2005

More Than the Camel’s Nose: The Sarbanes-Oxley Act as Bad News for Lawyers, Clients, and the Public

Timothy P. Chinaris

Belmont University - College of Law

Follow this and additional works at: https://repository.belmont.edu/lawfaculty

Part of the Legal Writing and Research Commons

Recommended Citation
31 Ohio Northern Univ. L. Rev. 359 (2005)
More Than the Camel's Nose: The Sarbanes-Oxley Act as Bad News for Lawyers, Their Clients, and the Public

TIMOTHY P. CHINARIS*

I. INTRODUCTION

Business executives, accountants, lawyers, and the general public have shown great interest in the Sarbanes-Oxley Act ("the Act") that was passed by Congress and signed into law by President George W. Bush in 2002. Designed as securities legislation, the Act reaches into areas of lawyer conduct, and the regulation of that lawyer conduct, that previously were the domain primarily of state supreme courts. Lawyers, law firms, and bar organizations have recognized that the concept of what it means to be an ethical lawyer has been altered by the Act. Related developments spawned by the Act's passage will continue to change the ethical landscape for many lawyers, even those who do not practice securities law.

This article offers an overview of this important area by asking and briefly answering three questions. First, where did the Sarbanes-Oxley Act come from? Second, what is the Act? Third, and most importantly for our purposes, why should lawyers care about the Act and its related developments?

II. WHERE DID THE SARBANES-OXLEY ACT COME FROM?

High-profile corporate scandals involving securities and the securities markets have generated much discussion and controversy in the past few years. Enron, Arthur Andersen, WorldCom, Global Crossing, Adelphia, Tyco, and even not-so-happy homemaker Martha Stewart have all entered our collective consciousness and become symbolic of perceived shortcomings in corporate governance and integrity.

The Sarbanes-Oxley Act was passed in response to these incidents of corporate misconduct. Congress passed the Act on July 25, 2002, by an almost unanimous vote. Five days later, on July 30, 2002, President Bush

* Associate Dean for Information Resources and Professor of Law, Thomas Goode Jones School of Law, Faulkner University. J.D., University of Texas 1984; M.L.I.S., Florida State University, 1996; B.S., Florida State University, 1977.

1. A June 29, 2005 search for "Sarbanes-Oxley Act" located more than 10,000 documents in Westlaw's "all news" database, approximately 6,700 documents in Westlaw's legal periodicals database, and a whopping 878,000 documents on the popular Internet search engine Google.

signed it into law. His signing statement noted that the Act "adopts tough new provisions to deter and punish corporate and accounting fraud and corruption, ensure justice for wrongdoers, and protect the interests of workers and shareholders." Although not mentioned by the president, the Act also affects the professional responsibilities of lawyers in a variety of ways.

III. WHAT IS THE SARBANES-OXLEY ACT?

A. Generally

The Sarbanes-Oxley Act brings major changes to the laws governing publicly traded securities. The Act is codified in titles 11, 15, 18, 28, and 29 of the United States Code and may be accessed at various Internet sites. The Act establishes or strengthens regulations that apply to corporate "issuers" of publicly traded securities, as well as to directors, officers, employees, auditors, and attorneys of issuers. Many of these changes are in the form of requiring the Securities and Exchange Commission (the "SEC") to issue final rules implementing the broader directives contained in the Act. Some of the key provisions contained in or required by the Act are highlighted below.

B. Stronger Corporate Governance and Oversight

1. The audit committee of an issuer’s board of directors must be "directly responsible" for hiring, compensation, and oversight of the outside auditor. It also must have authority to hire independent counsel and other advisers "as it determines necessary to carry out its duties." The audit committee of an issuer’s board of directors must be "directly responsible" for hiring, compensation, and oversight of the outside auditor. It also must have authority to hire independent counsel and other advisers "as it determines necessary to carry out its duties."6

2. Each member of an issuer’s audit committee must be an independent member of the board of directors.7

3. Specific citations are provided throughout these materials as those sections are discussed.


5. The Sarbanes-Oxley Act generally defines an "issuer" as "an issuer (as defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c)), the securities of which are registered under section 12 of that Act (15 U.S.C. 78l), or that is required to file reports under section 15(d) of that Act (15 U.S.C. 78o(d)) or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 (15 U.S.C. 77a et seq.), and that it has not withdrawn." 15 U.S.C.A. § 7201(a)(7). For purposes of the attorney professional standards section of the Sarbanes-Oxley Act, the definition of "issuer" also includes "any person controlled by an issuer, where an attorney provides legal services to such person on behalf of, or at the behest, or for the benefit of the issuer, regardless of whether the attorney is employed or retained by the issuer" but does not include "a foreign government issuer." 17 C.F.R. § 205.2(h).


