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Bring on 'Da Noise: The Sec's Proposals Concerning Professional Conduct for Attorneys Under Sarbanes-Oxley

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BRING ON 'DA NOISE: THE SEC'S PROPOSALS CONCERNING PROFESSIONAL CONDUCT FOR ATTORNEYS UNDER SARBANES-OXLEY

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ABSTRACT

In the wake of Enron's and numerous other corporate scandals, Congress enacted the Sarbanes-Oxley Act, which empowered the Securities and Exchange Commission (the Commission) to establish rules of professional conduct for attorneys who appear before it. In November 2002, the Commission released a proposal where attorneys would be required to report perceived violations of corporate governance and Commission rules "up-the-ladder." Additionally, if the company failed to make an appropriate response, the attorney would be required to make a "noisy withdrawal." After an onslaught of comments against the proposal, the Commission issued an alternative proposal for comment.

Under the alternative rule, the issuer, rather than the attorney, would be responsible for notifying the Commission of an attorney's withdrawal. The alternative rule has sparked a fair amount of controversy. Many support the rule as consistent with the Commission's duty under Section 307 of the Sarbanes-Oxley Act and necessary to effectuate "up-the-ladder" reporting. Others oppose the alternative rule because they believe the rule is in conflict with attorney-client privilege rules.

The alternative rule will aid in the restoration of market integrity by granting corporate attorneys the ability to call public attention to violations of securities laws without destroying the attorney-client privilege. Because the reason for adopting rules concerning professional conduct of attorney is ultimately to protect the investing public, placing the burden of disclosure on the issuer, rather than the attorney, will result in sufficient disclosure to put the public on notice of serious problems. As a result, corporate executives and accountants will be less likely to enter into fraudulent transactions on behalf of the issuer.

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I. INTRODUCTION

The collapse of Enron and numerous other corporate scandals of late have delivered an immense blow to consumer confidence and the "integrity of the securities and other markets that make American capitalism work."[1] Investors no longer trust corporations or their highly compensated executives. Corporate executives, however, are not solely to blame. As evidenced in the obstruction of justice charges against Arthur Andersen, the accountants entrusted with auditing corporations were easily swayed by the power of the almighty dollar. Along with greedy executives and less-than-honest accountants, the frauds that these companies perpetrated could not have been accomplished without the assistance of lawyers.[2] Corporate transactions require the work of lawyers. Thus, without significant reforms to the rules of professional responsibility of lawyers, other reforms will have no significant impact.[3]

In response to the corporate scandals and behavior of lawyers involved, the American Bar Association convened a Task Force on Professional Responsibility to consider revisions to the Model Rules. In its Preliminary Report, the Task Force states:

> [E]videnced by recent failures of corporate responsibility, the exercise by such independent participants of active and informed stewardship of the best interests of the corporation has in too many instances fallen short. Unless the governance system is changed in ways designed to encourage such active and informed stewardship, . . . public trust and investor confidence in the corporate governance system will not be restored.[4]

Thus, the rules that govern attorney behavior must be adjusted to restore confidence and integrity to the marketplace.

The Securities and Exchange Commission (the Commission) is empowered to prescribe "minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in

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[1]Roger C. Crampton, *Enron and the Corporate Lawyer: A Primer on Legal Ethical Issues*, 58 BUS. LAW. 143, 144 (2002).

[2]*Id.*

[3]*Id.*

[4]ABA Task Force on Corporate Responsibility, *Preliminary Report of the American Bar Association Task Force on Corporate Responsibility*, 58 BUS. LAW. 189, 194 (2002).

the representation of issuers."[5] Such standards must include requirements for "up-the-ladder" reporting, "requiring an attorney to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation" by notifying the chief legal officer or the chief executive officer.[6] If such officers do not respond, the attorney must report violations to the audit committee, a committee of independent directors, or the full board of directors.[7] The Sarbanes-Oxley Act thus required the Commission to address previously sacrosanct attorney-client privilege and confidentiality issues along with well-established means for attorney discipline.

In response, on November 6, 2002, the SEC Commissioners voted to adopt a rule that significantly affected attorney-client relationships.[8] As first proposed, the Commission mandated not only that attorneys report perceived violations of corporate governance and SEC rules "up-the-ladder"[9] but also that attorneys effect a "noisy withdrawal" by reporting to the Commission and withdrawing from the representation if the company did not make an "appropriate response."[10] The "noisy withdrawal" provisions were not mandated by the Sarbanes-Oxley Act; however, as the Commission stated in its press release, such requirements "are important components of an 'up the ladder' reporting system."[11]

In this proposed rule, "Implementation of Standards of Professional Conduct for Attorneys" dated November 21, 2002 [12] (the First Proposed Rule), the Commission stated that "while the Commission has opined on a case-by-case basis that lawyers appearing and practicing before the Commission have an obligation to report corporate misconduct to appropriate officers and directors, it has not adopted comprehensive standards directing attorneys to report instances of misconduct."[13] Under

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[5]Sarbanes-Oxley Act of 2002, 15 U.S.C. § 7245 (2002).

