

The Sarbanes-Oxley Act Of 2002 And Its Impact On The Attorney-Client Privilege And Legal Ethics

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Abstract

Congress passed the Sarbanes-Oxley to restore confidence in publicly traded corporations. The Act changed legal ethics and decades old attorney-client privilege. This paper explores its impact on business.

1. Introduction

The “Sarbanes-Oxley Act of 2002,” (the “Act”) is one of the most significant federal laws passed in the past decade. Indeed, it may be the most far reaching law impacting public companies since the passage of the original Securities and Exchange Acts of 1933 and 1934, which established the Securities and Exchange Commission (SEC) and established rules for public issuers of securities.¹ It runs 66 pages, has 11 separate titles, and 69 total sections.²

The Act imposed reporting obligations on publicly traded corporations, established a new federal accountancy oversight bureaucracy, and it supplanted an industry-wide recognized oversight body. It also prohibited accounting firms from providing some consulting services to companies they audit. It expanded the definition of obstruction of justice, required certain corporate managers to sign off on financial reports to attest that adequate controls are in place to detect mistakes and fraud, required companies to create and disclose a code of ethics and to have a financial expert on the board of directors, and it also required companies to provide more information to investors when reporting “pro forma” numbers, or figures that are not in accordance with standards used for financial statements filed with the SEC. It also partly caused a change in centuries old doctrine involving lawyers and the clients they represent – the attorney client privilege. This paper explores the scope of Sarbanes-Oxley Act and its impact on the attorney-client privilege and ethics in American business.

2. History Of The Securities Laws In The United States

2.1. The “Roaring Twenties” And The Depression

Prior to 1933, there existed few laws regulating securities in American. Laissez-faire was the government policy regarding the stock market in the early part of the 20th Century. During the roaring 1920’s, fortunes were made and lost in the stock market as institutions as individuals, “played the market.”

In late March 1929, just after the inauguration of President Herbert Hoover, the Federal Reserve Board was meeting every day behind closed doors. The “Fed” discussed many items, but primarily the volatile stock market and the national economy. The first of many ‘mini’ crashes and recoveries began on Monday, March 25, 1929. As a

¹ House Resolution 3763, 116 STAT. 745, Public Law 107-204, July 30, 2002

² Securities Act of 1933, May 27, 1933, ch 38, Title I, § 1, 48 Stat. 74; Securities Exchange Act of 1934, June 6, 1934, c. 404, Title I, § 1, 48 Stat. 881.

result, for the next six months, it was one of the most volatile times in market. On “Black Tuesday”, October 29, 1929, the stock market lost over 11% of its total value. By the end of November of 1929, stock market investors had lost almost \$100 billion in assets. In just two months in the fall of 1929, the market had lost 40 percent of its value. This marked the point where the Roaring 20’s ended and the Great Depression started. The stock market continued to fall until July of 1932 with the Dow at 41.22, down 89.2% from its previous high (from 381.17 to 41.22.) The stock market did not see the previous high for another 22 years.

In 1932, Franklin D. Roosevelt was elected President of the United States, defeating Herbert Hoover’s re-election bid. FDR had campaigned on a platform promising the American worker a “New Deal.” Shortly after his election, FDR, during his first 100 days in office, was able to get dozens of new laws passed and enacted. One of those laws was the Securities and Exchange Act of 1933.

2.2. The Securities Act of 1933

The 1933 Securities and Exchange Act is often referred to as the "truth in securities" law. It sets out two basic objectives:

- 1) That investors should receive financial and other significant information concerning securities being offered for public sale; and
- 2) It prohibited deceit, misrepresentations, and other fraud in the sale of securities.

The Act accomplished these goals by requiring the disclosure of important financial information through the registration of securities. Utilizing this information, investors, not the government, could make informed judgments about whether or not to purchase a company's securities. While the SEC Act requires that the information provided be accurate, it does not guarantee it. As a result, the Act provides investors who purchase securities and suffer losses with important recovery rights if they can prove that there was incomplete or inaccurate disclosure of important information.

