHINGTON ATTORNEYS' OBLIGATIONS UNDER THE RPCs (July 26, 2003), available at <http://www.wsba.org/lawyers/groups/ethics2003/formalopinion.doc> (cautioning that lawyer in Washington should not disclose "confidences and secrets" permitted to be disclosed under Section 205 where such disclosure is not permitted by RPC 1.6(b)(1)); see also Sue Reisinger, *Two State Bars Protest SEC Rule*, NAT'L L.J., Sept. 15, 2003, at 1 (explaining that State of Washington only allows disclosure to prevent client from committing crime or pursuant to court order).

34. See Letter from Giovanni P. Prezioso, General Counsel, Securities and Exchange Commission, to Washington State Bar Association (July 23, 2003), available at <http://www.sec.gov/news/speech/spch072303gpp.htm> (stating in publicly released letter that Supreme Court has consistently upheld authority of federal agencies to implement rules of conduct that diverge from and supercede state laws that address same conflict).

prohibition of lawyers disclosing client confidences because "it is unclear whether the SEC had the authority to adopt Rules 205.3(d) and 205.6(c) [authorizing lawyers to disclose material violations and protecting them from state discipline] or that either of those rules preempts state laws."<sup>35</sup>

How will this controversy be resolved? One legal scholar, commenting on earlier allegations that the SEC lacks this authority, has asserted: "[A] claim that the SEC's noisy withdrawal proposal exceeds legislative intent is clearly misplaced" because it "erroneously suggests that Section 307 set forth maximum rather than minimum standards . . . [and] thus misses the mark based on the clear language of the statute and the absence of any legislative intent to the contrary."<sup>36</sup>

This comment appears to overstate both the clarity of Section 307 and the absence of legislative intent under Section 307 that it not obligate lawyers to report outside the company. Senator Edwards of North Carolina, principal sponsor of Section 307, when responding to questions by Banking Committee Chair Sarbanes during debate on the Act, stated that Section 307 would not obligate lawyers to report anything outside the company.<sup>37</sup> Senator Enzi of Wyoming, another sponsor, also commented:

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35. CORPS. COMM., BUS. LAW SECTION, STATE BAR OF CALIF., COMMENT ON JULY 23, 2003 PUBLIC STATEMENT BY SEC OFFICIAL (Aug. 5, 2003), available at <http://www.ethicsandlawyering.com/issues/files/calseclettertosec.pdf> (noting that protection of client confidences is essential to legal system and that disclosure of client confidences could adversely affect both client and attorney).

36. See Thomas Lee Hazen, *Administrative Law Controls on Attorney Practice—A Look at the Securities and Exchange Commission's Lawyer Conduct Rules*, 55 ADMIN. L. REV. 323, 348-49 (2003) (responding to criticism of SEC's noisy withdrawal proposal as outside scope of statutory mandate of Section 307). "Congress could have . . . define[d] proper legal representation rather than deferr[ing] to the SEC. . . . Congress followed a pattern that is familiar under many provisions of the securities laws . . . [by setting] a minimum standard but allow[ing] the SEC to define the eventual standard more broadly." *Id.* at 349 n.131.

37. See 148 CONG. REC. S6557 (daily ed. July 10, 2002) (statement of Sen. Edwards). Senator John Edwards (D-NC) offered Section 307 as an amendment to the then pending corporate responsibility legislation. See *id.* (offering amendment). Section 307 was in response to SEC General Counsel David Becker's suggestion of the need for legislation in order to authorize a Commission rule requiring lawyers to report misconduct up the ladder within the company client. See Letter from David Becker, General Counsel, Securities and Exchange Commission, to Richard W. Painter, Professor, University of Illinois College of Law (Mar. 28, 2002), available at <http://www.abanet.org/buslaw/corporateresponsibility/becker.pdf> (responding to Professor Painter's question whether lawyers should have heightened responsibilities for reporting violations of securities laws). During Senate debate on the Edwards Amendment, the following explanatory colloquy occurred between Senator Edwards and Committee Chair Paul Sarbanes (D-MD):

MR. SARBANES. It is my understanding that this amendment, which places responsibility upon the lawyer for the corporation to report up the ladder, only involves going up within the corporate structure. He doesn't go outside of the corporate structure. So the lawyer would first go to the chief legal officer, or the chief executive officer, and if he didn't get an appropriate response, he would go to the board of directors. Is that correct?

