Regulation of Lawyer Conduct Under Sarbanes-Oxley: Minimizing ...
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Regulation of Lawyer Conduct Under Sarbanes-Oxley: Minimizing Law-Firm Liability by Encouraging Adoption of Qualified Legal Compliance Committees

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I. INTRODUCTION 223
II. HISTORY AND HINDSIGHT 226
III. DISCUSSION AND ANALYSIS OF THE SEC'S IMPLEMENTATION OF § 307 229
A. *Implementing the Sarbanes-Oxley Act* 229
B. *"Up the Ladder" Reporting Requirement* 232
C. *Evidence of a Material Violation?* 233
D. *Concerns about Confidentiality of Client Information* ... 237
E. *Increased Power for Attorneys and Intrusion into Commercial Decision Making* 239
IV. "NOISY WITHDRAWAL" AS A POTENTIAL SOLUTION FOR CORPORATE FRAUD 240
V. THE QUALIFIED LEGAL COMPLIANCE COMMITTEE ALTERNATIVE: A SILVER BULLET? 242
VI. CONCLUSION 251

I. INTRODUCTION

The Sarbanes-Oxley Act of 2002[1] represented Congress's rapid[2] response to major corporate scandals such as the collapse of Enron Corporation, the bankruptcy of WorldCom, and the executive extravagance most typified by the actions of Tyco CEO Dennis

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

2. *See* John Paul Lucci, *Enron–The Bankruptcy Heard Around the World and the International Ricochet of Sarbanes-Oxley*, 67 ALB. L. REV. 211, 215 (2003) (noting that Sarbanes-Oxley was passed a mere seven months after Enron Corporation filed for bankruptcy).

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Kozlowski.[3] The financial scandals involving WorldCom, Qwest, Global Crossing, Tyco, and Enron cost shareholders 460 billion dollars,[4] not to mention the many jobs lost and the costs to other firms who were suppliers to these companies.[5] Many observers have called Sarbanes-Oxley the most significant legislation governing U.S. securities markets since the 1930s.[6] President George W. Bush boasted that the Sarbanes-Oxley Act represented "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt."[7]

Most of the provisions of Sarbanes-Oxley are aimed at the executives and accountants who are, for the most part, justifiably blamed for "all the Enron-WorldCom-Global Crossing chicanery" that the bill seeks to quash.[8] These provisions require CEOs to personally certify the accuracy of corporate financial statements and other filings with the Securities and Exchange Commission (SEC),[9] increase disclosures for off-balance sheet transactions such as those at the center of the Enron scandal,[10] enhance penalties for white-collar crime,[11] and increase auditor independence.[12] Most of these provisions are, if anything, good for attorneys in that the enormous amount of effort necessary for compliance and the inevitable

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3. *See, e.g., Exorcism at Tyco; CEO Ed Breen & Co. aim to run a big, solid, and, yes, boring company. But first they must drive out Dennis Kozlowski's ghost*, FORTUNE, Apr. 28, 2003 (detailing, among other things, Mr. Kozlowski's $6,000 shower curtain).

4. David L. Cotton, *Fixing CPA Ethics Can Be an Inside Job*, WASH. POST, Oct. 20, 2002, at B2.

5. *Id.*

6. *See* Herbert Grubel, *Regulators vs. Adam Smith*, WALL ST. J., Oct. 3, 2002, at A14, *available at* 2002 WL-WSJ 3407728 (calling the Sarbanes-Oxley Act "the most significant change to American corporate governance since the Securities Act of 1933 and the Securities and Exchange Act of 1934"); *see also Bloody but Unbowed*, INT'L MONEY MKTG., Nov. 8, 2002, at 38 (suggesting that the Sarbanes-Oxley Act is the single most significant regulatory shift since the Great Depression).

7. Elisabeth Bumiller, *Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002, at A1.

8. Lucci, *supra* note 2, at 215.

9. Sarbanes-Oxley Act of 2002, Pub. Law 107-204, § 302, 116 Stat. 745, 777-78 (2002) (codified in scattered sections of 15 U.S.C.).

10. *Id.* at § 401.

11. *Id.* at tit. IX.

12. *Id.* at tit. II.

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litigation over non-compliance will create a substantial amount of additional work for corporate and securities lawyers.

Attorneys, however, did not emerge unaffected by the Act's litany of new regulations. Congress, under section 307 of the Act, directs 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."[13] The statute further directs that any regulation include rules "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."[14] Further, "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)" the statute requires 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."[15] These specific rules[16] have become known as the "up the ladder" reporting requirement that now applies to attorneys who practice before the SEC.[17]

First, this paper will briefly discuss the period prior to passage of the Sarbanes-Oxley Act and what, if anything, the legal profession might have done differently to prevent the sweeping nature of the regulation under the Act. Second, the paper will discuss in detail the SEC's implementation of section 307 through its rulemaking authority, the issues raised, and possible ramifications of the SEC rules, and other proposals such as compulsory "noisy withdrawal." Third, the Qualified Legal Compliance Committee, an alternative reporting structure created by the SEC, will be described, evaluated, and recommended as the possible solution to all of the

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13. 15 U.S.C. § 7245 (2004).
14. *Id.*
15. *Id.*
16. *Id.*
17. Lucci, *supra* note 2, at 226; Susan J. Stabile, *Sarbanes-Oxley's Rules of Professional Responsibility Viewed Through a Sextonian Lens*, 60 N.Y.U. ANN. SURV. AM. L. 31, 47-52 (2004).

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attorney-client issues created by the required up the ladder reporting requirement.

II. HISTORY AND HINDSIGHT

Prior to the passage of the Sarbanes-Oxley Act, the SEC had attempted to regulate attorneys who practice securities law through enforcement proceedings rather than through the rulemaking process.[18] Such enforcement was primarily accomplished through use of the SEC's power to bar an attorney from appearing or practicing before the SEC if, after a hearing, it determined the attorney to "be lacking in character or integrity or to have engaged in unethical or improper professional conduct"[19] or to have "willfully violated, or willfully aided and abetted the violation"[20] of securities laws, whether or not any violation was proven in court.[21] The SEC also could have sought an injunction against an attorney in federal district court.[22]

In the 1970s, the SEC began an aggressive campaign against attorneys without any change in securities law or any directive from Congress.[23] During the decade, the SEC brought eighty-five cases against attorneys under a rule enacted in 1935, first used against an attorney in 1950, and used only five times against a lawyer prior to 1960.[24] In the early 1970s, the SEC also attempted to impose an obligation upon attorneys to inform the Commission when clients violated securities laws and attempted to seek injunctive relief against attorneys who did not do so.[25] The court, however, did not agree that attorneys should inform the Commission of violations and held that it is enough to take sufficient steps to persuade the client to comply with securities law.[26]

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18. Ann Maxey, *SEC Enforcement Actions Against Securities Lawyers: New Remedies vs. Old Policies*, 22 DEL. J. CORP. L. 537, 548 (1997).
19. Rules of Practice, 17 C.F.R. § 201.102(e) (2004).
20. *Id.*
21. *Id.*
22. Maxey, *supra* note 18, at 548.
23. *In re* Keating, Muething & Klekamp, 47 S.E.C. 95, 112 (1979).
24. *Id.*
25. SEC v. Nat'l Student Mktg. Corp., 457 F. Supp. 682, 714 (D.D.C. 1978).
26. Maxey, *supra* note 18, at 550-51.