7. Id. at § 301(m)(3)(A).
3. Each audit committee must establish a procedure that allows the issuer’s employees to anonymously submit their "concerns regarding questionable accounting or auditing matters."8

C. Increased Outside Auditor Independence

1. Outside auditors are prohibited from performing certain non-audit services contemporaneously with an audit, including:

   a.) bookkeeping or other services relating to the audit client’s accounting or financial statements;
   b.) design and implementation of financial information systems;
   c.) appraisal or valuation services;
   d.) management or human resources functions; and
   e.) legal services and expert services unrelated to the audit.9

2. The lead and review partners of an auditing firm must be changed after performing auditing services for an issuer "in each of the 5 previous fiscal years."10

3. A new conflict of interest regulation provides that an auditing firm may not perform auditing services for an issuer for at least one year after any audit firm employee who participated in auditing the issuer has been hired as a key financial officer for the issuer.11

4. A new Public Accounting Oversight Board has been created to oversee the audit of publicly traded companies.12

D. Enhanced or Additional Corporate Disclosures

1. Chief executive officers and chief financial officers of companies filing quarterly or annual reports under the Securities Exchange Act of 1934 must include specific certifications in each of those reports. Among other things, these officers must certify that:

   a.) the officer has reviewed the report;
   b.) based on the officer’s knowledge, the report does not contain any untrue statement of material facts or omit material facts necessary to make the report not misleading;

8. Id. at § 301(m)(4)(B).
9. Id. at § 201(a).
10. Id. at § 203(j).
12. Id. at § 101(a).
c.) based on the officer's knowledge, the financial information in the report fairly presents, in all material respects, the financial condition and results of operations of the company;

d.) the officer is responsible for, and has evaluated the effectiveness of, the company's internal controls; and

e.) the officer has disclosed to the company's auditors and board of directors' audit committee all significant deficiencies in the internal controls and any fraud involving management or employees who play a role in internal controls.  

2. Chief executive officers and chief financial officers of issuers also must make specific certifications in each periodic report filed by the issuer that contains financial statements. These officers must certify that:

a.) the report fully complies with named sections of the Securities Exchange Act of 1934; and

b.) the information in the report fairly presents, in all material respects, the financial condition and results of operations of the issuer. Knowingly or willfully filing a false certification is punishable by stiff criminal penalties (up to 10 years imprisonment and a fine of up to $1,000,000 for knowingly filing a false certification, and up to 20 years imprisonment and a fine of up to $5,000,000 for willfully filing a false certification).  

3. Issuers must make "plain English" disclosures to the public "on a rapid and current basis" of any additional information "concerning material changes in the financial condition or operations of the issuer." This includes any "trend and qualitative information" that the SEC by rule determines "is necessary or useful for the protection of investors and in the public interest." 

4. Annual and quarterly reports of publicly traded companies must disclose all material off-balance sheet transactions, obligations, and relationships that "may have a material current or future effect" on the company's financial condition.

13. Id. at § 302(a).
14. Id. at § 906.
15. Id. at § 409(i).
16. Id. at § 401(a)(j).
5. Each issuer must disclose in its periodic reports whether its audit committee has at least one member who is a "financial expert" (as defined by the SEC). If the audit committee does not have such an expert, the report must disclose the reasons why it does not.17

E. Greater Insider Accountability

1. The reporting deadline for persons who are required to disclose changes of beneficial ownership of securities has been moved up to the second business day after the transaction (instead of the current requirement of the tenth day of the month after the trade took place).19

2. The conflict of interest provisions in the securities laws have been strengthened to generally prohibit personal loans to any director or officer of a publicly traded company.20

3. Issuers must disclose in their periodic reports whether they have adopted a code of ethics for senior financial officers. If an issuer has not adopted a code of ethics, the issuer must disclose the reasons why it has not.21

F. Assessment of Internal Corporate Controls

Annual reports must include an internal control report that, among other things, contains "an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting." The issuer's outside auditor must attest to and report on this assessment.22

18. Such persons include any person who is "directly or indirectly the beneficial owner of more than 10 percent of any class of [registered] equity security" and any person who is a "director or an officer of the issuer of such security." Id. at 403(a)(1).
19. Id. at § 403(a)(2)(B).
20. Id. at § 402(a)(2)(B).
21. Id. at § 406(a).
22. Id. at § 404.
G. Greater Civil and Criminal Penalties for Violations

1. The Act establishes criminal penalties for:

   a.) knowingly destroying, altering, or falsifying documents with the intent to obstruct a federal investigation or bankruptcy case;23
   b.) knowingly and willfully violating new requirements for retention of corporate audit records;24
   c.) corruptly altering, destroying, mutilating, or concealing a document or record with the intent to impair its integrity or use in an official proceeding;25 and
   d.) knowingly defrauding someone in connection with publicly traded securities or fraudulently obtaining money in connection with the purchase or sale of publicly traded securities.26

2. Penalties for willful violations of the Securities Exchange Act of 1934 by natural persons are increased from up to $1,000,000 and/or 10 years imprisonment to up to $5,000,000 and/or 20 years imprisonment. For other than natural persons, the penalties go from up to $2,500,000 to up to $25,000,000.27

3. Civil sanctions have also been enhanced:

   a.) the statute of limitations for securities fraud has been lengthened to 2 years after discovery of the facts constituting the violation or 5 years after the violation, whichever comes earlier;28 and
   b.) debts resulting from someone’s violations of securities laws are no longer dischargeable in bankruptcy.29

H. Whistleblower Protection for Corporate Employees and Others

1. Employees of publicly traded companies who are discharged, demoted, or otherwise harassed or discriminated against as a result of providing information or assistance in an investigation or proceeding regarding alleged violations of securities laws (or other