In general, securities sold in the U.S. must be registered. The registration forms that companies file do provide some basic, essential facts. In general, registration calls for:

- 1) A description of the company's properties and business;
- 2) A description of the security to be offered for sale;
- 3) Information about the management of the company; and
- 4) Financial statements certified by independent accountants.

Registration statements and prospectuses become public shortly after filing with the SEC.

Not all offerings of securities must be registered. Some exemptions from the registration requirement include:

- 1) Private offerings to a limited number of persons or institutions;
- 2) Offerings of limited size;
- 3) Intrastate offerings; and
- 4) Securities of municipal, state, and federal governments.

There may, however, be certain state registration requirements in addition to the '33 Act (typically called state “blue sky laws”).

2.3. The Securities And Exchange Act Of 1934

A year after the 1933 SEC Act, Congress passed the 1934 Act which created the Securities and Exchange Commission. The Act authorized the SEC to utilize broad authority over all aspects of the securities industry. Some of the powers delegated to the SEC included the power to register, regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as the nation's securities' self regulatory organizations ("SROs"). The various stock exchanges, such as the New York Stock Exchange, and American Stock Exchange are SROs. The National Association of Securities Dealers, which operates the NASDAQ system, is also an SRO.

The '34 Act also identified and prohibited certain types of conduct in the markets and provided the Commission with disciplinary powers over regulated entities and persons associated with them. The '34 Act also empowered the SEC to require periodic reporting of information by companies with publicly traded securities.

Companies with more than \$10 million in assets whose securities are held by more than 500 owners must file annual and other periodic reports. These reports are available to the public through the SEC.

The Securities Exchange Act also governed the disclosure in materials used to solicit shareholders' votes in annual or special meetings held for the election of directors and the approval of other corporate action. This information, contained in proxy materials, must be filed with the Commission in advance of any solicitation to ensure compliance with the disclosure rules. Solicitations, whether by management or shareholder groups, must disclose all important facts concerning the issues on which holders are asked to vote.

The Securities Exchange Act required disclosure of important information by anyone seeking to acquire more than 5 percent of a company's securities by direct purchase or tender offer. Such an offer often was extended in an effort to gain control of the company. As with the proxy rules, this allowed shareholders to make informed decisions on these critical corporate events.

The securities laws broadly prohibit fraudulent activities of any kind in connection with the offer, purchase, or sale of securities. These provisions form the basis for many types of disciplinary actions, including actions against fraudulent insider trading. Insider trading is illegal when a person trades a security while in possession of material nonpublic information in violation of a duty to withhold the information or refrain from trading.

The '34 Act requires a variety of market participants to register with the Commission, including exchanges, brokers and dealers, transfer agents, and clearing agencies. Registration for these organizations involves filing disclosure documents that are updated on a regular basis.

The SROs must create rules that allow for disciplining members for improper conduct and for establishing measures to ensure market integrity and investor protection. SRO proposed rules are published for comment before final SEC review and approval.

2.4. Enron, Global Crossings And Arthur Andersen

After the passage of the '33 and '34 Securities Acts, Congress passed a number of tangential acts³ but the most significant addition to securities laws occurred with the passage of the Sarbanes-Oxley Act of 2002. Part of the impetus for the Sarbanes-Oxley Act was the recent, high profile bankruptcy filings of a number of companies, such as Enron, Global Crossings, and WorldCom, as well as the indictment of the outside auditor for those companies, one of the best known accounting firms in the world, Arthur Andersen, LLP.

³ Public Utility Holding Company Act of 1935, Trust Indenture Act of 1939, Investment Company Act of 1940, Investment Advisers Act of 1940

2.4.1. Enron

Enron is an Oregon corporation with its principal place of business in Houston, Texas. In 2001, Enron was the seventh largest corporation in the United States based on its reported revenues. In the previous ten years, Enron had evolved from a regional natural gas provider to a trader of natural gas, electricity and other commodities, with retail operations in energy and other products. In January of 2001, Enron stock was trading at over \$82 per share. At one point, it was ranked as high as #5 in terms of total revenue among US companies by Fortune Magazine in 2002.⁴

On October 16, 2001, Enron issued a press release announcing a \$618 million net loss for the third quarter of 2001. That same day, but not as part of the press release, Enron announced to analysts that it would reduce shareholder equity by approximately \$1.2 billion. The market reacted immediately and the stock price of Enron shares plummeted.⁵ The Securities and Exchange Commission ("SEC"), which investigates possible violations of the federal securities laws, opened an inquiry into Enron on October 17, 2001, and requested in writing information from Enron.