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In the early 1980s, the SEC, in the *Carter and Johnson* decision,[27] took the position that a lawyer learning of substantial and ongoing disclosure violations by his or her clients must take prompt steps to end the client's non-compliance. But the ruling was not vigorously enforced because the SEC announced in 1982 that it would only discipline lawyers if a district court found that the lawyer aided and abetted a violation.[28] Nonetheless, the ruling was certainly indicative of the agency's view that lawyers are expected to do more than simply look the other way when faced with a violation.

The Sarbanes-Oxley Act represents the first substantial effort to regulate the professional conduct of corporate attorneys by federal statute. The accounting profession, on the other hand, has been required to report illegal acts to the client's board of directors since the Securities and Exchange Act of 1934 and, since 1995, must also report such acts to the SEC.[29] It seems difficult to believe that the scandals at Enron and other corporations represent the first time that it has been necessary to rethink the ethical responsibilities of corporate attorneys. Rather, it is more likely that Congress has never before found it to be desirable to intrude into an area that has always been self-regulated through the American Bar Association[30] and through each state's bar association.[31] Time will reveal whether such an intrusion will prove helpful or necessary, but it is clear that Sarbanes-Oxley represents a departure from past practice and, perhaps, a departure that may have been avoided had action been taken sooner at the state level.

Sarbanes-Oxley filled the void created when the ABA failed to act. For example, the ABA's Ethics 2000 Commission,[32] when

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27. *In re* Carter & Johnson, No. 34-17597, [1981] Fed. Sec. L. Rep. (CCH) P 84,145 (Feb. 28, 1981).

28. Maxey, *supra* note 18, at 553.

29. Symposium, *The Evolving Legal and Ethical Role of the Corporate Attorney After the Sarbanes-Oxley Act of 2002*, 52 AM. U. L. REV. 613, 617 (2003) [hereinafter *The Evolving Role of the Corporate Attorney*].

30. The American Bar Association promulgates the Model Rules of Professional Responsibility which are, with variances, adopted by each state.

31. *The Evolving Role of the Corporate Attorney*, *supra* note 29, at 614 (noting that state bar associations, not federal agencies, have traditionally regulated attorney conduct).

32. *See* American Bar Association, Center for Professional Responsibility, Ethics 2000 Commission, *available at* http://www.abanet.org/cpr/ethics2k.html (last visited on Nov. 20, 2004) (providing an overview of the Ethics 2000

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revising the Model Rules of Professional Conduct, declined to change the section that suggests remedies available to attorneys who learn of individuals who are injuring the client organization.[33] Specifically, the ABA did not require the reporting of illegal acts to the organization's board of directors or highest authority, even when substantial injury to the client organization is likely.[34] The ABA refused despite prior attempts by the SEC to impose ethical standards on attorneys and an increasingly hostile business environment at the end of the 1990s.

Similarly, prior to Sarbanes-Oxley, the ABA refused to amend Model Rule 1.6 to even permit an attorney to disclose illegal conduct to prevent a future crime, despite provisions in the "vast majority" of states permitting such disclosure.[35] In August 2003, in response to Sarbanes-Oxley, the ABA followed the recommendations of its Task Force on Corporate Responsibility and finally modified the rules to require up the ladder reporting and to permit, in very limited circumstances, disclosure outside the organization.[36] This approval in the ABA's House of Delegates was by a narrow 218 votes for to 201 votes against, indicating how divided the profession is on the issue of outside disclosure, despite most states having forged ahead of the ABA on the issue.[37]

Simply put, had the ABA, through the Ethics 2000 Commission, chosen to require attorneys to report illegal acts to their own client's board of directors, it is probable that Congress would

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Commission, the Commission's report, minutes, testimony, and additional information).

33. *The Evolving Role of the Corporate Attorney*, *supra* note 29 at 617; *Ethics 2000 Commission Changes to Model Rules of Professional Conduct Rule 1.13*, *available at* http://www.abanet.org/cpr/e2k-rule113.html (last visited Nov. 20, 2004).

34. *The Evolving Role of the Corporate Attorney, supra* note 29 at 617; *Ethics 2000 Commission Changes to Model Rules of Professional Conduct Rule 1.13*, *available at* http://www.abanet.org/cpr/e2k-rule113.html (last visited Nov. 20, 2004).

35. *The Evolving Role of the Corporate Attorney*, *supra* note 29, at 617-18; MODEL RULES OF PROF'L CONDUCT R. 1.6 (2003). *See also* Craig Schneider, *The Attorney's Dilemma*, CFO MAG. (Oct. 2003) (explaining that forty-two states permit and four states (Florida, New Jersey, Virginia, and Wisconsin) require lawyers to disclose confidential information to prevent or rectify a client's fraud).

36. MODEL RULES OF PROF'L CONDUCT R. 1.6(b) (2003); MODEL RULES OF PROF'L CONDUCT R. 1.13 (2003).

37. Schneider, *supra* note 35.

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have not felt the need to intervene. Even if Congress had acted, the statute and the SEC's implementation of the statute through its rulemaking process would likely have been much narrower. Instead, as this discussion will later indicate, the SEC rules are broad brushstrokes that reach beyond securities law and create significant ambiguities that the ABA could have avoided had it cooperated earlier.

III. DISCUSSION AND ANALYSIS OF THE SEC'S IMPLEMENTATION OF § 307

A. *Implementing the Sarbanes-Oxley Act*

The Securities and Exchange Commission implemented the up the ladder requirement of section 307 of the Sarbanes-Oxley Act by creating a rather broad mechanism that openly claims to supersede the standards of any state or other U.S. jurisdiction where the standards might conflict.[38] It is likely that the reality of the new federal rules was the sole motivation for the ABA's decision to finally modify its Model Rules to conform to the SEC's rulemaking decisions.[39] Until each state adopts the ABA's changes to the model rules, there will be some degree of confusion among attorneys regarding which standard applies. This is unlikely to be a significant problem because most states allow for up the ladder reporting, and the SEC simply requires it.[40] In such a situation, a lawyer who complies with the federal rule likely will not violate state-ethics requirements. On the other hand, a lawyer in a state that does not allow disclosure of privileged or confidential information, except to prevent a death or violent crime, may run into ethical problems at the state level if she chooses to exercise her option to disclose information to the SEC as allowed under the federal rules.[41] The

38. Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205.1 (2004).

39. *See supra* notes 29-36 and accompanying text (discussing the ABA's reluctance to modify the Model Rules of Professional Conduct to require up the ladder reporting and to allow disclosure to prevent a financial crime).

40. 17 C.F.R. § 205.3; *see also infra* notes 53-66 and accompanying text (discussing in detail the federal up the ladder reporting requirement).

41. 17 C.F.R. § 205.3(d)(2); *see also infra* notes 62-66 and accompanying text (discussing in detail the disclosure provisions of § 205).

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rules attempt to provide immunity from discipline under inconsistent state standards for good faith compliance with section 205 of the federal rules, but this is not explicitly provided for in the federal statute and an aggressive state bar might challenge such immunity.[42]

More alarming, however, is the opposite scenario, where a lawyer dutifully complies with all state ethical requirements but fails to comply with the federal up the ladder reporting rule because the attorney is unaware that she is "appearing and practicing before the Commission in the representation of an issuer."[43] Appearing and practicing before the Commission includes several different types of practice. The most obvious categories of legal work that would clearly notify an attorney that she is subject to the SEC's professional conduct rules include "representing an issuer in a Commission administrative proceeding or in connection with any . . . investigation, inquiry, information request or subpoena."[44]

But rules also apply to any attorney[45] who transacts business, including communicating in any form with the SEC[46] or providing advice on laws, rules, or regulations regarding any document that the attorney has notice will be filed with or incorporated into a document that will be filed with or submitted to the SEC.[47] Because the rules do not limit the scope of "attorney" to those providing legal advice or working as lawyers on the particular filing or communication,[48] this rule could lead to broad application of these provisions in general or to a rush to find defendants after a future Enron-like scandal.