[6]Securities and Exchange Commission, "Implementation of Standards of Professional conduct for Attorneys," 68 Fed. Reg. 6296 (Feb. 6, 2003).

[7]*Id.*

[8]SEC Proposes Rules to Implement Sarbanes-Oxley Act Provisions Concerning Standards of Professional Conduct for Attorneys, SEC News Release 02-158, 2002 WL 31474838 (S.E.C.) (Nov. 6, 2002).

[9]"The proposed rule would also provide an alternative system for reporting evidence of material violations." *See* 17 C.F.R. Part 205 (2002) (SEC Release Nos. 8150, 46868, 33-8150, 34-46868). Issuers may, but are not required to, establish a qualified legal compliance committee composed of "at least one member of the issuer's audit committee, and two or more independent members of the issuer's board" for the purpose of investigating reports of material violations made by attorneys. *Id.*

[10]*Id.*

[11]*Id.*

[12]*See supra* note 9.

[13]*Id.* at *5.

the First Proposed Rule, the Commission discussed the "noisy withdrawal" and disaffirmation obligations of an attorney who had not received an "appropriate response" from the issuer in instances of "material violation" of the Commission's rules.

The First Proposed Rule distinguished between an issuer's retained attorneys (those outside the issuer firm) and employed attorneys (those within the firm). Outside attorneys, who made reports but did not receive appropriate responses, were required to withdraw (with notice to the Commission) and disaffirm any previous, "tainted" work submitted to the Commission if the attorneys believed that the reported violation was ongoing or about to occur, and was likely to result in serious financial injury.[14] Inside attorneys acting under similar beliefs, however, while still required to disaffirm any tainted submissions, did not have to resign.[15]

Under the First Proposed Rule, when an attorney reasonably believed that a material violation had already occurred and would have no ongoing effect, the attorney was permitted to take similar steps as long as the attorney also reasonably believed that the reported material violation likely caused substantial injury to the financial interest of the issuer or investors.[16]

> Finally, an attorney formerly employed or retained by an issuer who reasonably believed that he or she had been discharged because he or she fulfilled the reporting obligation imposed by the First Proposed Rule was given the option, but was not required, to notify the Commission of his or her belief that he or she was discharged for reporting evidence of a material violation and also to disaffirm in writing any submission to the Commission that he or she participated in preparing that was tainted by the violation.[17]

The First Proposed Rule Release stated simply and emphatically that "[a] notification to the Commission under this section does not breach the attorney-client privilege."[18]

In discussing the "noisy withdrawal" proposal in the First Proposed Rule, the Commission logically stated:

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[14] *Id.* at *8.

[15] *Id.*

[16] *Id.*

[17] *Id.*

[18] *See* 17 C.F.R. Part 205 (2002). This view was hotly contested by many commentators.

> The limited disclosure involved in the "noisy withdrawal" required by Section 205.3(d) should provide such a powerful incentive for an issuer to take actions appropriate to prevent or rectify a material violation that such "noisy withdrawals" should be rare. Requiring such "noisy withdrawal" appears appropriate to protect shareholders and investors, where the reported material violation appears likely to result in substantial financial injury to the issuer or investors, by effectively requiring an issuer's directors to act and by virtually ensuring an immediate inquiry by the Commission if they do not.[19]

The hue and cry that followed the First Proposed Rule was loud and immediate. On November 25, 2002, "[t]hirty prominent securities lawyers . . . told the Securities and Exchange Commission in no uncertain terms that key portions of a proposed rule to mandate that public company lawyers report evidence of their client corporations' securities law violations would impair those lawyers' ability to render independent legal advice."[20] The letter, signed by former SEC Commissioner Edward H. Fleischman on behalf of himself and twenty-nine other lawyers, stated that "the rule proposal would 'demean and directly undermine' zealous representation."[21] What followed were hundreds of comments to the SEC,[22] the majority coming from attorneys. Many criticized the "noisy withdrawal" proposals.

On January 23, 2003, the Commission backed off its earlier stance of requiring or permitting "noisy withdrawal" to extend the period for comment on these particular rules. As it stated in its press release, "[g]iven the significance and complexity of the issues involved, including the implications of a reporting out requirement on the relationship between issuers and their counsel, the Commission decided to continue to seek comment and give thoughtful consideration to these issues."[23] The Commission is still considering the "noisy withdrawal" provisions. On January 23, 2003, the Commission also proposed an alternative to the "noisy withdrawal" rule, which would place the burden of reporting the attorney's withdrawal on the issuer, rather than the attorney.

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[19] *Id.*

[20] Securities Law Daily Highlights, Nov. 29, 2002.

[21] *Id.*

[22] The comments on the proposed rules that have been filed electronically are available at http://www.sec.gov/rules/proposed/s74502.shtml. At the time this article was submitted for publication, there were a total of 252 comments filed on the website. *Id.*

[23] Securities and Exchange Commission 03-13, 2003 WL 164827 (S.E.C.) (Jan. 23, 2003).