Ultimately, Enron filed for federal bankruptcy protection, at the time, the largest bankruptcy in U.S. history. Its filing led to thousands of employees losing their life savings in 401(k) plans tied to the energy company's stock. Although Enron still exists, it is a mere shadow of its former self.

Many of Enron's problems stemmed from what are known in the tax laws as the establishment, and accounting for, "special purpose entities." These SPEs can take many forms, but were used by Enron to transfer certain expenses "off balance sheet" and report equity that may have been realized, but not received.

One of Enron's investments was in an Internet start-up company by the name of Rhythms NetConnections ("RNC"). That investment increased in value by \$300 million shortly after Enron's investment. Because of the federal securities laws, Enron could not sell the stock immediately. Despite this the company wanted to count the paper gain as profit, include that in their financial documents, and therefore make Enron shares of stock appear more attractive to investors.

When the increase in value of RNC was discussed by the senior financial managers at Enron, they allegedly came up with an accounting technique to create a private partnership in the Cayman Islands that would protect -- or hedge -- the Rhythms investment, by locking in the gain. Ordinarily, Wall Street firms would provide insurance, for a fee, to protect such a risk. But RNC was such a risky stock at the time that insurance was unavailable at a reasonable premium. Since the gain would amount to 30 percent of its profit for the year, Enron needed to come up with a different strategy.

Enron's idea was to establish a SPE, which would purchase the gain in RNC from Enron. That gain could then be shown as revenue on Enron's balance sheet. Since the SPE was a separate entity, Enron did not have to show the liability of the purchase on the Enron financial statements. However, since Enron established the SPE, sometimes funding it with Enron stock, the risk of loss, if RNC's paper profit decreased, or disappeared, was also born by Enron. If the stock price of Enron or the tech company (RNC) fell precipitously at the same time, the hedge would fail and Enron would be left with heavy losses.

Enron funded the SPE, which was named "LJM," allegedly after the CFO's wife and two children. A number of other partnerships with shell companies were created, many with names like "Chewco" and "JEDI", purportedly inspired by Star Wars characters

⁴ Fortune, March 31, 2002, <http://www.fortune.com/fortune/information/Presscenter/0,03302002F500,00.html>

⁵ <http://news.findlaw.com/hdocs/docs/enron/usandersen030702ind.html>, paragraph 6.

Eventually, the Internet boom wound down, and share prices started to come down on Internet stocks. On October of 2001, Enron was forced to disclose \$1 billion in losses, more than half from LJM deals gone badly. Thus began a chain of events that would destroy Enron's stock price, force it to file bankruptcy, and wipe out thousands of jobs and tens of billions of dollars in savings.

On December 2, 2001, Enron filed what was then the largest bankruptcy in US history – with assets totaling \$63 billion. In February of 2002, Andrew Fastow, Enron's CFO, and former Enron CEO Kenneth Lay both appeared before Congress, which was holding hearings on the Enron matter. Both invoked their Fifth Amendment rights against self-incrimination. Almost two years later, Enron is still in bankruptcy. Enron's auditor was Arthur Andersen, LLC.

2.4.2. Global Crossings

Global Crossing was formed in 1999 from a merger between a Hamilton, Bermuda based fiber-optics cable specialist and a US telecommunications firm. Initially, it was regarded as one of the most promising of the new generation of telecommunications providers that sprang up in the late 1990s.

The company's stock market valuation at one point was as high as \$75 billion. But the company built up heavy debts rolling out its high-speed optic cable network. Global Crossing struggled with the debt incurred from building its global network, which links more than 200 major cities in 27 countries. When companies stopped spending on broadband, its revenue stalled and, then decreased.