Bankruptcy, antitrust, and class-action attorneys are often involved in work that has securities law implications and must be made aware that this work is subject to the section 205 rules. For others, it will be less obvious, such as a labor lawyer who assists the human resources department and provides executive compensation

42. 17 C.F.R. § 205.6(c).

43. 17 C.F.R. § 205.1.

44. 17 C.F.R. § 205.2(a)(3).

45. *See* 17 C.F.R. § 205.2(c) (defining an attorney to be "any person who is admitted, licensed, or otherwise qualified to practice law in any jurisdiction, domestic or foreign, or who holds himself or herself out as admitted, licensed, or otherwise qualified to practice law").

46. 17 C.F.R. § 205.2(a)(1).

47. 17 C.F.R. § 205.2(a)(4).

48. *See* 17 C.F.R. § 205.2(c) (defining "attorney" under § 205).

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information for inclusion in a 10-K filing[49] with the Commission or simply sends the SEC a fax. Is she considered to be practicing before the Commission and therefore required to be sufficiently aware of securities laws so as to recognize evidence of a material violation? The answer is unclear, but a literal reading of the rules suggests that she would be subject to the statute, be required to report evidence of a material violation, and potentially be subject to sanction should she fail to do so.

Perhaps more likely, a CEO or other officer who is a lawyer, and who the media and government are looking to prosecute, could be charged for failing to report evidence of a violation in such an instance. The rule also does not specify when an attorney's practice or appearance before the SEC terminates. The rule suggests that once an activity causes a lawyer to fall under the rules, any evidence she encounters that may suggest an unrelated violation in the future should trigger the reporting requirement.

The SEC and the government, of course, may choose not to enforce the section 205 rules in such a manner. The SEC has indicated sensitivity to concerns that the section 205 definitions of "appearing and practicing" and "attorney" may lead to aggressive enforcement against lawyers who are not acting in a legal capacity. The Commission has responded by changing the original proposed rules to include an exclusion for an attorney who engages in activities that might be considered "appearing and practicing" other than in an attorney-client context.[50] But the possibility of aggressive enforcement exists still. Aggressive enforcement should be alarming to anyone with a legal background in a corporate environment, whether they practice law or otherwise, because aggressive enforcement could effectively end a professional career.[51] Section 205 adds that violating these professional conduct rules is the same as violating the Act and is subject to the same civil penalties and

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49. A 10-K is the annual report that public companies must file each year with the SEC and typically includes information on the holdings and compensation of officers and directors of the company.

50. 17 C.F.R. § 205.2(a); *see also* Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 47,276, 68 Fed. Reg. 6,296 (Feb. 6, 2003).

51. *See* 17 C.F.R. § 205.6(b) (providing for temporary or permanent denial of the privilege of appearing or practicing before the Commission as an available administrative sanction for violations of § 205).

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remedies as violating the Act.[52] Thus, the SEC can, without any need to prove the actual violation, ban the hypothetical CEO with a law license from serving as an officer of a public company for not having reported evidence of a violation under section 205.

B. "Up the Ladder" Reporting Requirement

The basic reporting requirement imposed on attorneys under the section 205 rules begins with the relatively non-controversial notion that, when working for an organization (as in-house or outside counsel), the client is the organization and not the individual employees, officers, or directors.[53] The rule then requires an attorney who becomes "aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer" to report the evidence to the issuer's chief legal officer or to both the chief legal officer and the organization's CEO.[54] The reporting attorney may also report the evidence of a material violation to an organization's Qualified Legal Compliance Committee (QLCC) if the organization has established such a committee.[55] Once the chief legal officer receives the evidence of a material violation, she is required to "cause such inquiry into the evidence of a material violation as he or she reasonably believes is appropriate to determine whether the material violation described in the report has occurred."[56]

The chief legal officer is then required to provide "an appropriate response within a reasonable time" to the reporting attorney, who is then required to evaluate that response.[57] If the chief legal officer determines that no material violation has occurred, is ongoing, or is about to occur, then she must notify the reporting attorney and provide the basis for that determination.[58] Unless the chief legal officer believes there is no material violation, she must take all reasonable steps to cause the issuer to adopt an appropriate

52. 17 C.F.R. § 205.6(a).
53. 17 C.F.R. § 205.3(a).
54. 17 C.F.R. § 205.3(b)(1).
55. *See infra* Section V. (discussing the Qualified Legal Compliance Committee alternative in depth).
56. 17 C.F.R. § 205.3(b)(2).
57. 17 C.F.R. § 205.3(b)(2)-(3).
58. 17 C.F.R. § 205.3(b)(2).

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response and must advise the reporting attorney of the steps taken.[59] This may include steps or sanctions to stop ongoing violations, to remedy or address past violations, or to minimize the likelihood of future or recurring violations.[60] The organization may also, as an appropriate response, with the consent of its board of directors, retain or direct another attorney to review the evidence and determine remedial steps or determine that a colorable defense exists to any alleged violation.[61]

The reporting attorney is required to evaluate the response provided by the chief legal officer to determine whether or not it is an "appropriate response."[62] If the response is appropriate, then the reporting attorney is not required to take any further action.[63] If the reporting attorney determines that the response is not appropriate, then she must report the evidence of the material violation to the audit committee of the organization's board of directors.[64] The attorney must also advise the chief legal officer and the directors who received the report of the reasons why she found the chief legal officer's response to be inappropriate.[65] The reporting attorney is permitted to bypass the chief legal officer reporting process and proceed directly to the audit committee if the attorney reasonably believes that it would be futile to report evidence of a material violation to the chief legal officer and CEO.[66]

C. *Evidence of a Material Violation?*

The requirement under section 205 that an attorney report "evidence of a material violation" is both broad and ambiguous and may be interpreted very differently by individual attorneys and chief legal officers. A material violation is defined as simply a material

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59. *Id.*
60. 17 C.F.R. § 205.2(b)(2).
61. 17 C.F.R. § 205.2(b)(3)(ii).
62. 17 C.F.R. § 205.3(b)(3).
63. 17 C.F.R. § 205.3(b)(8).
64. *See* 17 C.F.R. § 205.3(b)(3)(i)-(iii) (requiring the reporting attorney to notify the audit committee or, if there is no audit committee, a committee of independent investors or, if there is no such committee, the entire board of directors).
65. 17 C.F.R. § 205.3(b)(9).
66. 17 C.F.R. § 205.3(b)(4).

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violation of state or federal securities law.[67] Breaches of fiduciary duties arising under state law or a "similar material violation of any United States federal or state law" are also included.[68]

The scope of fiduciary duties seems to have previously be a matter of state corporation law. Section 205 goes well beyond any prior SEC authority and suggests that an attorney is expected to not only look for violations of securities law, but also to act as a policeman, sending up flags over potential conflicts of interest, self-dealing, misfeasance, nonfeasance, abuses of trust, abdication of duty, and any other potential breaches of a duty of loyalty or duty of care.[69] The attorney must be sufficiently aware of the corporation law of each jurisdiction where a client operates or is incorporated in order to perceive such a breach when it arises. This also creates an opportunity for sanctions against corporate officers and directors who are attorneys but who do not report any evidence of a conflict of interest or other breach of fiduciary duty where the conflict or breach cannot be directly sanctioned (e.g. for lack of evidence). It is unlikely that violations of fiduciary duties would have been part of these reporting requirements had the American Bar Association not failed in its mission to provide meaningful self regulation of the legal profession.[70]

This problem is compounded by the requirement that an attorney report "evidence of a material violation" rather than being limited to evidence of actual, clear, known violations.[71] Evidence, under the rule, means "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur."[72]

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67. *See* 17 C.F.R. § 205.2(i) (defining material violation); *see also infra* notes 71-80 and accompanying text (discussing the issue of "materiality").