Under the alternative proposal, the attorney would not be required to disaffirm documents filed with the Commission. Instead, the issuer would disclose the attorney's withdrawal on Form 8-K, 20-F, or 40-F, as applicable. If the issuer failed to promptly submit such a filing, the attorney would be permitted to inform the Commission of the issuers' failure to disclose.[24]

The alternative "noisy withdrawal" rule has sparked a fair amount of controversy. Many support the rule as consistent with the Commission's mandate under Section 307 considering it necessary to effectuate the "up-the-ladder" reporting rule. The alternative proposal addresses the situation where an issuer inappropriately refuses to implement remedial measures. Numerous commentators, however, oppose the proposal because they feel the provision is in conflict with state ethics laws. These authors believe that the alternative proposal will aid in the restoration of market integrity by granting corporate attorneys the ability to call public attention to such dealings without destroying the attorney-client privilege. As a result, corporate executives and accountants will be less likely to enter into fraudulent transactions on behalf of the reporting company.

This article will argue that the alternative "noisy withdrawal" provision of the Commission rules, if implemented, will dissuade corporate executives from entering into fraudulent transactions. First, this article will discuss the objective of the provision, including the benefits and problems associated with requiring issuers to disclose an attorney's withdrawal. Second, the article will argue that the alternative provision will not affect attorney-client privileges or confidentiality principles. Third, the article will compare the disclosure requirements regarding auditors and the requirements under bankruptcy law to the proposed rule for attorneys.

II. THE ALTERNATIVE "NOISY WITHDRAWAL" RULE

The Commission's alternative "noisy withdrawal" rule places the burden of disclosure on the issuer.[25] In doing so, the Commission believes

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[24]Securities and Exchange Commission Proposed Rules, "Implementation of Standards on Professional Conduct for Attorneys," 68 Fed. Reg. 6324 (Feb. 6, 2003).

[25]Sections 205.3(d) through (f) provide the following:

> (d) *Actions required where there is no appropriate response within a reasonable time.*
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> (1) Where an attorney who has reported evidence of a material violation under paragraph (b) of this section rather than paragraph (c) of this section:
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> (i) Does not receive an appropriate response, or has not received an appropriate response in a reasonable time,
>
> (ii) Has followed the procedures set forth in paragraph (b)(3) of this section, and

that it has responded to the numerous concerns of the original "noisy withdrawal" rule. "Requiring issuers to report attorney withdrawals in a public filing with the Commission may also provide protection to investors by alerting them to the possibility of ongoing material violations by issuers."[26]

> The alternative proposal does not contain "noisy withdrawal" and disaffirmation requirements and requires attorney action only where the attorney reasonably concludes that there is substantial evidence that a material violation is

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> (iii) Reasonably concludes that there is substantial evidence of a material violation that is ongoing or about to occur and is likely to cause substantial injury to the financial interest or property of the issuer or of investors:
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> (A) An attorney retained by the issuer shall withdraw from representing the issuer, and shall notify the issuer, in writing, that the withdrawal is based on professional considerations.
>
> (B) An attorney employed by the issuer shall cease forthwith any participation or assistance in any matter concerning the violation and shall notify the issuer, in writing, that he or she believes that the issuer has not provided an appropriate response in a reasonable time to his or her report of evidence of a material violation under paragraph (b) of this section.
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> (2) An attorney shall not be required to take any action pursuant to paragraph (d)(1) of this section if the attorney would be prohibited from doing so by order or rule of any court, administrative body or other authority with jurisdiction over the attorney, after having sought leave to withdraw from representation or to cease participation or assistance in a matter. An attorney shall give notice to the issuer that, but for such prohibition, he or she would have taken such action pursuant to paragraph (d)(1) or (d)(2), and such notice shall be deemed the equivalent of such action for purposes of this part.
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> (3) An attorney employed or retained by an issuer who has reported evidence of a material violation under this part and reasonably believes that he or she has been discharged for so doing shall notify the issuer's chief legal officer (or the equivalent thereof) forthwith.
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> (4) The issuer's chief legal officer (or equivalent thereof) shall notify any attorney retained or employed to replace an attorney who has given notice to an issuer pursuant to paragraph (d)(1), (d)(2) or (d)(3) of this section that the previous attorney has withdrawn, ceased to participate or assist or has been discharged, as the case may be, pursuant to the provisions of this paragraph.
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> (e) *Duties of an issuer where an attorney has given notice pursuant to paragraph (d).* Where an attorney has provided an issuer with a written notice pursuant to paragraph (d)(1), (d)(2) or (d)(3) of this section, the issuer shall, within two business days of receipt of such written notice report such notice and the circumstances related thereto on Form 8-K, 20-F, or 40-F, as applicable.
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> (f) *Additional actions by an attorney.* An attorney retained or employed by the issuer may, if an issuer does not comply with paragraph (e) of this section, inform the Commission that the attorney has provided the issuer with notice pursuant to paragraph (d)(1), (d)(2) or (d)(3) of this section, indicating that such action was based on professional considerations.

See id. at 6335-36 (citation omitted).

[26] *Id.* at 6329.