24. Id. at § 802(a)(1).
25. Id. at § 1102(c)(1).
26. Id. at § 807.
27. Id. at § 1106(2).
28. Id. at § 804(b).
federal laws prohibiting fraud on stockholders) now have a civil cause of action against the employer. Remedies may include compensatory damages, reinstatement, and litigation costs and fees.\textsuperscript{30}

2. Any knowing and intentional retaliation against any person who provides law enforcement officials with “truthful information relating to the commission or possible commission of any Federal offense” is punishable by a fine or up to 10 years in prison. Retaliation can include interference with someone’s “lawful employment or livelihood.” This provision protects anyone, not just employees of an issuer.\textsuperscript{31}

\textbf{I. Heightened Attorney Responsibilities}

1. Portions of the Act reflect the assumption that the conduct of issuers’ lawyers contributed to the problems that led to the Act’s passage. The Act addressed the perceived need to more strictly regulate these lawyers’ conduct by directing the SEC 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 in any way in the representation of issuers, including a rule—

a.) 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

b.) 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.\textsuperscript{32}

2. The rules considered and adopted by the SEC in compliance with the Act’s directives are discussed in Section IV below.

\textsuperscript{30} Id. at § 806(c)(2).
\textsuperscript{31} Id. at § 1107(e).
\textsuperscript{32} Id. at § 307.
3. It is unlawful for any officer or director of an issuer, "or any other person acting under the direction thereof," to take any action to fraudulently influence, manipulate, or mislead outside auditors.33

IV. WHY SHOULD LAWYERS CARE ABOUT THE ACT AND RELATED DEVELOPMENTS?

A. Generally

Only a true Rip Van Winkle of a lawyer could not be aware that the Sarbanes-Oxley Act is now the law of the land. Fewer lawyers, however, might appreciate the various levels on which the Act and its related developments could affect their practices and the legal profession. Some of these effects are direct and immediate, while others are less obvious or may present only potential concerns that might never be realized. These areas of concern—and, in many cases, risk—for lawyers are discussed below.

B. New Obligations for Lawyers’ Clients

As mentioned in Section III above, the Act creates or revises a number of obligations on the part of issuers and the officers, directors, auditors, and "insiders" of issuers. In order to properly advise their clients, lawyers for these affected entities and individuals must understand and be able to apply these new or changed regulations. The Act has raised the stakes by toughening the criminal and civil penalties for violations. Lawyers who fail to properly advise their clients regarding these regulations might open themselves up to legal malpractice claims.

C. New Obligations for Lawyers Practicing Before the SEC

Probably the most direct effect of the Act on the regulation of lawyer conduct springs from its section 307, which required the SEC 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 in any way in the representation of issuers." Specifically, the Commission was directed to promulgate rules requiring that such lawyers report evidence of "a material violation of securities law or breach of fiduciary duty or similar violation by the [issuing] company or any agent thereof" to the client company’s chief legal counsel ("CLO") or chief executive officer ("CEO"). If the CLO or CEO does not “appropriately respond” to the lawyer’s report, the lawyer must report the evidence to the audit

33. Id. at § 303(a).
committee of the board of directors, to a committee of independent directors, or to the board itself. This procedure has been called "reporting up the corporate ladder." Under this "up the ladder" approach, the lawyer's communications are made to appropriate officials within the corporate client, and so should remain protected by any applicable privilege.

The SEC responded to this legislative mandate by publishing for comment 2 proposed rules. The first rule, which may be called the "up the ladder rule," has now been finalized and is codified at 17 C.F.R. Part 205. (The final rule as adopted by the SEC alternatively permits a corporation's lawyer to make the required reports to an established "qualified legal compliance committee.") Having been adopted as required by section 307, this rule has the force and effect of law. The second proposed rule, which may be called the "noisy withdrawal rule," is still pending; it has been the target of much criticism and may or may not be approved in its proposed form. These two rules, and the concerns that they cause for many lawyers, are discussed below.

1. The "Up the Ladder Rule"

Simply stated, the "up the ladder rule" is designed to require in-house and outside lawyers who become aware of corporate wrongdoing to report it up the corporate chain of command. If the lawyer receives an appropriate response at any point along the line, his or her duty has been satisfied. (Alternatively, if the lawyer has reported the material violation to the client corporation's qualified legal compliance committee, the lawyer's reporting obligations have been satisfied and the lawyer has no further obligation to assess the issuer's response to the report.)

If a lawyer who initially reported to the CLO or CEO does not receive an appropriate response within a reasonable time, the lawyer must "explain his or her reasons" to the CLO, the CEO, and the directors to whom the lawyer reported. At that point, the "up the ladder rule" permits, but does not require, the lawyer to take a significant additional step. The rule states that the lawyer then "may reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably

34. The exact language of this part of section 307(2) of the Act is quoted in Section III.I.1., above.
37. Id. at § 205.6(a) provides: "A violation of this part by any attorney appearing and practicing before the Commission in the representation of an issuer shall subject such attorney to the civil penalties and remedies for a violation of the federal securities laws available to the Commission in an action brought by the Commission thereunder."
38. Id. at § 205.3(c)(1).
believes necessary” in order to: (1) “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”; (2) prevent the issuer from committing certain criminal acts (e.g., perjury); or (3) “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” (emphasis supplied).39

One of the rule’s underlying premises is a concept familiar to corporate lawyers: their client is the organization, rather than the individuals within it.40 This principle has long been expressed in ABA Model Rule of Professional Conduct 1.13(a), which provides: “A lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents.” Unfortunately, once one gets beyond this starting point, application of the rule is not at all simple. Several portions of the rule’s language leave important issues open to interpretation and, thus, to uncertainty.