"The [Edwards] [A]mendment . . . would not require the attorneys to report violations to the SEC, only to corporate legal counsel or the CEO, and ultimately, to the board of directors."<sup>38</sup> Based on these assertions and other factors, a court might hold that the SEC lacks authority under Section 307 to require lawyers to report outside the company. Until these issues are resolved, however, it is in both the public interest and the interest of affected lawyers for state authorities to take a no-action position with respect to lawyers who report material violations outside the company in good faith reliance upon SEC rules.

## VI. AN APPROPRIATE REGULATORY RESPONSE

In our judgment, the fundamental issue to be confronted in addressing the SEC's pending mandatory noisy withdrawal proposal (whether reporting the lawyer's withdrawal is by the lawyer or the company) is whether a compelling justification exists for so significant a change in the client-lawyer relationship. We agree with those who say that mandating disclosures of confidences and threatening to impose sanctions on lawyers would interfere with client access to effective and independent legal counsel and impede the ability of lawyers to counsel compliance. Undeniably, the client-lawyer relationship is dependent upon the client's assurance that its communications with its lawyer will remain confidential and that the lawyer is dedicated to the client's best interests, unfettered by self-interest or other conflicts. Not only would mandatory withdrawal and disclosure interfere with the client-lawyer relationship, it would inevitably impair the ability of company boards to make crucial business decisions when the lawyers are required to substitute their judgment for the board's.

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MR. EDWARDS. Mr. President, my response to the question is the only obligation that this amendment creates is the obligation to report to the client, which begins with the chief legal officer, and, if that is unsuccessful, then to the board of the corporation. There is no obligation to report anything outside the client—the corporation.

MR. SARBANES. I think that is an important point. I simply asked the question in order to stress the fact that that is the way this amendment works. This has been a very carefully worked out amendment . . .

148 CONG. REC. S6557.

38. 148 CONG. REC. S6555 (daily ed. July 10, 2002) (statement of Sen. Enzi). More recently, Chairman Oxley of the House Committee on Financial Services filed an opening statement on the issue at hearings held on February 4, 2004 by the Subcommittee on Capital Markets on "The Role of Attorneys in Corporate Governance." In it, he noted:

This attorney misconduct led to a legislative remedy in the Sarbanes-Oxley Act requiring attorneys to report securities law violations "up the ladder" to the general counsel and chief executive officer, and if necessary the board of directors. While the SEC has implemented this sensible requirement as set forth in the Act, the Commission clearly went beyond congressional intent in proposing the noisy withdrawal mandate, but has since scaled back the provision.

150 CONG. REC. D56 (daily ed. Feb. 4, 2004) (statement of Sen. Oxley).



The foregoing values inherent in the traditional relationship between clients and their lawyers are, of course, not absolute. They are subject to exceptions to accommodate competing considerations, such as the desirability to avoid frauds that will cause substantial harm. But these exceptions under state legal ethics rules are carefully tailored to minimize harm to the core values underlying the client-lawyer relationship. Thus, for example, the exceptions to confidentiality usually are permissive, allowing the lawyer to exercise professional judgment based on the circumstances.<sup>39</sup> The exception for client fraud also may be limited to situations where the client uses the lawyer's services to commit the fraud. Ultimately, the right balance must be attained in the face of competing values.

Public policy requires that extreme caution be exercised before putting in jeopardy core values such as access to counsel and the ability of boards to make business decisions. Furthermore, those seeking to displace these core values should bear the burden of satisfactorily rebutting the following observations:

(1). *There is no compelling justification for taking the risk inherent in an SEC noisy withdrawal rule.*

It seems clear that SEC mandated noisy withdrawal is likely to apply only to the rarest of cases. Irrevocable damage to the client-lawyer relationship, however, is likely to apply broadly by virtue of the mere existence of the noisy withdrawal requirement. Sufficient leverage to achieve corporate compliance is already afforded lawyers through permissive reporting out, but without as much disruptive impact on the client-lawyer relationship as would result from a mandatory requirement.<sup>40</sup> The client knows permissive reporting allows its lawyer to exercise professional judgment taking into account all the circumstances without being concerned whether remaining as its lawyer in order to counsel compliance will result in charges against the lawyer.

(2). *An SEC noisy withdrawal rule is likely to have the adverse consequences we describe.*

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39. For a discussion of the disclosure standards for lawyers advising clients, see *supra* notes 27-28 and accompanying text. For a further discussion of the standard in the SEC's Part 205 Rules, see *supra* note 9 and accompanying text.