> ongoing or about to occur and is likely to cause substantial injury to the issuer.[27]

Upon learning of evidence of a material violation, and after reporting such evidence "up-the-ladder" without appropriate response, the attorney retained by the issuer must notify the issuer in writing that his withdrawal is based on professional reasons. An attorney employed by the issuer must stop participating in any matter concerning the violation and must notify the issuer of his belief that the issuer has not taken appropriate measures.[28]

The Commission states that an objective for the alternative proposal "is to provide notice of such an event to both the Commission and the public without unduly intruding on the attorney-client relationship."[29] It accomplishes the Commission's objective and proves to be better than the original proposal of "noisy withdrawal." It is also much more likely to be accepted by the legal community.

A. *Benefits of the Alternative Proposal*

1. Increased Disclosure to Investors

The primary role of the Securities and Exchange Commission is to protect investors by requiring disclosure of company information. The Sarbanes-Oxley Act expressly requires rules to be "in the public interest and for the protection of investors."[30] The best way the Commission can protect investors is by increasing public disclosure of potential material violations of securities laws. The alternative "noisy withdrawal" provision fits squarely within the mission of the Commission by increasing company disclosure to investors. Thus, the rule empowers the investor to determine what the attorney's withdrawal means within the context of his or her personal investing objectives.

Without significant changes, the existing system of professional responsibility would continue to be inadequate in meeting the needs of the securities market. The alternative proposal is necessary to correct a long-

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[27]*Id.* at 6328.

[28]Securities and Exchange Commission Proposed Rules, "Implementation of Standards on Professional Conduct for Attorneys," 68 Fed. Reg. 6324, 6328 (Feb. 6, 2003).

[29]*Id.*

[30]Securities and Exchange Commission, "Implementation of Standards of Professional Conduct for Attorneys," 68 Fed. Reg. 6296 (Feb. 6, 2003).

standing deficiency in the enforcement of professional conduct of attorneys[31]—primarily, a lack of federal ethics rules.

The proposed rules seek to promote the investor protection goals of federal securities laws.[32] Sarbanes-Oxley "seeks to vindicate the public interest in compliance with laws protecting shareholders and other public investors."[33] In his comments, Professor Stephen Bundy noted that "the language and context of the statute both indicate that the preferred mechanism for achieving compliance is to activate mechanisms . . . through which the issuer and its managers can fulfill their obligations to ensure compliance with governing law."[34] Therefore, the primary benefit of the alternative rule is increased disclosure by the issuer. Such disclosure is best facilitated by the issuer, rather than the individual attorney or law firm involved, because the issuer is already responsible for disclosure of its business practices. It seems to be a natural progression to require the issuer to report the withdrawal of counsel under the alternative proposal.

2. Uniform Professional Conduct Standards

The "up-the-ladder" reporting rules and the alternative proposal offer a federal standard for attorneys and issuers appearing before the Commission. Attorneys appearing and practicing before the Commission should be regulated by uniform federal standards.[35] Securities law creates a national system upon which the world economy depends. The Commission "is responsible for the enforcement of securities laws, and such enforcement should not leave a realm of conduct with such a strong influence to the states."[36]

The alternative rule is promulgated under a federal statute. Additionally, the rules provide a federal standard of professional conduct. Therefore, the fact that the Commission is drafting rules under a federal

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[31] Comments of William H. Simon, "Proposed Rules on Standard of Professional Conduct For Attorneys under Section 307 of the Oxley-Sarbanes Act," Dec. 13, 2002.

[32] Comments of Stephen McG. Bundy, "Standards of Professional Conduct," Oct. 14, 2002.

[33] *Id.*

[34] *Id.*

[35] *Id.*

[36] Bundy Comments, *supra* note 32. Some states, however, may resist a movement toward a uniform federal standard, desiring instead to stringently enforce their own reporting and disclosure rules. For instance, "The Washington State Bar Association is warning its corporate lawyers not to disclose client information allowed by new Securities and Exchange commission regulations unless such disclosures are also permitted by the state's own professional conduct rules." Mark Hansen, *State Fights the SEC*, Aug. 29, 2003, *available at* http://www.abanet.org/journal/ereport/au29sec.html.

statute, Sarbanes-Oxley, may mean that there is an implied partial preemption of state ethics rules.

A federal standard is necessary for the Commission to regulate in an intelligible, coherent manner.[37] The transactions that the Commission regulates involve multiple states. When an ethical issue arises, the choice of law provisions that determine which state's ethics rules apply to such interstate transactions are sometimes ambiguous and often capricious. For example, the rules typically default to the jurisdiction where the attorney is licensed. The licensing jurisdiction, however, should not be determinative over federal matters.[38]

Therefore, by implementing a federal standard of professional conduct and increasing public disclosure of potential violations of securities laws, the alternative proposal is a beneficial addition to the guidelines that govern securities industry professionals and issuers.