68. *See* 17 C.F.R. § 205.2(i).

69. *See* 17 C.F.R. § 205.2(d) (defining a breach of fiduciary duty); *see also* Karl A. Groskaufmanis, *Climbing "Up the Ladder": Corporate Counsel and the SEC's Reporting Requirement for Lawyers*, 89 CORNELL L. REV. 511, 517 nn.33-34 (2004) (discussing fiduciary duty principles articulated in federal securities laws and other statutes that have been broadly construed).

70. *See supra* notes 32-37 and accompanying text (discussing the ABA's reluctance to modify the Model Rules of Professional Conduct to require up the ladder reporting and to allow disclosure to prevent a financial crime).

71. 17 C.F.R. § 205.3(b).

72. 17 C.F.R. § 205.2(e).

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This seems to give the attorney both a great deal of power and an awkward responsibility. An attorney, lacking the big picture perspective, may stumble upon any number of memos or other evidence while engaged in, for example, due diligence relating to a transaction or stock offering that she might feel should be disclosed or that might suggest a non-legal problem with the transaction. For example, should the attorney question an acquisition under the cover of pointing out potential nonfeasance if she believes the business is being overvalued? If the target company does business with an entity in which the acquiring company's director owns an equity interest, must the attorney (who may not be directly involved in the acquisition, but simply is aware of the conflict) question the appropriateness of the transaction? Ultimately, the vagueness surrounding the word "evidence" begs the question of materiality. The term "material" remains undefined in the statute and its meaning is elusive.[73] Although perhaps a material violation is like obscenity in the eyes of Justice Stewart–one "knows it when [one] sees it,"[74] such a standard is unsatisfying and will probably lead to a degree of confusion and chaos among well-meaning attorneys.

Professor Jeffrey Bauman,[75] in a symposium at American University, told a story about his own experience as a young attorney drafting a registration statement for an insurance company.[76] In asking the necessary questions to draft the registration statement, he remarked that he thought it was necessary to disclose a particular fact.[77] The CEO promptly explained to him that he just did not understand reality and that the CEO, having been in the business for thirty years, knew that the fact was not material.[78] If a junior attorney simply disagrees with the client as to whether or not a fact is material (and therefore, whether or not failing to disclose it would be a "material violation") must she go up the ladder to her supervising attorney and then force the supervisor to go to the client's chief legal

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73. *See* 17 C.F.R. § 205.2(i) (defining "material violation" in a circular manner as involving "a material violation").

74. Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J. concurring).

75. Professor Jeffrey Bauman specializes in corporate law at Georgetown University Law Center. Additional information on Professor Bauman is available at *The Evolving Role of the Corporate Attorney*, *supra* note 29, at 656.

76. *The Evolving Role of the Corporate Attorney*, *supra* note 29, at 660-61.

77. *The Evolving Role of the Corporate Attorney*, *supra* note 29, at 660-61.

78. *The Evolving Role of the Corporate Attorney*, *supra* note 29, at 660-61.

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officer and on up the ladder?[79] A corporate lawyer is likely to have clients in many different industries and, although the attorney should possess a superior understanding of the law, the client's officers will have a better understanding of the client's business than the attorney would ever have. Before the promulgation of the section 205 rules, deference to the client's judgment would not create liability for the attorney. Further, if the section 205 rules only required reporting clear, known violations then, once again, the attorney could safely decline to report ambiguous scenarios. But, it is alarming that, under the section 205 rules, an attorney could potentially be liable for drafting a document reflecting a client's judgment that, in hindsight, was incorrect.

This problem also arises when the up the ladder reporting process is triggered. The reporting attorney and the chief legal officer may disagree with some frequency as to the materiality of a potential violation. When this occurs, and the disagreement is legitimate (i.e., not an attempt by the chief legal officer to dispose of a problem, but rather an honest difference in interpretation), is the reporting attorney subject to discipline for failing to reject the chief legal officer's determination as an inappropriate response?[80]

This internal conflict is precisely the situation that the up the ladder reporting requirement sought to rectify, yet it is unclear that it will be effective in doing so. At Enron, for example, Stuart Zisman, a new junior attorney, commented that many of Enron's financial transactions "might lead one to believe that the financial books at Enron are being manipulated."[81] This junior attorney has, in essence, complied with new rules requiring that he report the information to his supervising attorney.[82] In this Enron scenario, Zisman was reprimanded for using "critical and inflammatory"

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79. *See* 17 C.F.R. §§ 205.4-.5 (providing that, while subordinate attorney may report directly to the client's chief legal officer when she believes her supervisory attorney has not complied with the reporting requirements, a subordinate attorney is only required to report evidence of a material violation to the supervisory attorney, who must then follow the up the ladder reporting procedures detailed in § 205.3).

80. *See* 17 C.F.R. § 205.3(b)(3) (requiring the reporting attorney to evaluate the chief legal officer's response and, if she finds it to be inappropriate, to report the evidence of a material violation to the audit committee).

81. April Witt & Peter Behr, *Dream Job Turns Into a Nightmare*, THE WASH. POST, July 29, 2002, at A01.

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

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language by his supervisor, Mark Haedicke.[83] Is it realistic to believe that the new rules, which allow (but do not require) the junior attorney to circumvent her supervisor and go to the chief legal officer when she believes that her supervisor is not in compliance, would have motivated the Enron attorney to act differently? It seems clear that Zisman risked an unpleasant working environment and potentially jeopardized his future career. Although an in-house attorney may not be terminated for complying with section 205, the reporting regime may also create an unpleasant work environment and career advancement concerns when an attorney reports colleagues or co-workers up the ladder.[84] In light of these concerns, a junior attorney would probably have to be quite certain of both the violation and the materiality of the violation before proceeding. In situations that are truly black and white, it is likely that the junior attorney would have raised questions prior to the implementation of section 205, presumably through an informal process.

D. Concerns About Confidentiality of Client Information

Many experts are concerned that the newly implemented section 205 rules may have a chilling effect on communications between members of the client organization and counsel. This may result in a worst-case scenario where executives simply make decisions in legally risky or gray areas without consulting counsel at all.[85] A CFO who is handling SEC disclosures and is not certain how to handle a situation may be concerned about reports that may be made to the board of directors or, even worse, to persons outside the organization.[86] This fear is not unfounded because lawyers, concerned about shielding themselves from liability, may over-report potential violations to shift the risk of liability away from themselves and towards the directors.

Many CEOs have stated that the most important roles that in-house lawyers are expected to play are as "legal educator" and as

83. Witt & Behr, *supra* note 81.

84. *See* 17 C.F.R. § 205.3(b)(10) (providing an attorney, who reasonably believes she has been discharged for reporting evidence of a material violation, the right to report this belief to the former client's board of directors).

85. Schneider, *supra* note 35.

86. Schneider, *supra* note 35.

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"ethics advisor."[87] CEOs believe that these roles are often more important than representing management on specific issues.[88] If clients rely on in-house counsel to prevent legal issues from arising (rather than putting out legal fires after the fact), then the role of in-house counsel is clearly chilled if counsel is expected to raise these areas of concern with the CEO.