First, the rule applies to “attorneys appearing and practicing before the Commission in the representation of an issuer” (emphasis supplied). While this includes actually representing an issuer in a proceeding or filing before the SEC, the rule stretches the definition far enough to include providing advice or preparation assistance regarding any document that is expected to be filed with the SEC.41 This could mean, for example, that a lawyer who merely provides a summary of a corporate client’s recent litigation activity for inclusion in one of the company’s required reports to the SEC has thereby become subject to these regulations.42 Furthermore, a lawyer need not even personally engage in any of these activities to be held to be practicing before the SEC. The rule expressly states that the supervisor of a lawyer who

39. Id. at § 205.3(d)(2)(iii).
40. Id. at § 205.3(a) provides:
   An attorney appearing and practicing before the Commission in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization. That the attorney may work with and advise the issuer’s officers, directors, or employees in the course of representing the issuer does not make such individuals the attorney’s clients.
41. Id. at § 205.2(a)(1)(i) provides that appearing and practicing before the SEC means:
   Providing advice in respect of the United States securities laws or the Commission’s rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document.
actually engages in these activities also will be deemed to be practicing before the Commission. If these types of indirect interaction with the SEC subject lawyers to the Act's requirements, its sweep is broad indeed. One might question whether such a broad definition goes beyond the mandate of Section 307 of the Act by purporting to regulate lawyers who are only tangentially involved in securities compliance matters (and who might have limited experience in the area).

Such an expansive view of which lawyers are required to take affirmative action in this area is quite outside of the norm of the state bar ethics rules that require lawyers to take action that may be potentially adverse to a client or is outside of the scope of what the lawyer was engaged to do for the client. These rules typically affect only those lawyers who are directly involved in the particular situation. Importantly, these rules usually are triggered by a lawyer's "knowledge" of certain information. In contrast, the "up the ladder rule" is triggered when a lawyer merely "becomes aware of evidence of a material violation by the issuer."

Second, the reporting standard is awkwardly phrased. A lawyer is required to report up the ladder when he or she has "material evidence of a material violation of securities law or breach of fiduciary duty or similar violation" by the client company. Evidence of a material violation is defined, using a grammatically questionable double negative, to mean "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur" (emphasis supplied). This may mean that a lawyer has the duty to report up the ladder only when there can be no reasonable question about whether a violation has occurred or will occur, or it may mean that something less triggers the reporting requirement.

43. 17 C.F.R. § 205.4(b) (2005) provides in pertinent part: "To the extent a subordinate attorney appears and practices before the Commission in the representation of an issuer, that subordinate attorney's supervisory attorneys also appear and practice before the Commission." Of course, this includes the issuer's chief legal counsel. Id. at § 205.4(a).

44. The SEC's assurances that it will not use this broad definition as a trap for unwary lawyers provides little comfort. See, e.g., "Lawyers Anxiously Discuss SEC's New Focus on Performance of Their Professional Duties," 20 LAW. MAN. PROF'L CONDUCT 597 (comments of SEC Deputy Enforcement Dir. Linda Thomsen). Such determinations necessarily will be made in hindsight, from the viewpoint of the agency rather than from that of the lawyer who was facing an uncertain situation at the time. The author's experience in the lawyer disciplinary arena shows that these types of "20/20 hindsight" determinations rarely work to the lawyer's benefit.

45. See, e.g., MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2005); id. at R. 3.3(a).


47. Id. at § 205.2(e).
Third, it is not at all clear what will be considered an "appropriate response" for purposes of a lawyer—or the SEC—being satisfied that the lawyer has complied with his or her obligations. Although the rule makes a lengthy attempt to define this term,\(^48\) it is clear that a lawyer who is accused by the SEC of failing to fulfill his or her duties under this rule will be open to second-guessing about whether the response to the lawyer's action really was an "appropriate" one.

A fourth concern is that the language of the rule might muddy the waters in connection with breach of fiduciary duty claims. The rule requires a lawyer to report "material violations," and in turn a material violation is defined to include "a material breach of fiduciary duty arising under United States federal or state law."\(^49\) It has been suggested that this might bring state law issues of fiduciary duties under the umbrella of the federal securities laws, which previously was not the case.\(^50\)

Finally, the most controversial provision of the "up the ladder rule" concerns the interplay between the rule and a lawyer's duty of confidentiality under the rules of professional conduct\(^51\) applicable in the jurisdiction where the lawyer is licensed. The rule expressly permits a lawyer to disclose confidential information to the SEC if the lawyer's attempts to prevent or rectify a material violation through the up the ladder approach are not met with an "appropriate response" within a reasonable period of time. The problem lawyers might face is that this provision is inconsistent with the confidentiality provisions of some states' rules of professional conduct.