Global Crossing came under fire for its use of swaps and disclosure of so-called "capacity swaps" in its trading documents, which allegedly made its financial statements look more profitable than they should have⁶ It too, used the accounting firm of Arthur Andersen as its auditor.⁷

On January 28, 2002, Global Crossing filed for bankruptcy in the U.S. Bankruptcy Court for the Southern District of New York and coordinated proceedings in the Supreme Court of Bermuda. At the time of its filing, it was the fourth largest bankruptcy in history. It had \$22.4 billion in assets and \$12.4 billion in liabilities. Eventually it terminated over 9,000 employees. Under its reorganization plan, existing common equity and preferred shareholders get no stake in the company. Global Crossing's creditors would get a combination of cash, new debt and new equity in the restructured company.⁸

2.4.3. WorldCom/MCI

WorldCom (renamed MCI), which filed for Chapter 11 bankruptcy protection in July of 2002 (with \$104 billion in assets -- currently the largest in US history), owns, through its UUNET subsidiary, a significant portion of the Internet backbone, as well as MCI/Sprint and a number of other telecommunications companies.⁹ It is the US's second largest long distance telephone company.

Although precise measurement of Internet traffic is virtually impossible, UUNET appears to account for between 30 and 50 percent of traffic at any time. In addition, WorldCom provides other Internet services such as Virtual Private Networks, Web hosting and broadband access.¹⁰

⁶ <http://news.bbc.co.uk/1/hi/business/1886014.stm>

⁷ <http://news.bbc.co.uk/1/hi/business/1886014.stm>

⁸ <http://news.bbc.co.uk/1/hi/business/1886014.stm>

⁹ <http://www.newsfactor.com/perl/story/18843.html>

¹⁰ <http://www.newsfactor.com/perl/story/18843.html>

WorldCom's problems first came to light in late June of 2002 when it announced that it had overstated its earnings by \$3.8 billion for the previous 16 months.¹¹ That action resulted in a wiping out of \$1.4 billion in reported profit in 2001 and \$130 million in the first quarter of 2002.¹²

When it announced its restatement of earnings, WorldCom said in a press release that it would also cut 17,000 of its 85,000 employees worldwide, and it immediately fired its chief financial officer, Scott Sullivan.¹³

Eventually, WorldCom restated earnings taking off nearly \$11 billion over a 4 year period.¹⁴ Its auditor was also Arthur Andersen, LLC.

2.4.4. Arthur Andersen

Arthur Andersen LLP was an accounting partnership that performed accounting and consulting services for businesses throughout the United States and the world. It was one of the so-called 'Big Five' accounting firms in the United States in 2001, having its headquarters in Chicago, Illinois, with offices throughout the world.

For 16 years, up until Enron filed for bankruptcy in December 2001, Enron retained Andersen to be its auditor. Enron was one of Andersen's largest clients worldwide. It earned tens of millions of dollars from Enron in annual auditing and other fees.

Andersen performed both internal and external auditing work for Enron mainly in Houston, Texas, and it established within Enron's offices in Houston a work space for the team that had primary responsibility for performing audit work for Enron. In addition to Houston, Arthur Andersen personnel performed work for Enron in Chicago, Illinois, Portland, Oregon, and London, England.¹⁵

On October 19, 2001, Enron alerted the Andersen audit team that the SEC had begun an inquiry regarding the Enron "special purpose entities" and the involvement of Enron's Chief Financial Officer. The next morning, an emergency conference call among high-level Andersen management was convened to address the SEC inquiry. During the call, it was decided that documentation that could assist Enron in responding to the SEC was to be assembled by the Andersen auditors.¹⁶

After spending Monday, October 22, 2001 at Enron, Andersen partners assigned to the Enron engagement team allegedly engaged in a wholesale destruction of documents at Andersen's offices in Houston, Texas. Andersen personnel were called to urgent and mandatory meetings. The team was allegedly instructed by Andersen partners and others to destroy immediately documentation relating to Enron, and told to work overtime if necessary to accomplish the destruction. During the next few weeks, tons of physical documentation were shredded, and numerous computer files were deleted.¹⁷

Among the documents cited by Prosecutors against Andersen was an October 12, 2001 memo that directed workers to destroy all audit material, except for the most basic "work papers." Document and file destruction occurred up to the date that the Securities and Exchange Commission issued subpoenas on November 8, 2001, to assist it in its investigation of alleged financial wrongdoing at Enron.