The concerns about a chilling effect on the communication between client-officers and attorneys are further exacerbated by provisions allowing (but not requiring) an attorney to reveal information to the SEC without client consent.[89] An attorney may reveal confidential information necessary to prevent the issuer from committing a material violation that is "likely to cause substantial injury to the financial interest or property" of the organization or its investors or to prevent the issuer from committing perjury, suborning perjury, or perpetrating a fraud upon the SEC.[90] Additionally, such confidential information may be disclosed "to rectify the consequences of a material violation . . . that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors" where the attorney's services were used in furtherance of the injury.[91]

This position does not go far beyond what state bar ethics rules already allow in most jurisdictions.[92] But the position represents a specific attempt to erode the attorney-client privilege and, as such, is a disturbing development to many academics and practitioners. "Lawyers are and should remain vital parts of the corporate team who can function to prevent corporate criminal activity by virtue of their role as trusted advisors. No one calls a policeman until after the crime is committed."[93] When the attorney-client privilege is eroded or when the client cannot rely on such a privilege, it is likely that the client will withhold critical information that is necessary to the representation if the client knows it may be shared with the SEC. The abilities of lawyers are better used to prevent violations from occurring than to expose violations. In

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87. *The Evolving Role of the Corporate Attorney*, *supra* note 29, at 670.

88. *The Evolving Role of the Corporate Attorney*, *supra* note 29, at 670.

89. 17 C.F.R. § 205.3(d)(2).

90. 17 C.F.R. § 205.3(d)(2)(i)-(iii).

91. 17 C.F.R. § 205.3(d)(2)(iii).

92. *See supra* notes 35-37 and accompanying text (discussing the ABA Model Rules of Professional Conduct and state bar rules on disclosure to prevent fraud).

93. *The Evolving Role of the Corporate Attorney*, *supra* note 29, at 671.

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doing so, lawyers lose access to the information necessary to give advice in the future. Instead of going to lawyers to ask if something is "kosher" in order to keep the company out of trouble, a client may choose to keep quiet, viewing attorneys not as a part of the team but rather as enemies.[94] Attorneys who act as defense counsel in an SEC, civil, or criminal proceeding are not exempted from the up the ladder reporting requirement or the option to disclose unless they were hired specifically to assert a colorable defense to a material violation that was properly reported or were hired by a qualified legal compliance committee.[95] The SEC says it does not intend to impair zealous advocacy essential to the SEC's processes nor to discourage issuers from seeking effective and creative legal advice.[96] It seems strange, however, to allow an attorney to share confidential information with the SEC when the SEC is acting as prosecutor. Because the SEC is already investigating infractions of the securities laws, the Commission will have the information necessary to assess whether lawyers complied with the section 205 reporting requirements and, unlike the attorney, the SEC will have the benefit of perfect hindsight.[97] These reporting requirements and the attorney's leverage from the threat of disclosure may chill discussion between executives and attorneys or, just possibly, it may remind attorneys of the fiduciary duty that they owe to the organization rather than to its constituents that existed all along.[98]

E. Increased Power for Attorneys and Intrusion Into Commercial Decision Making

The practical effect of these rules, however, may not be extensive use of the option to disclose or even of the up the ladder reporting requirement. Instead, the lawyer may maintain her role as trusted advisor by pushing for changes to corporate decisions with the express or implied threat of the reporting process serving as leverage. This may allow the attorney to force advice upon a

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94. *The Evolving Role of the Corporate Attorney*, *supra* note 29, at 627.

95. 17 C.F.R. § 205.3(b)(6)(ii).

96. *The Evolving Role of the Corporate Attorney*, *supra* note 29, at 624.

97. Groskaufmanis, *supra* note 69, at 522.

98. *See* DongJu Song, Note, *The Laws of Securities Lawyering After Sarbanes-Oxley*, 53 Duke L.J. 257, 287 (2003) (referring to MODEL RULES OF PROF'L CONDUCT R. 1.13(a) (2002)).

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reluctant corporate client because, if "managers believe that an attorney will report information up the ladder, they are naturally more likely to abide by the legal opinions" of that attorney.[99] This, of course, leads lawyers to make or influence business decisions that have always, until now, been assumed to be the province of business experts.[100] Even if the business experts can make the final decision, the legal profession has always been concerned that, when lawyers are involved in these decisions, they are less independent and thus are unable to question these decisions later.[101]

IV. "NOISY WITHDRAWAL" AS A POTENTIAL SOLUTION FOR CORPORATE FRAUD

The SEC has proposed, but has not yet implemented, a requirement that an outside attorney who initiates the up the ladder reporting process required by section 205 and does not receive an "appropriate response"[102] and reasonably believes the material violation is ongoing or is about to occur, must promptly withdraw from representation, notify the Commission of her withdrawal, and disaffirm any submission to the SEC that the attorney was involved in preparing and that is impacted by the violation.[103] Inside counsel would be required to disaffirm tainted work product but not to resign.[104] If the violation is completed and is not ongoing, the attorney may follow the same procedure.[105] An alternative proposal

99. *Id.*

100. *See, e.g.*, Shlensky v. Wrigley, 237 N.E.2d 776, 780 (Ill. App. Ct. 1968) (creating the "business judgment" rule that holds that it is beyond the jurisdiction and ability of the courts to determine whether corporate directors made a wise or correct business decision).

101. This issue has typically been raised when lawyers seek to sit on the board of directors of a client corporation. Despite these concerns, serving as a client's attorney and as a director is permitted. *See* ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 410, at 8-12 (1992) (deriving general guidelines that a lawyer serving on the board of a corporate client should follow in order to minimize the risk of violating the model rules).

102. *See supra* notes 56-66 and accompanying text (discussing the requirement of an "appropriate response" from the chief legal officer to the reporting attorney).

103. Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71,670, 71,674 (2002).

104. *Id.*

105. *Id.*

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would require that the attorney "reasonably conclude" that there is "substantial evidence" of a violation.[106] This is a higher standard than the "reasonable belief" necessary to trigger the up the ladder reporting process, but possibly "too narrow to adequately protect investors."[107] Another proposal would require that an attorney withdraw, but not disaffirm, work product.[108] In this instance, the client, rather than the attorney, would be required to notify the SEC of the withdrawal and, if the client fails to do so, the attorney could then call the SEC's attention to this fact.[109]

Opponents of noisy withdrawal generally make two arguments. First, as the SEC acknowledges, a noisy withdrawal requirement goes beyond the authority delegated to the SEC by Congress.[110] This argument is particularly apt because, unlike the concept of upward reporting or permissive withdrawal or disclosure, there is no mention of noisy withdrawal or disaffirmation of work product in the actual Model Rules of Professional Conduct, although the comments to Model Rules 1.6, 1.2, and 4.1 allow both under narrow circumstances.[111] Noisy withdrawal and disaffirmation of work product, however, are never required under the Model Rules.[112]

Second, opponents argue that attorneys will be excluded from meetings where confidential information is discussed because the attorney has become a corporate watchdog.[113] In essence, this is tantamount to turning over a client to law enforcement authorities for past violations—a concept wholly inconsistent with zealous representation.[114]

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106. Lance Cole, *Corporate Criminal Liability in the 21st Century: A New Era?*, 45 S. TEX. L. REV. 147, 165 (2003).

107. *Id.* at 166.

108. Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8186, Exchange Act Release No. 47,282, 68 Fed. Reg. 6324, 6328 (proposed Feb. 6, 2003).

109. *Id.* at 6329-30.

110. 15 U.S.C. § 7245 (2004) (requiring implementation of up the ladder withdrawal and authorizing the SEC to issue additional related rules).