The rules of professional conduct of some states currently permit, or even require, a lawyer to reveal otherwise confidential information to prevent the commission of a future crime or fraud. A few permit or require disclosure of confidences to rectify the consequences of a client's past crime or fraud, but states with such rules are in the distinct minority.\(^52\) A lawyer who chooses to make a disclosure of confidential information as permitted by the SEC's "up the ladder rule" might be violating his or her confidentiality obligations as established in the rules of professional conduct for the jurisdiction in which

\(^{48}\) See id. at § 205.2(b).

\(^{49}\) Id. at § 205.2(i).

\(^{50}\) See Mannino, Edward, Lawyer Liability for Client Fraud: The Impact of Enron, WorldCom, and Other Corporate Wrongdoing, 14 PRACTICAL LITIGATOR, July 2003, at 27, 30.

\(^{51}\) The term "rules of professional conduct" is used here generically. Most states have adopted a version of the ABA MODEL RULES OF PROF'L CONDUCT, typically with some state-specific modifications. See http://www.abanet.org/cpr/mrpc/alpha_states.html (last visited June 29, 2005).

\(^{52}\) A comprehensive list of the states that permit or require disclosures to prevent future crimes or frauds or to rectify past ones is compiled at Report of the American Bar Association Task Force on Corporate Responsibility, n.89 (Mar. 31, 2003), available at http://www.abanet.org/buslaw/corporate_responsibility/final_report.pdf (last visited June 29, 2005).
the lawyer is licensed to practice law. This, in turn, could lead to civil liability for malpractice or breach of fiduciary duty if damages result from the lawyer's disclosure.

Through the "up the ladder rule," the SEC is actively encouraging lawyers to disclose confidential information to the possible detriment of their clients. This necessarily will have a chilling effect on the attorney-client relationship, at least from the standpoint of the client—which means that clients will be less likely to share information with the very legal counsel who could help them comply with the law. This effect, of course, is at odds with the intended purposes of the Act.

The SEC takes the position that the SEC regulations are federal law that preempts any contrary state law provisions. This position has yet to be tested in court. In the meantime, however, at least 2 state bar organizations have warned their members that the state rules of professional conduct, not the SEC's rules, must govern their conduct. Fortunately for lawyers in these states (and others), the confidentiality disclosures permitted by the "up the ladder rule" are permissive rather than mandatory disclosures—a lawyer "may" disclose, but is not required to do so. This fact helps minimize the problems that flow from inconsistent rules. Such an escape valve, however, might no longer exist if the SEC decides to adopt its proposed "noisy withdrawal rule."

2. The Proposed "Noisy Withdrawal Rule"

The concerns that many lawyers have expressed about operation of the "up the ladder rule" are dwarfed by the outcry over the SEC's proposed "noisy withdrawal rule." At the same time the SEC published for comment the rule that ultimately was adopted as the "up the ladder rule," it sought comments on a rule that went even further in terms of disclosure of confidential information—the "noisy withdrawal rule." That comment period was later formally extended to April 7, 2003, after the SEC added a proposed alternative reporting procedure in response to some earlier comments on its original proposal. The SEC has yet to take final action on the "noisy withdrawal rule" or its alternative.


55. Id.
The proposed "noisy withdrawal rule" specifically addresses the duty of a lawyer who has reported a material violation up the ladder but has not received an appropriate response within a reasonable time. The proposed rule distinguishes between outside lawyers and in-house counsel. The following duties apply to lawyers who initially reported the evidence of material violations to the CLO or CEO; they do not apply if the lawyer reported to the client's qualified legal compliance committee.

In situations where the material violation has not yet occurred or is ongoing, and is likely to cause substantial financial or property harm, outside counsel must withdraw from the representation, promptly give written notice of the withdrawal to the SEC "indicating that the withdrawal was based on professional considerations," and "promptly disaffirm[ing] to the Commission" any opinion or representation "that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading." The proposed rule, however, does not specify the scope of any such withdrawal. For example, would withdrawal be required from all matters the lawyer is handling for that client, or only from the specific matter in question?

In situations where the material violation has not yet occurred or is ongoing, and is likely to cause substantial financial or property harm, in-house counsel are not required to resign their employment, but they must notify the SEC in writing of their intent to disaffirm an opinion or representation "that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading," and then must follow through and promptly disaffirm in writing.

In situations where the material violation has already occurred and is not ongoing, the duties referenced above, for both outside and in-house counsel, are permissive rather than mandatory (the proposed rule uses "may" rather than "shall"). Additionally, any lawyer hired to replace a lawyer who has withdrawn from the representation must be informed by the issuer's CLO that the prior lawyer withdrew "based on professional considerations."

As might be expected, many lawyers and lawyer groups are concerned that, if adopted, this "noisy withdrawal rule" could place a lawyer who practices before the SEC in a situation where complying with the SEC-
mandated disclosure of confidential information would violate the rules of professional conduct applicable in the state where the lawyer is licensed. And, as noted in Section IVC.1 above, some state bar organizations are notably unswayed by the SEC's preemption arguments—thus placing these lawyers in an even more uncomfortable position.

A very controversial provision in the proposed rule states: "The notification required to the Commission prescribed by this paragraph (d) does not breach the attorney-client privilege."\(^6\) The law in this area, however, is not as well-settled as the SEC apparently believes. There have been instances where a corporation's disclosure of otherwise-privileged information to the SEC, even pursuant to a confidentiality agreement, has been deemed to be a waiver of the corporation's attorney-client or work product privileges for other purposes.\(^6\) A lawyer who makes a disclosure in reliance on the SEC's position could end up losing an important privilege that otherwise might protect a client.