B. *Problems With the Alternative Proposal Voiced by Commentators*

Despite its potential benefits, the alternative "noisy withdrawal" proposal still suffers from several problems in the eyes of commentators. First, the proposed rule fails to clarify what happens when an attorney responds unreasonably. Second, the rule does not address what happens if the evidence has been referred to the issuer's qualified legal compliance committee. Third, the rule places no limits on an attorney's obligation to withdraw. Fourth, the proposal does not provide for instances where the issuer is permitted not to disclose the attorney's withdrawal. Fifth, the rule does not prevent the issuer from making a preemptive discharge of the attorney. Finally, the alternative proposal does not specify whether disclosure to the Commission will be public or private.

1. Unreasonable Attorney Withdrawal

The first potential problem is the attorney who withdraws unreasonably or overly hastily. There is a potential problem that an attorney may withdraw unnecessarily and to the detriment of the issuer for fear of losing his license to practice. While an attorney will have the duty

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[37]*See* Remarks by Senator Michael Enzi, 148 Cong. Rec. at S6555:

I am usually in the camp that believes States should regulate professionals within their jurisdiction. However, in this case, the [s]tate bars as a whole have failed. They have provided no specific ethical rule of conduct to remedy this kind of situation. Even if they do have a general rule that applies, it often goes unenforced.

[38]Simon Comments, *supra* note 31.

to withdraw under certain circumstances, those circumstances might be rare. The attorney must exhaust the "up-the-ladder" reporting before withdrawing. Therefore, the vast majority of violations will be rectified within the walls of the issuer.

The few instances where "up-the-ladder" reporting is not enough will require the withdrawal of the attorney. By requiring the issuer to disclose the withdrawal of an attorney, however, the issuer has the opportunity to explain the circumstances of the withdrawal. An unreasonable withdrawal will be explained by the issuer. Thus, in the rare case of an overzealous attorney who withdraws prematurely, the issuer will retain the power to disclose the withdrawal in its own words—not the words of the withdrawing attorney, as in the originally proposed "noisy withdrawal" rule.

2. The Role of the Qualified Legal Compliance Committee

The second potential issue arises when the evidence of a material violation has been referred to the issuer's qualified legal compliance committee (a QLCC). A QLCC is a committee of independent directors with the requisite authority to initiate an investigation and recommend appropriate action for the issuer to take. The rule would not apply to attorneys who reported evidence of material violations to an issuer's QLCC. The rule fails to explain, however, whether an exemption also applies to an attorney who reports a material violation to the chief legal officer or the chief executive officer who, in turn, refers the report to the QLCC.

Commentators have argued that attorneys in this situation should be exempt from the rule.[39] In theory, an attorney has responded appropriately by reporting "up-the-ladder." Whether the attorney must withdraw will depend on the individual circumstances and how the QLCC responds. Therefore, while the rule does not expressly address this sort of situation, the withdrawal of an attorney and the subsequent disclosure by the issuer will be determined on a case-by-case basis.

3. Limits on the Obligation to Withdraw

The third issue concerns whether there are limits on the attorney's obligation to withdraw. Commentators have noted that "an unlimited withdrawal obligation would be unreasonable and unduly disruptive to

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[39]Comments of Skadden, Arps, Slate, Meagher & Flom, LLP, "Re: Proposed Rule: Implementation of Standards of Professional Conduct for Attorney," Apr. 1, 2003, *at* http://www.sec.gov/rules/proposed/s74502/skadden1.htm.

companies that retain law firms to handle a diverse array of matters, many of which are unrelated to the securities laws, fiduciary duties or similar laws."[40] The law firm of Skadden, Arps has noted that if the attorney must "withdraw from all matters in which it represents the issuer, a significant portion of the issuer's legal work could come to a standstill and cause irreparable harm to the issuer and its shareholders."[41]

As an alternative, Skadden, Arps proposes that the rule require withdrawal only from matters where the material violation relates and matters where the attorney is appearing and practicing before the Commission.[42] Due to the complexity and breadth of securities law, however, any matter related to the issuer may be related to a material violation; separating matters when an attorney may still participate will be extremely difficult. Additionally, disclosure of the partial withdrawal of an attorney may mask significant violations by an issuer. Therefore, if an attorney is in a situation where he must withdraw, such withdrawal must be complete.

4. Instances When Disclosure is Not Required by Issuer

The fourth issue is whether there are circumstances where the issuer is permitted not to disclose the attorney's withdrawal. Under the alternative proposal, the issuer must disclose any withdrawals related to the issuer's failure to respond to "up-the-ladder" reporting of material violations of securities laws. The attorneys must make judgments as to whether they are aware of evidence of material violations. They must also determine whether the issuer has responded appropriately. These judgments will be difficult to make and may run the risk of being second-guessed by the Commission.[43] Once these decisions are made, however, the issuer will have the responsibility to report the withdrawal if it relates to a material violation. The issuer will not have the opportunity to pick and choose which attorney-withdrawals it will disclose. It must disclose all attorney-withdrawals surrounding potential material violations.