¹¹ <http://www.internetnews.com/xSP/article.php/1377151>

¹² Ibid.

¹³ Ibid.

¹⁴ <http://www.nwfusion.com/edge/news/2003/0722mciworld.html>

¹⁵ <http://news.findlaw.com/hdocs/docs/enron/usandersen030702ind.html>

¹⁶ <http://news.findlaw.com/hdocs/docs/enron/usandersen030702ind.html>

¹⁷ Ibid.

Andersen and Enron were both indicted on obstruction of justice charges¹⁸ and, on June 15, 2002, a federal jury in Texas found Andersen guilty of a single charge of obstruction. Andersen officially ceased doing public accounting business on August 31, 2002, and 26,000 Andersen US partners and employees lost their employment. Many partners and retirees lost a substantial portion of their life savings and pensions. All in all, over 2300 Andersen public company clients were forced to engage new audit firms with all the disruptions and costs associated with an auditor change.

3. Sarbanes-Oxley

3.1. Authors Of The Act

Paul S. Sarbanes, Maryland's Democratic senior Senator (elected for a 5th 6- year term in 2000), and Congressman Michael G. Oxley of Ohio's fourth district, serving his eleventh term in the House of Representatives, (Chairman of the House Committee on Financial Services), were the primary original authors of the Act.

The Act is aimed primarily at "issuers" of public securities which now exist or soon will exist. Section 2 of the Act refers to the Securities and Exchange Acts of 1933 and 1934, and mirrors the definition of an issuer in those acts.

An issuer is any company that issues public stock, whose stock is publicly traded, or soon will be. It will also include a company that has not issued public stock, but has issued public debt – corporate bonds. Other "securities" (not just stock and bonds) may fall within the purview of the Act.

3.2. The Public Company Accounting Oversight Board

The first section of the Act sets out the establishment and organization of a newly created Accounting oversight board – the Public Company Accounting Oversight Board, known as PCAOB. It answers to the Securities and Exchange Commission, and it will oversee audits of public companies to ensure fairness and consumer confidence in the auditing system. All public accounting companies are required to register with the Board by October 26, 2003.

Current members of the Board are: Kayla J. Gillan, Daniel L. Goetzer, Willis D. Gradison, Jr., Charles D. Niemeier, and William J. McDonough - Chair. The Board is to establish accounting and auditing standards for companies regulated by the Act, including public accounting companies who act as auditors.

The Board has come under criticism in the media for the salaries paid to the Board members. All board members except the Chair will receive salaries of \$452,000 per year. The Chair will receive a salary of \$560,000.¹⁹ All of the Board members receive more than any member of the Securities and Exchange Commission (each receives \$142,500 per year), than any member of the President's cabinet (\$171,900 for the Secretary of State and Attorney General), or even the President of the United States of America (\$400,000).²⁰

The Act provides that the Board has investigation, enforcement and punishment authority over public accounting companies, both domestic and foreign, although the Act does not establish in personam jurisdiction over the foreign accounting companies.

¹⁸ Sec. 1512

¹⁹ Citizens Works, January 10, 2003, <http://www.citizenworks.org/admin/press/accountingoversight-pr.php>

²⁰ Ibid.

3.3. Reporting Requirements

Section 302 of the Act requires Chief Executive Officers and Chief Financial Officers to personally verify the accuracy of the financial reports issued by their company.

3.3.1. Internal Controls

Section 404 requires companies to have sufficient internal controls to assure accuracy for financial reports in place by June 15, 2004 (extended from the fall of 2003). Small companies and foreign businesses have until April 15, 2005 to implement the controls. Auditors, retained from outside the company or in house employees, will have to certify that sufficient controls exist by the deadline.