The SEC apparently attempted to address some of these concerns by seeking comment on an alternative reporting proposal. This alternative does not require the reporting lawyer to notify the SEC of the lawyer's withdrawal from the representation or to disaffirm any opinions or documents the lawyer provided to the SEC.\(^6\) (The lawyer's withdrawal from the representation would still be required.) Instead, the issuer would be required to promptly give the SEC written notice of the lawyer's withdrawal "and the circumstances related thereto."\(^6\) This alternative proposal also would permit, but not require, the lawyer to inform the SEC that the lawyer had given the required notice to the issuer in the event that the issuer has not so notified the SEC.\(^6\)

Even this alternative proposal presents problems for lawyers and their clients. At a minimum, it puts the lawyer in the position of policing the client to see if the client has appropriately satisfied the SEC's interpretation of the reporting requirements. Under either proposal, the attorney-client relationship would be negatively affected. Clients will be less willing to confide in their

---

63. *Id.* (to be codified at 17 C.F.R. § 205.3(d)(3)).


65. Implementation of Standards of Prof'l Conduct for Att'y's, 68 Fed. Reg. 6,324, 6,329-30 (proposed Feb. 6, 2003) (to be codified at 17 C.F.R. § 205.3(e)).

66. *Id.*

67. *Id.* (to be codified at 17 C.F.R. § 205.3(f)).
lawyers because they can expect that any notification of attorney withdrawal in compliance with a "noisy withdrawal rule" would almost certainly trigger an SEC investigation. Such an investigation, in turn, will result in adverse market consequences for the issuer client, and perhaps potential litigation against the client as well.

3. Regulatory Rule Changes in Other Areas of Law Practice

It is likely that the SEC's willingness to aggressively regulate the conduct of lawyers practicing before it, even to the extent of adopting regulations that may conflict with state bar standards, will encourage other administrative agencies to be bolder in this area. For example, the United States Patent and Trademark Office has published for comment proposed Rules of Professional Conduct that would replace its Code of Professional Responsibility.68

4. Changes to ABA and State Rules of Professional Conduct

One might ask how the ABA Model Rules of Professional Conduct square with the obligations imposed on lawyers by the Act and the related SEC regulations. The ABA has scrambled to make its rules more responsive to the concerns that prompted the passage of the Act. In a move with potentially wide-ranging implications for many lawyers, in August 2003 the American Bar Association reacted to the passage of the Act (and to the causes that prompted the Act's passage) by amending two key provisions of its Model Rules of Professional Conduct.

Rule 1.13, "Organization as client," was amended to essentially require69 that a lawyer go up the corporate ladder to protect the interests of an organizational client and to further provide that, if the corporate authorities are unresponsive, the lawyer may (but is not required to) disclose confidential information outside the corporate client, "but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization" (emphasis supplied).70

Perhaps more significantly, Rule 1.6, "Confidentiality of information," was revised to add new exceptions to a lawyer's duty of confidentiality. Model Rule 1.6 now permits, but does not require, lawyers to reveal confidential information in order to prevent a client "from committing a crime


69. The prior version of ABA MODEL RULES OF PROF'L CONDUCT R. 1.13 encouraged but did not require the "up the ladder" approach.

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 and to "prevent, mitigate or rectify substantial injury to the financial interests or property of another" that has resulted from the client's use of the lawyer's services in committing a crime.71

Many states are now reviewing their own rules of professional conduct to determine whether their rules should be amended to adopt the ABA's Act-related changes.72 States that do not currently have rules consistent with the ABA's changes are likely to face pressure to conform.

5. Expanded Concerns about Lawyers' Liability

Does the Act, or the related SEC regulations, expand the bases on which lawyers might be held liable to their clients—or others—for malpractice, breach of fiduciary duty, or other civil or criminal claims? Careful analysis indicates that the answer is "yes," despite the SEC's announced intention to the contrary.

The rules already adopted by the SEC pursuant to Section 307 of the Act73 state that "Nothing in this part [17 C.F.R. Part 205] is intended to, or does, create a private right of action against any attorney, law firm, or issuer based upon compliance or noncompliance with its provisions."74 This language might sound comforting, but one must remember that the Preamble to the ABA Rules of Professional Conduct (which has been adopted by many states as part of their rules of professional conduct) says essentially the same thing.75 Yet, courts have permitted plaintiffs in legal malpractice cases to use the violation of a rule of professional conduct to support a malpractice claim.76

71. Id. at 1.6, n.2.
72. The ABA Joint Committee on Lawyer Regulation has established a web site that tracks states' activity in response to the ABA "Ethics 2000 Commission" changes to the MODEL RULES OF PROF'L CONDUCT; it is at http://www.abanet.org/cpr/jclr/jclr_home.html (last visited Apr. 3, 2004). Some of these states are reviewing the Aug. 2003 changes prompted by the Act, as well.
74. 17 C.F.R. § 205.7 (2005).
75. The "Scope" portion of the Preamble states, in pertinent part:
Violation of a Rule [of Professional Conduct] should not itself give rise to a cause of action against a lawyer nor should it create any presumption in such a case that a legal duty has been breached. In addition, violation of a Rule does not necessarily warrant any other nondisciplinary remedy, such as disqualification of a lawyer in pending litigation. The Rules are designed to provide guidance to lawyers and to provide a structure for regulating conduct through disciplinary agencies. They are not designed to be a basis for civil liability.
76. See Restatement (Third) Of the Law Governing Lawyers § 52, comment (f) and cases cited thereunder. In Florida, for example, violation of the rules of professional conduct does not create a cause of action but may be used as "some evidence as negligence." Pressley v. Farley, 579 So.2d 160, 161 (Fla.
No great imagination is needed to see that violations of the SEC's regulations could be put to a similar use.