111. *See* Song, *supra* note 98, at 277-81 (discussing the Model Rules of Professional Conduct extensively and how they relate to proposed noisy withdrawal rules).

112. *See* Song, *supra* note 98, at 279.

113. Ryan Morrison, Note, *Turn Up the Volume: The Need for "Noisy Withdrawal" in a Post Enron Society*, 92 KY. L.J. 279, 299 (2003).

114. *Id.* at 280.

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Some experts argue that, even if implemented, the noisy withdrawal rule will rarely come into play. A partner at Gray Cary Ware & Freidenrich LLP, for example, suggests that noisy withdrawal has "such a draconian effect that the company would be falling all over itself to convince the reporting attorney that they were wrong, that there was no material violation, or that they had addressed the issue appropriately."[115] Further, a required withdrawal will not be appealing to an attorney because the lawyer then risks becoming unemployed or, at the very least, losing a fee-paying client.[116] This again raises the appearance of the attorney acting as policeman and the concern that attorneys will be in a position to force a corporation into abiding by safe, conservative legal advice that minimizes the risk of liability for the attorney involved.

V. THE QUALIFIED LEGAL COMPLIANCE COMMITTEE ALTERNATIVE: A SILVER BULLET?

The implemented section 205 rules provide an alternative to the up the ladder reporting process.[117] An organization's board of directors may establish a Qualified Legal Compliance Committee.

A Qualified Legal Compliance Committee is a committee of an issuer, which also may be an audit or other committee of the issuer that: (1) consists of at least one member from the audit committee or, if none, a committee of directors who are not employed by the company and who are not "interested persons" as defined by the Investment Company Act of 1940,[118] and two or more members of the issuer's board of directors who are not employed by the issuer; (2) has adopted written procedures for the confidential receipt, retention, and consideration of any report of evidence of a material violation; (3) has been authorized by the board of directors to inform the chief legal officer and CEO of any reports of evidence of a violation (unless futile), to determine whether an investigation is necessary, to report information, where necessary, to the audit committee or to the full board, to initiate an investigation, and to retain expert personnel; and (4) is authorized to recommend

115. Schneider, *supra* note 35.

116. Morrison, *supra* note 113.

117. *See supra* notes 53-56 & 62-66 (discussing the "up the ladder" reporting process mandated by 17 C.F.R. § 205).

118. 15 U.S.C. 80a-2(a)(19) (2000).

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implementation of an appropriate response and to vote to notify the SEC where the issuer fails to implement a recommended appropriate response.[119]

If the organization has previously established a Qualified Legal Compliance Committee (QLLC), and an attorney representing that issuer becomes aware of evidence of a material violation by the client or any employee, officer, director, or agent thereof, the attorney may report such evidence to the QLLC.[120] If the reporting attorney does this, she has fulfilled her obligation to report the evidence and is not required to assess the response or take any further action.[121] Similarly, if the chief legal officer receives a report of evidence of a material violation, she, too, may refer the evidence to the QLCC in lieu of conducting an investigation.[122] If the company fails to take the remedial measures that the QLCC directs, each member of the committee is authorized to or, under proposed noisy withdrawal rules,[123] becomes individually responsible for notifying the SEC of the material violation and for disaffirming any tainted submission to the SEC.

Because reporting evidence of a material violation to a QLCC absolves the reporting attorney of any additional responsibilities, after an attorney reports evidence to a QLCC, she cannot then decide to notify the SEC as would be permitted under the up the ladder reporting scheme.[124] Further, and more importantly, if so-called noisy withdrawal rules are implemented, an attorney who reports to a QLCC is not subject to the requirement that the reporting attorney withdraw from the representation, notify the SEC, and disavow tainted work product.[125]

If an organization opts not to create a QLCC, then attorneys working for the organization must report any evidence of a material violation to the chief legal officer. Under the section 205 rules surrounding the chief legal officer reporting option, the reporting attorney retains a responsibility to evaluate the chief legal officer's

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119. 17 C.F.R. § 205.2(k).

120. 17 C.F.R. § 205.3(c)(i).

121. *Id.*

122. 17 C.F.R. § 205.3(c)(2).

123. *See supra* notes 103-09 and accompanying text (discussing proposed noisy withdrawal provisions).

124. 17 C.F.R. § 205.3(c)-(d).

125. *See supra* note 104 and accompanying text (discussing proposed noisy withdrawal provisions).

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response, and to report an inappropriate response to a committee of the board of directors.[126] The reporting attorney also has the option to reveal to the SEC, without consent, confidential information to prevent the client from committing a material violation that is likely to cause substantial injury or from committing or suborning perjury.[127] An attorney may also disclose a material violation to rectify consequences where the attorney's services were used in furtherance of the violation.[128] Under proposed noisy withdrawal rules, the reporting attorney will be required to disaffirm any submission that is tainted by a material violation and, if the attorney is outside counsel, to withdraw.[129] Each attorney's perspective may vary as to what should be disclosed and, ultimately, the possibility of an unwarranted disclosure is a risk to the client. The practical reality that a disgruntled attorney who was discharged by the organization may be eager to disclose in order to retaliate or to seek publicity is a serious peril both to the organization and to the attorney-client relationship.

The QLCC provisions of section 205 essentially eliminate the concern of an unwarranted disclosure. Because the QLCC is required to have the authority contact the SEC,[130] the QLCC option does not completely avoid the possibility of the disclosure of confidential and potentially embarrassing information outside of the organization. It does, however, eliminate any unwarranted disclosures by risk averse or disgruntled attorneys by designating the QLCC as the only entity with the option (or, under proposed noisy withdrawal rules, the obligation) to disclose outside of the organization. This allows attorneys to focus on their primary responsibilities to the client while knowing that they are not at risk for sanctions for failing to follow the up the ladder reporting procedure after they notified the QLCC. This may result in excess reporting to shield liability, but it should appeal to directors and CEOs. Although the rules allow the QLCC to disclose information,[131] as a practical matter, the QLCC option all but

126. 17 C.F.R. § 205.3(b)(3)(i).

127. 17 C.F.R. § 205.3(d)(2)(i)-(iii).

128. 17 C.F.R. § 205.3(d)(2)(iii).

129. *See supra* notes 103 & 108 and accompanying text (discussing proposed noisy withdrawal provisions).

130. 17 C.F.R. § 205.2(k)(4).

131. 17 C.F.R. § 205.2(k).

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eliminates the possibility of embarrassing disclosure. The opinion of the QLCC is not likely to be ignored if the consequence of doing so is disclosure (and a subsequent SEC investigation and the accompanying negative publicity). Additionally, the board of directors that implements the QLCC's recommendations consists, in part, of the members of the QLCC who will be in a position to influence the outcome of any board decisions.

In addition to avoiding potential liability, attorneys will soon come to prefer QLCC-equipped clients because there is no need or even pressure to embarrass a client, no risk of alienating other clients, and no pressure to evaluate the response received from the up the ladder process to determine if it is an "appropriate response."[132]

Corporations, however, are likely to be less enthusiastic about establishing a QLCC. Although the QLCC does effectively manage the risk of a voluntary disclosure to the SEC, or under noisy withdrawal rules, a required disclosure, these are relatively minimal risks. Corporate management presumably assumes that once reported up the ladder, the company will not continue to engage in conduct that its lawyers are convinced is illegal.[133]

The decision to form a QLCC will likely drive up the costs of directors and officers liability insurance,[134] a cost that has already escalated in the post-Enron era of corporate responsibility.[135] Although lawyers may desire to shift liability from themselves to the members of the board of directors who are appointed to the QLCC, the company may not be eager to absorb the expense for a problem that it does not perceive as an imminent risk. Further, the vague requirement to report evidence of a breach of fiduciary duty may cause some officers and directors to prefer to use the up the ladder

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132. Aegis J. Frumento, *New Ways to Make 'Em Talk: Real Time Enforcement, Sarbanes-Oxley, and the Corporate Order*, 3 J. OF INVESTMENT COMPLIANCE 62 (2003).