Section 409 requires “real-time” reporting of events that may materially affect the company. At present, there is no time period to certify compliance, and no set agreement on what “material events” are, but “real-time” is within 48 hours after the event occurs.

3.3.2. Time Periods.

The Act specifies time periods for retention of financial work papers, correspondence, or any communications or documentation containing conclusions or opinions about audit information.

In June of 2003, the NASD instituted new rules and regulations for its members mandating that all so called “instant messages” be retained for at least 3 years, and instant messages must adhere to the same record keeping and supervisory requirements as e-mail under the Act.

3.3.3. Criminal Penalties

Section 802 specifies criminal penalties for destruction or alteration of documents. After it was revealed that Arthur Andersen employees destroyed thousands of Enron records, this section was placed in the Act with teeth. Penalties for violation of 802 can be as simple as a fine, to up to 20 years in prison for a person who “knowingly alters, destroys, mutilates ...” a record or document with the intent to impede an investigation.

4. The Attorney-Client Privilege

The attorney client privilege is a legal doctrine that has been traced as far back as the 1500s in the England of Elizabeth I. Its present form was described by John Wigmore in his famous treatise, *Wigmore on Evidence*.²¹ It protects communications by clients, both individuals and organizations, to their attorneys. Without a waiver of the privilege, a legal excuse, or consent by the client, the attorney is prohibited from revealing a protected communication, except in very limited circumstances. In today’s litigious society, the privilege prevents an attorney from testifying against her client (unless the privilege is waived), as well as from revealing client confidences to anyone else in general, provided they are confidences entrusted within the attorney-client relationship.

Generally, to be protected, the communication must be with an attorney, or in some cases to the attorney’s directly employed staff. The protection extends to client statements, non-verbal communications or writings to an attorney, and the attorney’s statements, non-verbal communications and writings to the client. The communication, however, must be in the context of receiving legal advice.

²¹ John Henry Wigmore, *Evidence* § 2311, 599 (John T. McNaughton rev. ed. 1961). Confidentiality is one of the “fundamental conditions . . . necessary to the establishment of a privilege against the disclosure of communications...” [and its existence] “... must be essential to the full and satisfactory maintenance of the relationship between the parties” before any privilege should be recognized. § 2311, 599.

There are some exceptions to the privilege. For example, an attorney who is a conspirator cannot claim the privilege if a co-conspirator is a client.

The privilege exists for many policy reasons. Considering communications to be confidential and cannot be disclosed is said to encourage complete truthfulness in the communication so that the attorney is apprised of all facts and situations faced by the client. If communications were subject to discovery and disclosure, clients would not be entirely truthful with their attorneys. And, attorneys who receive the disclosure will encourage the clients to come into voluntary compliance with the law.

The attorney client privilege has generated controversy and a number of court decisions designed to establish a “bright line” of when the privilege exists and when it does not. Historically, “confidential information” has been expanded to include various agents of both the attorney and the client,²² third parties with whom the client sought legal advice from a common attorney (joint clients),²³ or with whom the client shares a common interest or community of interests but are represented by different attorneys.²⁴ It has been expanded to permit different clients with different attorneys to share confidential communications in a joint defense effort.²⁵ Through the concept of limited waiver, some courts have permitted the client to share his privileged communications with some third parties but not with others; in addition, courts have approved limited waivers indirectly through the use of protective orders.²⁶

In addition to this general principle of law, all state bar associations, as well as the American Bar Association (“ABA”) have established ethical obligations on an attorney not to disclose confidential information received by a client in the context of legal advice. Again there are limited exceptions, such as when an attorney is aware that a crime is about to be committed or physical harm may come to a third party. In those cases, the attorney is generally able to disclose limited communications to prevent those acts from occurring, but there is no requirement that the attorney do so.

In partial response to section 307 of the Sarbanes-Oxley Act, the American Bar Association, at its annual meeting at San Francisco, California, in August of 2003, substantially changed rules 1.6 and 1.13. The new rules read as follows:

Rule 1.6 Confidentiality of Information

(a) A lawyer shall not reveal information relating to representation of a client unless the client consents after consultation, except for disclosures that are impliedly authorized in order to carry out the representation, and except as stated in paragraph (b).