In terms of the duty of competent representation owed to clients, the Act clearly creates new areas of concern for corporate lawyers. For example, if a lawyer's failure to determine and report evidence of "material violations" should redound to the detriment of the client or others, the lawyer could be liable for malpractice or perhaps breach of fiduciary duty. Or, a lawyer's disclosure of confidential client information in an attempt to comply with the SEC's regulations could lead to a breach of fiduciary duty claim by the corporation or its shareholders against the lawyer.77

In-house lawyers for issuers have additional concerns of their own under the Act. If an in-house lawyer participates (e.g., receives information, investigates, advises, or takes part in disciplinary or other action) in the issuer's action against an employee who is later deemed a "whistleblower" under the Act, he or she may be liable for civil or criminal penalties.78

Additionally, some of the Act's general provisions for liability would apply to anyone, including outside or in-house counsel. For example, the Act makes it a crime for anyone to knowingly destroy, alter, or falsify documents with the intent to obstruct a federal investigation or bankruptcy case.80

Finally, these concerns about the heightened likelihood of lawyer liability are exacerbated by the fact that the Act's "reporting up" provisions might actually result in a corporation's lawyer being less aware of critical information than he or she might be now. The reporting obligations might undermine the necessary free flow of information between corporate representatives and the corporation's lawyers. This result ill serves lawyers and their clients.

6. Other Effects within Law Firms and Corporate Legal Departments

Perhaps on a positive note for lawyers, they are not excluded from the protection of the "whistleblower" provisions of the Act. An in-house counsel who suffers retaliation for providing the SEC with information about the


77. This possibility is discussed in Ethics Alert: The New SEC Attorney Conduct Rules v. California's Duty of Confidentiality, supra note 42.


79. See id. at § 1107.

80. Id. at § 802(a).
corporate client’s possible wrongdoing is authorized to bring an action against the employer for civil remedies under Section 806 of the Act.\textsuperscript{81}

Over the years, some in-house counsel have sued their employers under state law retaliatory discharge claims, with mixed results.\textsuperscript{82} The advent of the statutory protection provided by the Act might strengthen the “public policy” argument in favor of permitting in-house counsel to maintain these claims in situations outside the scope of the Act’s reach.

Similarly, an outside counsel who suffers adverse employment action at the hands of his or her employer law firm in connection with reporting activity contemplated by the Act is likely to assert that public policy supports the existence of wrongful discharge liability on the part of the law firm.\textsuperscript{83}

Ironically, the very first reported “whistleblower” case under the Act involved lawyer conduct—albeit somewhat indirectly.\textsuperscript{84} After non-lawyer David Welch was discharged from his position as a bank’s chief financial officer, he sued the bank under the retaliatory discharge provisions of the Act.\textsuperscript{85} The bank’s defense was that Mr. Welch was not fired for whistleblowing activity, but for failing to meet with the bank’s executives, lawyers, and outside auditors without his personal counsel with him.\textsuperscript{86} The bank asserted that its attorney-client privilege would be waived if Mr. Welch’s personal lawyer attended.\textsuperscript{87} The author rendered an expert opinion to the effect that the bank’s position was spurious. The administrative law judge ultimately decided in favor of Mr. Welch, ordering him reinstated to his former position with back pay, in addition to awarding him fees and costs.\textsuperscript{88}

7. Potential Effect on Attorney-Client Privilege

Some concerns regarding the effect that the SEC’s “up the ladder rule” and its proposed “noisy withdrawal rule” could have on the attorney-client privilege are mentioned in Sections IVC.1 and 2, above. It is apparent that the

\begin{footnotes}
\item[81.] Id. at § 806.
\item[83.] Such a case might be brought under a claim similar to that asserted in Wieder v. Skala, 609 N.E.2d 105 (N.Y. 1992) (lawyer discharged for allegedly failing to follow employing law firm’s directives and thereby violating professional ethics rules has cause of action against firm for breach of contract; ethical practice of law is an implied term of the contract).
\item[85.] Id.
\item[86.] Id.
\item[87.] Id.
\item[88.] Id.
\end{footnotes}
Act and the related SEC rules are generating pressures that may chip away at the time-honored protections offered by the attorney-client privilege.

The attorney-client privilege typically protects communications concerning past acts about which a client (or potential client) seeks legal advice. In contrast, the privilege does not apply to legal advice sought for the purpose of committing a future crime or fraud. Disclosure of otherwise-privileged communications can waive the privilege. Under the “up the ladder rule,” a lawyer may choose to make a disclosure concerning a client’s past acts in fear that someone may rely on it and suffer harm in the future, which could result in a waiver of the privilege concerning that matter. The “noisy withdrawal rule” can create privilege problems as well. When a lawyer notifies the SEC of his or her withdrawal, the SEC is likely to seek proof of the lawyer’s compliance with the up-the-ladder requirements. This will put pressure on the lawyer and the client to disclose otherwise-privileged material. Furthermore, the SEC’s alternative proposal would result in public disclosure of the withdrawal “and the circumstances relating thereto,” again possibly resulting in loss of the privilege.