133. Song, *supra* note 98, at 280 n.146.

134. Symposium, *Lessons from Enron: A Symposium on Corporate Governance*, 54 MERCER L. REV. 731, 748 (2003); Theo J. Francis, *It Still Costs Big to Insure Against a Boardroom Scandal: Despite the Sarbanes-Oxley Bill, "D&O" Policy Prices Rise 30% and Cancellation Clauses Swell*, WALL ST. J., July 31, 2003, at C1.

135. *See Flotation Fever: Initial Public Offerings*, THE ECONOMIST, Mar. 20, 2004, at Finance & Economics section (indicating that premiums for directors' and officers' liability insurance have soared, making $100 million the minimum amount of capital raised to justify an initial public offering).

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reporting scheme, where many of these matters will be considered without board-level intervention.[136] Moreover, directors are not likely to accept an appointment to the QLCC—and the accompanying liability—when the board has the option to pass liability to its attorneys by refusing to establish a QLCC.

Although the rule allows the QLCC to be the same committee as the audit committee,[137] directors are likely to decline to serve on both. First, if the committees overlap, the board can use the regular up the ladder process with confidence that unresolved issues will eventually find their way to the audit committee in any event.[138] The audit committee, however, really should be focused on accounting issues and is already a heavily burdened and busy committee due to provisions throughout the remainder of the Sarbanes-Oxley Act.[139] In addition to the liability that serving on both committees may create, the reality is that serving on both the audit committee and the QLCC could become a near full-time job, especially if attorneys looking to shed liability behave conservatively and over-report evidence of material violations to the QLCC.[140] Although the New York Stock Exchange's new corporate governance rules now require a majority of directors of listed companies to be independent,[141] there could still be a shortage of willing, available disinterested directors at organizations with smaller boards if the audit committee and the QLCC do not overlap.[142]

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136. 17 C.F.R. § 205.3.

137. 17 C.F.R. § 205.2(k)(i).

138. 17 C.F.R. § 205.3(b).

139. *The Evolving Role of the Corporate Attorney*, *supra* note 29, at 632.

140. *See* Symposium, Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons?*, 48 VILL. L. REV. 1097, 1114, 1130 (2003) (suggesting that unless every issue is resolved in the most conservative manner possible, an attorney may need to report problems all the way to the board of directors and that attorneys may be driven to avoid potential evidence of violations and to over-report rather than providing high-quality guidance to officers and directors).

141. Corporate Governance Rules, p.4, *available at* http://www.nyse.com/pdfs/section303A_final_rules.pdf (last visited Nov. 20, 2004) (stating new corporate governance rules for NYSE listed companies).

142. Although corporations like General Electric have large boards and a large proportion of independent directors (eleven of sixteen), other companies have smaller boards, including Continental Airlines (ten), Watsco, Inc. (mid-sized company) (eight), and Amazon.com (eight). General Electric, Inc. Board of Directors *at* http://www.ge.com/en/company/companyinfo/executivebios/board_of_directors.htm (last visited Nov. 20, 2004); Continental Airlines, Inc.

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Second, establishment of a QLCC also effectively limits the possibility that lawyers will gain undue influence over business decisions through the threat of up the ladder reporting, or through a scheme of voluntary or compulsory disclosure.[143] Once a QLCC is established, only the QLCC retains an option (or, under noisy withdrawal rules, a requirement) to disclose confidential information to the SEC.[144] Accordingly, should the lawyer and the QLCC disagree as to whether or not a violation occurred or is about to occur, the QLCC can simply overrule the attorney without triggering an SEC investigation. The attorney is not required to assess the response for appropriateness; she has complied with the rules and thus is not subject to sanction,[145] and, as long as she is not discharged for having reported the evidence of the violation to the QLCC,[146] she is neither required nor permitted to make a noisy withdrawal.[147] Notwithstanding potential corporate resistance, the establishment of a QLCC provides management with a centralized methodology to control the disclosure of and to identify and rectify problems at their infancies before they spread out of control or are detected by authorities or by investors. Ultimately, however, it may fall to the lawyers to force client organizations to establish a QLCC to protect them from liability. This is a step that law firms should seriously consider for all corporate clients, even if the firm is engaged in what would traditionally be low-risk work.[148] The QLCC

Board of Directors *at* http://www.continental.com/company/investor/executives.asp (last visited Nov. 20, 2004); Watsco, Inc. Board of Directors *at* http://phx.corporate-ir.net/phoenix.zhtml?c=94992&p=irol-governance (last visited Nov. 20, 2004); Amazon.com, Inc. Board of Directors *at* http://phx.corporate-ir.net/phoenix.zhtml?c=97664&p=irol_management (last visited Nov. 20, 2004).

143. *See supra* notes 99-101 and accompanying text (discussing the increased influence of attorneys in business decisions).

144. 17 C.F.R. § 205.2(k)(4).

145. 17 C.F.R. § 205.3(c)(1).

146. *See* 17 C.F.R. § 205.3(b)(10) (permitting an attorney who reasonably believes she has been discharged for reporting evidence of a material violation to notify the company's board of directors thereof); *see also* 17 C.F.R. § 205.3(d)(1) (allowing a report under this section or any response thereto to be used in any investigation or litigation where an attorney's compliance with section 205 is at issue).

147. 17 C.F.R. § 205.3(b)-(c).

148. *See supra* notes 44-48 and accompanying text (discussing the broad definition of "appearing or practicing" before the commission).

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is a "very bright solution to the problem for lawyers, it is a lawyer-created solution for a lawyer problem;" the SEC states that, "if you wish to avoid attorney-client privilege problems," establish a QLCC.[149] The QLCC becomes an even more attractive solution should any of the proposed noisy withdrawal rules be adopted.[150] If noisy withdrawal is adopted, the risks to the client who does not form a QLCC include a required, embarrassing withdrawal by a reporting attorney in addition to other concerns surrounding the up the ladder process.

Reluctant clients simply must be required to form a QLCC as a condition of representation. The establishment of (or failure to establish) a QLCC must become one factor among the many risk factors considered by attorneys when deciding whether or not to accept a client.[151] Certain types of representation that rely heavily on disclosures to the SEC, such as clients that are startup companies or that are engaged in initial public offerings, should always be regarded as risky.[152] Similarly, potential clients with high management turnover, frequent insider-stock sales, or directors who have close ties to management could be more risky than others. Some suggest that malpractice insurance providers will, over time, define certain classes of risky clients, such as start-up clients with innovative products or those who have sued for malpractice in the past.[153] If a potential client or type of representation can be identified as risky and the risk to the attorney is not mitigated by a QLCC, a firm should seriously consider declining the engagement.

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149. *The Evolving Role of the Corporate Attorney*, *supra* note 29, at 685.

150. *See supra* notes 102-09 and accompanying text (discussing proposed noisy withdrawal rules).

151. *See* Emily J. Eichenhorn, *Departments: Managing Your Practice: Do You Take the Case? Examine Ethical, Professional and Business Risks of Potential Representations*, 64 OR. ST. B. BULL. 33, at 33-34 (Nov. 2003) (discussing risky classes of clients such as those whose attorneys frequently resign or are fired, those who risk the entity on a single transaction, those who are uncooperative, and others).