(b) A lawyer may reveal such information to the extent the lawyer reasonably believes necessary:

²² See, e.g., *Du Barre v. Livette*, Peake 108, 170 Eng. Rep. 96 (N.P. 1791) (interpreter); *LaLance & Grosjean Mfg. Co. V. Haberman Mfg. Co.*, 87 F. 563, 564 (C.C. S.D. N.Y. 1898); *United States v. United Shoe Machinery Corp.*, 89 F. Supp. 357 (D. Mass. 1950) (patent agents); *NLRB v. Harvey*, 349 F.2d 900, 907 (4th Cir. 1965) (detective); *United States v. Schmidt*, 343 F. Supp. 444, 446 (M.D. Pa. 1972) (accountant); *United States ex rel. Edney v. Smith*, 425 F. Supp. 1038, 1041 (E.D. N.Y. 1976)(secretaries and paralegals); *United States ex rel. Edney v. Smith*, 425 F. Supp. 1038 (E.D. N.Y. 1976) (psychiatrist); *United States v. Pipkins*, 528 F.2d 559, 563 (5th Cir. 1976) (handwriting expert); *Flood v. Waste Mgt., Inc.*, 1989 U.S. Dist. LEXIS 10822 (N.D. Ill. Sept. 13, 1989) (hypnotist).

²³ *In re Regents of the University of Cal.*, 101 F.3d 1386, 1996 U.S. App. LEXIS 30617, *9-10 (Fed. Cir. 1996).

²⁴ *United States v. Schwimmer*, 892 F.2d 237, 243 (2d Cir. 1989).

²⁵ *Diversified Industries, Inc. v. Meredith*, 572 F.2d 596 (8th Cir. 1977) (*en banc*).

²⁶ *Permian Corp. v. United States*, 665 F.2d 1214, 1216 (D.C. Cir. 1981).

(1) to prevent the client from committing a criminal act that the lawyer believes is likely to result in imminent death or substantial bodily harm; or

(2) 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 a client.

Rule 1.13 Organization as Client

(a) A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.

(b) If a lawyer for an organization knows facts from which a reasonable lawyer, under the circumstances, would conclude that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, and is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization.

Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to the highest authority in the organization, including, if warranted by the circumstances, to the highest authority that can act in behalf of the organization as determined by applicable law.

(c) Except as provided in paragraph (d), if,

(1) despite the lawyer's efforts in accordance with paragraph (b), the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action or refusal to act, that is clearly a violation of law, and

(2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial harm to the organization,

then the lawyer may reveal such information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.

(d) Paragraph (c) shall not apply with respect to information relating to a lawyer's representation of an organization to investigate an alleged violation of law, or to defend the organization or an officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law.

(e) A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to paragraphs (b) or (c), or who withdraws under circumstances that require or permit the lawyer to take action under either of those paragraphs, shall proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal.

(f) In dealing with an organization's directors, officers, employees, members, shareholders or other constituents, a lawyer shall explain the identity of the client when it is apparent that the organization's interests are adverse to those of the constituents with whom the lawyer is dealing.

(g) A lawyer representing an organization may also represent any of its directors, officers, employees, members, shareholders or other constituents, subject to the provisions of Rule 1.7. If the organization's consent to the dual representation is required by Rule 1.7, the consent shall be given by an appropriate official of the organization other than the individual who is to be represented, or by the shareholders.

5. Impact Of Sarbanes-Oxley In Light Of New Model Rules 1.6 & 1.13

5.1. Change In Corporate America

According to a House Financial Services Committee staff report, the number of audit committee meetings has increased by more than a third since the passage of the Act. In addition, 84% of U.S. multinationals have upgraded their auditing controls and compliance procedures. Another development is that over 50% the blue chip companies belonging to the Business Roundtable report that they have already formed truly independent boards.

The Public Company Accounting Oversight Board is up and running under the leadership of William McDonough, the distinguished former president of the Federal Reserve Bank of New York. And the board successfully met its July 16, 2003 deadline for announcing registration rules for the accounting firms it oversees.