5. Preemptive Strikes Against the Potential Withdrawal of Attorney

The fifth issue is whether the rule will prevent the issuer from preemptively discharging an attorney before he has the opportunity to

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[40] *Id.*

[41] *Id.*

[42] *Id.*

[43] Skadden, Arps Comments, *supra* note 39.

withdraw. Under the current proposal, there is no provision that prevents an issuer from discharging the attorney before he can withdraw, thereby avoiding the responsibility of disclosure. This is an issue that the Commission must address.

6. Whether the Disclosure Must Be Private or Public

The Commission requested comments on whether the issuer's disclosure of an attorney's withdrawal must be made publicly or confidentially to the Commission. The law firm of Sullivan & Cromwell believes that disclosure should be confidential so that "the issuer and the Commission can come to an understanding regarding the relevant facts free of an atmosphere of turmoil caused by disclosure to the public."[44] This private disclosure to the Commission, however, fails to further the goal of Sarbanes-Oxley to promote transparency in corporate operations. The withdrawal of an attorney must be disclosed publicly if the alternative proposal is to have any effect on investor confidence.

There are potential problems with the alternative proposal to "noisy withdrawal." These problems, however, are minor in comparison to the problems of maintaining the status quo. It is important to recognize that there is no perfect rule. Despite its best efforts, there will be difficulties with any promulgated rule. Therefore, the Commission must promulgate the best rule under the current circumstances. In the current climate, the best rule is the alternative proposal.

III. THE POTENTIAL CONFLICT BETWEEN THE ALTERNATIVE PROPOSAL AND CONFIDENTIALITY

A. *When Disclosure Beyond the Client Should Be Required*

The Model Rules of Professional Responsibility provide that an attorney "may not counsel or assist a client in conduct that is criminal or fraudulent."[45] If the Model Rules are to be interpreted to mean what they say, a lawyer is forbidden from disclosing confidential information either to prevent or rectify fraud on a third person, even when the lawyer learns of the fraud and it involves the use of the lawyer's services. The comments, however, permit a lawyer to "disaffirm documents"—such as legal opinions

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[44]Comments of Sullivan & Cromwell, LLP, "Re: Proposed Rules Relating to Implementation of Standard of Professional Conduct for Attorneys," Apr. 7, 2003, *available at* http://www.sec.gov/rules/proposed/s74502/sullivan040703.htm.

[45]MODEL RULES OF PROF'L CONDUCT R. 1.6 cmt. 11 (1998).

prepared for a client—"that are being, or will be, used in furtherance of the fraud, even though such a 'noisy' withdrawal may have the collateral effect of inferentially revealing client confidences."[46]

Forty-one states, however, have not adopted Model Rule 1.6 as recommended by the ABA.[47] Rather, these "[f]orty-one states permit a lawyer to disclose confidential information to prevent a client's criminal fraud."[48] Some states even require such disclosure.[49] In those states where the lawyer is permitted to disclose criminal fraud, Rule 4.1 is given additional strength. Because disclosure is permitted, a lawyer must "not knowingly . . . fail to disclose a material [fact to a third person] when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client."[50] Therefore, in reality, this rule creates an affirmative duty of disclosure.

B. *Whether the Alternative Noisy Withdrawal Rule Will Violate Confidentiality Provisions*

The primary concerns of commentators appear to surround confidentiality. Confidentiality interests of the corporate client, however, are not infringed by the attorney disclosure under the alternate proposal. It is universally understood that the attorney for a corporation represents the organization.[51] The attorney does not represent the officers or the board. "The organization speaks through agents, but the instructions of agents can be attributed to the organization only when the agent is acting within his or her authority."[52]

Moreover, the attorney-client privilege only applies to communications between lawyers and clients. The privilege does not apply to underlying facts. In keeping with the privilege, "[t]he Commission is not asking issuers to describe the back and forth between lawyer and client on

[46]Crampton, *supra* note 1, at 156 (quoting ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 366 (1992)).

[47]*Id.* at 157 (citing Attorneys' Liability Assurance Society, Inc., Ethics Rules on Client Confidences (2001), *reprinted in* THOMAS D. MORGAN & RONALD D. ROTUNDA, MODEL CODE OF PROFESSIONAL RESPONSIBILITY, MODEL RULES OF PROFESSIONAL CONDUCT AND OTHER SELECTED STANDARDS 134-44 (2002)).

[48]*Id.*

[49]*Id.*

[50]Crampton, *supra* note 1, at 157 (quoting MODEL RULES OF PROF'L CONDUCT R. 4.1(b) (2002)).

[51]Simon Comments, *supra* note 31.

[52]*Id.*

the matter that was the subject of the report."[53] The Commission asks for two things from issuers:

> One, a statement that the lawyer has resigned, whenever a resignation is received in connection with this rule; and two, a statement that the lawyer's resignation was in connection with the following matter, including a brief description of the matter, with no requirement that the issuer repeat or disclose any of what the lawyer actually said about the matter.[54]

The alternative proposed rule deals with situations where the attorney reasonably believes that the issuer's agents are engaged in material violations of securities laws, and that the officers and the board failed to take appropriate action. The issuer is the only holder of the attorney-client privilege. In other words, the issuer's officers and directors have no authority to assert the organization's confidentiality rights.[55] The attorney must make a decision whether it is in the interest of the client corporation to waive confidentiality. Thus, the attorney's duty to withdraw under the rule would not only be consistent with the attorney's duty of loyalty to the client, but would arise from the duty.