152. *See* Paul Marcotte, *The Biggest Malpractice Risk*, 73 A.B.A. J. 32, at 32 (August 1, 1987) (discussing how the initial public offerings of start-up enterprises are very risky for attorneys because attorneys who take equity positions or sit on boards are often held to be liable for eventual losses to shareholders).

153. *See* David A. Hyman, *Professional Responsibility, Legal Malpractice, and the Eternal Triangle: Will Lawyers or Insurers Call the Shots?*, 4 CONN. INS. L.J. 353, 375 (1997) (discussing the possibility that legal malpractice insurers will influence the selection of clients).

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Such advice, however, assumes that risky clients can be identified in advance, despite evidence suggesting this is not always the case.[154] Although attorneys can screen potential clients for prior violations, prior attorney withdrawals, past litigation with the SEC, shareholder derivative actions, or even complex business models that are difficult to value or understand, it will be difficult to identify all risks prior to gaining access to confidential information. Enron, for example, had a board with only two insiders[155] that was made expressly aware of all of the accounting risks that the company was undertaking.[156] "If judged by simplistic standards for good corporate governance, Enron met and exceeded those standards."[157] Although Enron's accountants and board members were aware that Enron was taking certain risks, it is possible that an attorney would only become aware of any risks at a client like an Enron through the course of the representation when, under the section 205 rules, if a QLCC had not been formed, the up the ladder process and the liability concerns associated with the process will already have been activated. This underscores the importance of persuading all potential clients of the need to adopt a QLCC prior to commencement of the representation.

Potential clients who express a reluctance to form a QLCC should be reminded that delay is not in their interests. Specifically, a QLCC that is formed after the emergence of evidence of a material violation is discovered does not relieve the reporting attorney of her duty to assess the response for appropriateness and, where necessary, to continue the reporting up the violation chain.[158] In addition to allowing for the free exchange of ideas and confidential information between attorney and client, the establishment of a QLCC also provides attorneys a greater opportunity for creativity and innovation

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154. For example, Enron exceeded all corporate governance standards and would not have been identified as "a risky client."

155. *See* Marianne M. Jennings, *A Primer on Enron: Lessons From a Perfect Storm of Financial Reporting, Corporate Governance and Ethical Culture Failures*, 39 CAL. W. L. REV. 163, 197-99 (2003) (citing Ken Lay and Jeffrey Skilling as the only insiders on the board).

156. *See id.* at 205-06 (describing how Arthur Andersen LLP partner David Duncan provided Enron's audit committee a document in 1998 detailing risky accounting judgments, disclosure judgments, and rule changes marked as high, medium, and low risk with at least one high risk item in each category).

157. *Id.* at 206.

158. 17 C.F.R. § 205.3(c).

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on behalf of the client.[159] This is ultimately what makes transactional lawyers so valuable; the gatekeeper, compliance role of the attorney is often less lucrative and secondary to the role of transaction designer and engineer.[160] Attorneys are often asked to pass on the legality of the transaction that they created and wish to "sell" to the client.[161] This, to a degree, parallels the conflict between the accountant as auditor and accountant as consultant.[162]

Attorneys will not be forced to take conservative positions to avoid the liability of failing to report an aggressive position as evidence of a material violation. The attorney can, instead, take aggressive positions and, if concerned, can include the QLCC in the decision process from the outset. This will shift the decision on an aggressive legal strategy to the directors on the QLCC who, presumably, better understand the corporation as a whole. This would not have averted the crisis at Enron, because the directors approved many of the risks taken by Enron, but it would protect attorneys from liability for the decisions of the directors, even if the section 205 reporting scheme had been in place at the time of the Enron collapse.[163]

Similarly, although no private cause of action exists under the section 205 rules,[164] the standards of conduct imposed by the SEC could become relevant negligence and malpractice claims brought against attorneys or law firms. Under the up the ladder reporting scheme, this will also encourage conservative legal advice and a tendency to over-report to avoid appearing negligent for failing to comply with the reporting standards. If the client has established a QLCC, however, the standards clearly indicate that reporting to the QLCC is the only step that an attorney is expected to take and, once

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159. *See* Song, *supra* note 98, at 288 (suggesting that the effect of the sanctions under the new rule will be to engender attorney conservatism and inhibit the spread of legitimate innovations).

160. Sean J. Griffith, *Crisis in Confidence: Corporate Governance and Professional Ethics Post-Enron,* 35 CONN. L. REV. 1223, 1225 (2003).

161. *Id.*

162. *Id.*

163. *See* Jennings, *supra* note 155, at 181-82 (indicating that the Enron Board of Directors allowed the establishment of special-purpose entities, supported them with Enron stock, structured them as off-the-books entities, approved their use to purchase Enron assets, and monitored their impact on Enron's financial statements and their claims on Enron stock).

164. 17 C.F.R. § 205.7.

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the evidence has been reported to the QLCC, the attorney is not permitted to take further action.[165] Thus the QLCC allows the attorney to know with certainty when she has taken every possible step and therefore limits the extent that the section 205 standards could be used to prove negligence in civil litigation. Although some corporate boards might be pleased to see their attorneys taking only conservative positions to avoid the dodgy off-balance sheet transactions and the aggressive practices that characterized Enron,[166] the boards will likely modify their position if attorneys start becoming obstacles to transactions that are both calculated risks and popular with management in order to protect themselves from liability.

VI. CONCLUSION

It seems clear that the Sarbanes-Oxley Act of 2002 is part of a backlash against corporate abuses that lead to major scandals such as the collapse of Enron. Section 307 of the Sarbanes-Oxley Act assures the inclusion of attorneys in regulatory schemes that have covered other financial professionals in various forms since the beginning of securities regulation in the 1930s. What remains unclear is whether further action, such as the adoption of noisy withdrawal, will continue to subject attorneys to additional, and often conflicting, ethical responsibilities. The American Bar Association can and should consider the implementation of self-regulation where necessary to deter additional regulation from outside bodies such as Congress and the SEC that do not place high value on privilege and other tenets of the legal profession. Because existing regulation is unlikely to disappear, responsible and self-interested attorneys will respond by educating themselves about the new rules and, where applicable, protecting themselves by encouraging or insisting that all clients, or at least more risky clients, form QLCCs. Law firms and corporations must educate members of their firms that engage in areas other than securities law or that engage in conduct that may have securities implications (such as bankruptcy and antitrust). The American Bar Association and each

165. 17 C.F.R. § 205.3(c).

166. *See In re* Enron Corp., No. 01-16034 (Bankr. S.D.N.Y. Sept. 21, 2002) (listing and detailing accounting and securitization abuses at Enron prior to the filing of Enron's Chapter 11 petition).

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state bar should learn from this potential failure of self-regulation and react more quickly and less defiantly if a similar crisis arises in the future.

Otherwise, the legal profession must simply learn to deal with the new rules that are now part of the legal operating environment, even if attorneys think they are too broad or ineffective. Despite the problems and ambiguities embedded in the section 205 rules, if the rules result in well-meaning managers and directors learning of festering trouble while they still have the opportunity to correct the problem, then the rules have benefited the true client, even if at the expense of some individuals. Additionally, more attorneys are likely to benefit from the additional work created by the rule (and the accompanying fees) than those who are actually injured by enforcement actions. Finally, the litigation, compliance work, and other engagements arising from remaining provisions of the Sarbanes-Oxley Act will employ many attorneys for many years to come; perhaps the additional vigilance required by section 307 will prove to be a small price to have paid.

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