5.2. Erosion Of Attorney-Client Privilege In An Area Of Heightened Ethics

One target of the Act was the perception that public companies could hide behind the "Attorney-client" privilege and self report securities violations, but not publicly report them. In effect, this "confession" could serve as a defense to lawsuits in general and exemplary damages, but could be "controlled" by in-house or outside counsel.

While each state has its own common law on the attorney-client privilege, most of the licensed attorneys in the United States belong to both their state association and a national association, the American Bar Association.²⁷ While membership in the ABA is not a requirement of any state licensure, it provides many valuable functions, one of which is to establish model rules of ethics as guidance for state associations to adopt, or not, as they see fit.

The Sarbanes-Oxley Act was cited by the ABA as the primary reason for its August 2003 change in the ethical obligations of attorneys advising public companies.²⁸ The ABA conference report notes that the Act will enhance communication both with in-house counsel and outside counsel. It will enhance the contribution of board members to public corporations, and

The new rule permits disclosure of an attorney where information would "prevent" a client from committing a crime, or fraud, which is "reasonably certain" to result in "substantial injury to the financial or property interests" of another. The new rule, therefore, allows a lawyer to inform about potential, as well as existing

²⁷ "Bar" refers to a physical barrier in a courtroom that separates spectators and attorneys at law "admitted to the bar." When a lawyer (who does not have to be licensed) passes the state license exam, or otherwise satisfies the state requirements to practice law (waiver), the lawyer "passes the bar" or is able to sit in front of the physical bar in the courtroom that signifies to Judges that a person is licensed as an Attorney and Counselor at Law.

²⁸ American Bar Association, Task Force on Corporate Responsibility, Section of Business Law, Section of Taxation, Section of Tort Trial and Insurance Practice, Standing Committee on Ethics and Professional Responsibility, Section on, Young Lawyers Division, Section of Real Property, Probate and Trust Law, Task Force on the Implementation of Section 307 of the Sarbanes-Oxley Act of 2002, Report to the House of Delegates, page 5 of 18.

and past client actions, if they have the potential to substantially harm another's financial interest. There is no limitation on "another" or a clear definition of what injury is a "substantial" injury.

5.3. Possible Outcomes Of The Change In The Future

The opening of the door to lawyer disclosure and the lack of definitiveness in the rule may expose attorneys to individual liability for failure to disclose. A "substantial injury" to another's financial or property interest will be the basis for an individual to claim that a failure to disclose harmed them. Each case will be litigated against a lawyer for breach of her ethical obligation of prior disclosure. Each case will claim that the lawyer was "reasonably certain" of harm to another's interest. Each case will claim that the individual suffered a "substantial injury" based on their individual financial or property situation.

This rule, passed in a vague and broad manner in an attempt to convince the public that attorneys were concerned about ethical lapses at Enron, WorldCom, and Arthur Andersen, is a first step at an erosion of the attorney-client relationship in the United States. It will expose attorneys to claims of unethical or unprofessional conduct by disgruntled investors who lost money investing in publicly traded stocks, bonds, and derivatives.

6. Conclusion

The Sarbanes-Oxley Act of 2002 was passed in an effort to achieve more transparency for public companies, avoid conflict of interests in auditing and accounting areas, and to restore public confidence in American commerce. While the Act has resulted in a number of changes, the unanticipated change in the attorney-client privilege, as articulated by the American Bar Association, may be one of the more significant changes, for the legal profession itself. Certainly the "tattle-tale" aspects of the new ABA ethical rule will be unattractive to in-house counsel, and they will go to great lengths to distance themselves from any information that would cause them to be "reasonably certain" that any information may have a "substantial harm" on the financial or property interests of another.

The new ABA ethical rules will result in higher legal costs for corporations, and a classic "trap for the unwary" for counsel who does not take steps to protect herself individually. While no state bar association has yet adopted the proposed ABA rule, certainly creative litigation will be inspired by the aspect of yet another "pocket" (counsel to public corporations) to pursue in the ever increasing brinkmanship of leverage litigation. 📖