There is no reason to assume that the professional conduct standards imposed by the alternative rule would substantially reduce contact between corporate agents and the attorney. "[T]he idea that 'noisy withdrawal' or the alternative's 'circumstances' provision would suddenly result in clients not talking to their lawyers seems untenable. Corporate clients (through their agents) confide in corporate lawyers . . . because corporations need legal advice."[56] Thus, it behooves an officer or director to continue consulting with counsel even though he is not the client.

Moreover, the communications involved are often from those seeking advice on how to evade the law. Advice regarding destruction or concealment of evidence that may be material to future claims should not be protected. As such, the alternative rule is in keeping with the attorney's duties under the rules of professional conduct. According to the *Restatement (Second) of Torts*, a person who discovers new information

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[53]Comments of Sonia Koniak et al., "Re: Proposed Rule: Implementation of Standards of Professional Conduct for Attorney," Apr. 7, 2003, *at* http://www.sec.gov/rules/proposed/s74502/lawprofs040703.htm.

[54]*Id.*

[55]*Id.*

[56]*Id.*

that makes a former disclosure untrue is under a duty to make disclosures needed to rectify the situation.[57]

IV. COMPARISON TO ISSUER'S REQUIREMENTS REGARDING AUDITORS AND UNDER BANKRUPTCY LAWS

A. *Similarity to Issuer's Duty to Disclose Disagreements with Auditors*

In 1985, the Commission requested comments on the practice of opinion shopping by an issuer selecting auditors. "'[O]pinion shopping' is generally understood to involve the search for an auditor willing to support a proposed accounting treatment designed to help a company achieve its reporting objectives even though that treatment might frustrate reliable reporting."[58] After reviewing comments, the Commission issued rules mandating the disclosure of registrant's auditors and any changes in auditors. Additionally, the Commission's rules require disclosure of disagreements between the issuer and the auditor.[59]

"Disagreements" include any difference of opinion on "any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedures which (if not resolved to the satisfaction of the former accountant) would have caused it to make reference to the subject matter of the disagreement in connection with its report."[60] Preliminary differences of opinion based on incomplete facts are not disagreements within this rule.

Additionally, the Commission requires disclosure of "reportable events"; such events "involve situations where the accountant has advised the registrant that it questions the accuracy or reliability of the registrant's financial statements, management's representations, the registrant's internal controls, or prior audits."[61]

"Disagreements" and "reportable events" are similar; they both "involve situations where the position of management may be considered

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[57]RESTATEMENT (SECOND) OF TORTS § 551(2)(c).

[58]Disclosure Amendments to Regulation S-K, Form 8-K and Schedule 14A Regarding Changes in Accountants and Potential Opinion Shopping Situations, Release No. 37-6766, 1988 SEC LEXIS 722 (Apr. 7, 1988).

[59]Regulation S-K, Item 304, "Changes in and Disagreements With Accountants on Accounting and Financial Disclosure," 17 C.F.R. § 229.304 (2003); and Regulation S-B, Item 304, "Changes in and Disagreements With Accountants on Accounting and Financial Disclosure," 17 C.F.R. § 228.304 (2003).

[60]17 C.F.R. § 229.304 (2003).

[61]*Id.*

to be generally at odds with that of the auditor."[62] A "disagreement" is a difference in opinion between auditors and management that is expressed either orally or in writing. A "reportable event" only requires that the auditors advise the registrant of its concerns:

> If, therefore, the auditor is dismissed, resigns or declines to stand for re-election before the registrant responds (to either agree or disagree) to the auditor's concern, the event must be reported. The auditor may not therefore merely advise the registrant of its concern and then resign (or be dismissed) prior to receiving a response from management and walk away without disclosure of its concerns.[63]

The requirements surrounding "disagreements" and "reportable events" are remarkably similar to those found in the alternative rule regarding "reporting out." Auditor opinions and financial statements are crucial to the registration process. Therefore, the reliability of the auditor is just as important as the reliability of an issuer's attorney. If the Commission requires the issuer to disclose "disagreements" or "reportable events" regarding the auditors, it naturally follows that the Commission should require the issuer to disclose the withdrawal of attorneys.

B. *Analogous Provisions in Bankruptcy Laws*

Federal bankruptcy rules establish that federal law controls the scope and availability of any claim that a party may exercise. These rules impose a duty upon debtors to disclose assets and liabilities. For example, Federal Rule of Bankruptcy Procedure 1007(b) states "the debtor . . . shall file schedules of assets and liabilities, a schedule of current income and expenditures, a schedule of executory contracts and unexpired leases, and a statement of financial affairs."[64] Given such a duty to disclose, the existence of assets cannot be protected by attorney-client privileges.