Additionally, regulated companies are getting increasing pressure from government regulators to turn over privileged materials as a demonstration of their “cooperation” with the government. Turning over these materials can result in a waiver of the privilege on those materials, or even on all materials relating to the same subject matter. This adds to the chilling effect that makes company personnel less likely to disclose these things to the company’s lawyers in the first place.

Finally, considering the SEC’s position that its regulations preempt any contradictory state law, it is easy to imagine what might happen if the present regulations do not have the desired effect of ending corporate wrongdoing. The SEC might attempt expand the reach of its regulations, ostensibly under the directives in Section 307 of the Act, in a way that further erodes the attorney-client and work product privileges by requiring, for example, an issuer’s lawyer to report past violations by the issuer.

8. The “Big Gorilla”—The Push Toward Nationalization of Lawyer Regulation

Perhaps the most far-reaching possible effect of the Act will be to increase the pressure for a “nationalization” of lawyer regulation. As more

89. See Implementation of Standards of Prof’l Conduct for Att’ys, supra note 65.
90. Implementation of Standards of Prof’l Conduct for Att’ys, 68 Fed. Reg. 6,324, 6,327-28 (proposed Feb. 6, 2003) (to be codified at 17 C.F.R. § 205.3(d)(3)).
federal agencies attempt to promulgate regulations that are inconsistent with state rules of professional conduct, the calls for a national standard of lawyer conduct will grow louder. The effect of such calls clearly has been felt in the area of "multijurisdictional" law practice—following the ABA’s urging, many states are rushing to make it easier for a lawyer licensed in one state to practice law in other states, where he or she is not licensed. These pressures, in turn, may invigorate the proponents of initial bar admission on the national level, instead of the current state-governed arrangement. Regardless of what one might think about the desirability of such "nationalization" of law practice and admissions standards, it is undeniable that this would be a major change to the system currently in place.

A serious, related problem is a move away from judicial regulation of lawyers. Our system of government is based on a separation of powers, where each of the three branches of government has its role to play. An independent judiciary is a key part of the balance of the branches. The persons who make the laws are not supposed to be the same ones who interpret and apply them in our court system. Lawyers, as “officers of the court,” are an integral part of the court system. Lawyers often challenge government action, including laws passed by the legislative branch. Lawyers must have a measure of independence in order to be able to do this effectively—which is why they are typically regulated by the judiciary of each state, rather than directly by the state legislature.

The Act, and the SEC rules it has spawned, are a challenge to continued judicial regulation of lawyers. The SEC has taken the position that its rules trump state ethics codes, despite the lack of any clear preemption in the Act itself. This puts lawyers in the awkward, dangerous position of being regulated by an entity other than that which licensed them to practice law. The SEC essentially acts as a prosecutorial body but at the same time regulates the conduct of the lawyers who are defending their clients in cases brought by the SEC—to the obvious detriment of the lawyers’ clients. It is inappropriate to use regulatory power over lawyers for this purpose.

92. For a discussion of “nationalization” in the area of legal ethics, see Fred C. Zacharias, Federalizing Legal Ethics, 73 Tex. L. Rev. 335 (1994).
V. Conclusion

The Sarbanes-Oxley Act was enacted as a response to serious problems of corporate wrongdoing. This goal is laudable, of course. Like many positive goals, however, this one is subject to the "law of unintended consequences." The Act contains varied measures aimed at publicly traded companies and the officers, directors, employees, auditors, and lawyers of those companies. Lawyers and bar organizations must carefully scrutinize the regulations already adopted by the Securities and Exchange Commission pursuant to the Act's directives, because the confidentiality disclosures urged by the SEC may be at odds with the rules governing lawyer conduct in individual states. Moreover, the Commission's assessment of the non-effect of such disclosures on the attorney-client and work product privileges is questionable, to say the least. The Commission's proposed "noisy withdrawal rule," if enacted, could raise even more serious concerns in these areas. All of these developments are likely to drive a wedge of suspicion and distrust between lawyers and clients, making it more difficult for lawyers to help ensure their clients' compliance with the law. This, in turn, will ultimately hurt the public that relies on compliance by corporate issuers of securities.

The fallout from the Act has affected other aspects of lawyer conduct regulation. Most notably, the American Bar Association has amended 2 of its key Model Rules of Professional Conduct (Rule 1.6 concerning confidentiality and Rule 1.13 concerning representation of corporate clients) to more closely conform to the dictates of the Act and the related SEC regulations. State bars whose rules differ from the ABA's models are likely to follow suit and revise their rules as well. Other consequences of the Act may include expanded lawyer liability on both civil and criminal fronts. In the final analysis, the Act and its related developments may change the bar admission and lawyer regulation models to those consistent with a "nationalized" law practice that is subject to legislative, rather than judicial, oversight. All lawyers, not just those who represent publicly traded companies, will be well advised to closely follow these developments.