40. See Patrick McGeehan, *Lawyers Take Suspensions on TV Azteca to Its Board*, N.Y. TIMES, Dec. 24, 2003, at C1 (describing how Section 307 has recently been applied to Mexico's second-largest television broadcaster). Lawyers for TV Azteca reportedly applied the SEC's Part 205 Rules to persuade Azteca's independent directors to investigate the adequacy of disclosure of its executive officer's dealings in Azteca's debt instruments. See *id.* (reporting lawyers' actions). Steven H. Scheinman of Akin Gump's New York office wrote the affected boards of directors that the firm had withdrawn from representing Azteca because, in the firm's opinion, certain transactions that the chief executive officer and the general counsel decided not to disclose were required to be disclosed pursuant to U.S. securities law. See *id.* (noting letter). Citing Section 307 of the Act, Mr. Scheinman reserved the right to inform the SEC of the firm's withdrawal from the representation. See *id.* (noting reservation).

No one can prove empirically that these adverse consequences will occur. Rather, it is a judgment based on our experience as counselors. But neither can the proponents of mandatory noisy withdrawal prove that the consequences will not occur. And they are the ones who should bear the burden when putting the core values in jeopardy. What is certain is that requiring lawyers to take action when they disagree with their clients or face sanctions for violating the law will inevitably shift the balance of decisionmaking from the directors charged with that responsibility to the company's lawyers, including when complex judgments, such as decisions regarding materiality, are involved.

*(3). An SEC noisy withdrawal rule will reduce rather than promote overall legal compliance.*

There may be an occasional case in which a lawyer's report to the SEC prevents a violation that would otherwise have occurred. But, in our judgment, these instances will be greatly exceeded by the numerous times lawyers are prevented from counseling clients on legal compliance because they are denied access to the relevant information as a consequence of mandated withdrawal. It is important to bear in mind that the U.S. securities regulatory system is largely a self-regulatory system that depends on the key role played by lawyers to enhance compliance. The valiant efforts of government enforcement staff and the check afforded by civil litigants provides only after-the-fact punishment in a few cases after the damage has been done. This should be compared to the effect of before-the-fact counseling that lawyers regularly perform.

*(4). Other measures that have been put in place to ensure corporate legal compliance will adequately address the problem.*

These other measures include: (1) the recently adopted SEC Part 205 reporting-up rules, (2) the ABA's enhancement of the Model Rules, as described above, (3) the SEC's effort to override inconsistent state rules that would prevent permissive reporting out, (4) the substantial efforts of law firms and law departments to put procedures in place to implement professional conduct rules, including those adopted by the SEC, (5) the enhancements in corporate governance that both encourage greater vigilance and oversight by independent directors and their committees and ensure that there is an effective body to address reports received from lawyers, and (6) the expanded responsibilities to police compliance imposed on others, such as outside auditors, who do not have the same duties and responsibilities to clients that lawyers do. We believe these measures should be given the opportunity to operate effectively before the Commission makes its decision whether to adopt a mandatory noisy withdrawal rule that could interfere with the client-lawyer relationship, impede lawyers' ability to counsel compliance and impair the ability of boards to make ultimate business judgments.

## VII. CONCLUSION

Many have suggested to the Commission that the up-the-ladder reporting requirements and permissive reporting-out provisions in the Part 205 Rules go far enough in enhancing the lawyer's role in corporate governance. The ABA and others have urged the SEC not to issue further rules for the present so that the effectiveness of the current Part 205 Rules, in combination with the other new corporate responsibility and accounting regulations, can be assessed.<sup>41</sup> Already, the active focus of company boards, management and advisers on improving corporate responsibility and complying with the letter and spirit of the Sarbanes-Oxley Act is helping restore public confidence in the financial markets.

In the not too distant future, the Commission is expected to tell us whether it agrees.

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41. See ABA CORPORATE RESPONSIBILITY REPORT, *supra* note 20, at 6-10 (summarizing recent reforms affecting corporate responsibility and asserting that SEC should not promulgate further rules until effectiveness of Section 205 has had chance to be effective). By reporting up the ladder, lawyers are already effectively causing independent directors to investigate management's failure to publicly disclose information believed by the lawyers to be material. See McGeehan, *supra* note 40, at C1 (providing example of up-the-ladder reporting rules' effect on disclosure of public information).