The attorney-client privilege is to be "narrow[ly interpreted] . . . because it is in 'derogation of the search for truth.'"[65] The court in *United States v. White* stated that "information . . . transmitted to an attorney with the intent that the information will be transmitted to a third party . . . is not

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[62] *Id.*

[63] Regulation S-K, Item 304, *supra* note 59, at 4.

[64] FED. R. BANKR. P. 1007(b) (2003).

[65] United States v. White, 950 F.2d 426, 430 (7th Cir. 1991) (quoting *In re* Walsh, 623 F.2d 489, 493 (7th Cir. 1980)).

confidential."[66] The court held that confidentiality cannot be claimed when "the information is to be disclosed on documents publicly filed."[67] Additionally, the Eighth Circuit held that information sought to be protected was not privileged because the debtor was required to disclose the information.[68]

Similarly, issuers are required to disclose accurate and complete financial and other information. The documents and conversations that pertain to registration statements and other filings to the Commission cannot be considered privileged because these communications deal with information that must be disclosed publicly. Even though bankruptcy rules are unique, they correlate with securities laws in that the primary goal is full and honest disclosure. Thus, similar to bankruptcy, the necessity of disclosure outweighs the importance of confidentiality.

V. CONCLUSION

The Commission is entrusted with protecting investors and maintaining the integrity of the markets. Section 307 of the Sarbanes-Oxley Act of 2002 requires the Commission to prescribe "minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers."[69] The standards must include a rule that requires an attorney to report "evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the company or any agent thereof"[70] to the chief legal counsel or chief executive officer and further, "up-the-ladder" when necessary.

The alternative proposal is designed to address situations where the "up-the-ladder" provisions are not enough. In requiring an issuer to notify the Commission when an attorney must withdraw, the alternative proposal restores public confidence by increasing disclosure by issuers without directly intruding on the attorney-client privilege. The alternative proposal is less likely to draw fire than its "noisy withdrawal" counterpart from the Bar. Requiring an issuer to disclose a disagreement with auditors has been an established SEC rule for more than a decade. The alternative proposal, requiring disclosure of attorney withdrawal, seems a logical next step.

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[66]*Id.* at 430 (citing United States v. Lawless, 790 F.2d 485, 487 (7th Cir. 1983)).

[67]*Id.*

[68]United States v. French, 46 F.3d 710, 714-15 (8th Cir. 1995).

[69]Securities and Exchange Commission, "Implementation of Standards of Professional Conduct for Attorneys," 68 Fed. Reg. 6296 (2003).

[70]*Id.*

One can only hope that lawyers for publicly traded companies will prove to be more principled than their counterparts in the accounting industry. As Judge Friendly presciently remarked, "In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar."[71] Although cogent arguments have been made for requiring attorneys themselves to report material violations to the SEC under certain limited circumstances,[72] it is clear that such a requirement would be challenged vigorously with protracted litigation.

Admittedly, even the alternative proposal's putting the burden of disclosure on the issuer may draw fire. The alternative, however, particularly after some of its shortcomings have been addressed, falls within the realm of disclosure obligations that have been adopted by the SEC with respect to other professionals. Because the reason for adopting rules concerning the professional conduct of attorneys is ultimately to protect the investing public, placing the burden of disclosure on the issuer, rather than the attorney, will, one hopes, result in enough disclosure to put the public on notice of serious problems. This disclosure could be compelled of the issuer without stepping directly into the minefield of lawyers' ethical obligations. As far as the investing public is concerned, disclosure itself is far more important than by whom the disclosure is made. Therefore, the alternative proposal is the best option set forth by the Commission.

UPDATE

Since this article was written, the American Bar Association has amended its Model Rules of Professional Conduct

> to require lawyers representing organizational clients to report law violations by officers or employees up the ladder to higher authorities in the organization in certain circumstances. The new rules further provide that if internal reporting is insufficient to protect the client organization from substantial harm, lawyers may report such wrongdoing to persons outside the organization.[73]

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[71]United States v. Benjamin, 328 F.2d 854, 863 (2d Cir.) *cert. denied sub nom.* Howard v. United States, 377 U.S. 953 (1964).

[72]*See, e.g.*, Simon Comments, *supra* note 31.

[73]Greg Pease, *Attorneys: ABA Amends Model Ethics Rules to Permit Up the Ladder Reports of Corporate Wrongs*, 35 Sec. Reg. & L. Rep. (BNA) 1358 (2003).

Revised Model Rule 1.6 permits "a lawyer to reveal information relating to the representation of a client to the extent the lawyer believes necessary to prevent the client from committing a crime or fraud that would lead to 'substantial injury to the financial interests or property of another.'"[74]

Revised Model Rule 1.13 "allows a lawyer who knows that actions by officers or employees will likely harm the company to refer the matter to higher-ups 'unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so.'"[75]

[74]James Podgers, *Corporate Watchdogs: ABA House OKs Rule That Would Allow Lawyers to Report Financial Wrongdoing*, ABA JOURNAL EREPORT (Aug. 15, 2003), *at* http://www.abanet.org/journal/ereport/au15house.html.

[75]*Id.*