THE SARBANES-OXLEY ACT: TURNING LAWYERS INTO CORPORATE WHISTLEBLOWERS?

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INTRODUCTION

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley").[1] Following in the wake of well-publicized financial failures of corporations such as Enron and WorldCom, the Act was designed to address various aspects of corporate governance and disclosure. Its provisions include requiring oversight of outside auditors of public companies, increasing criminal penalties for long-standing criminal statutes such as mail and wire fraud and creating new crimes for securities fraud, obstruction of investigations and improper certifications by corporate executives relating to public filings. Section 307 of the Act, the result of an amendment by Senator John Edwards of North Carolina, a former trial lawyer, required that the SEC issue rules "setting forth minimum standards of professional conduct for attorneys"

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[1] *See* Section 307, Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

representing issuers in any way before the Commission. Specifically, Section 307 required that the Commission set minimum standards such that an attorney, working for a public company, must report "evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company" to the chief legal officer (CLO) or chief executive officer (CEO) and, if he fails to receive an "appropriate response," to the audit or other independent committee of the board of directors. Most significantly for attorneys is the fact that these provisions are more than "ethics rules." They are, in fact, fully enforceable obligations under the Securities Exchange Act of 1934. This WORKING PAPER discusses the SEC final rule adopted in January of 2003 pertaining to "up the ladder" reporting and the proposed rules regarding required "noisy withdrawal" — which would, in effect, make attorneys whistleblowers with respect to corporate misconduct.

I. SEC IMPLEMENTATION

On November 21, 2002, the SEC issued proposed rules. It solicited comments and hosted a roundtable discussion regarding the proposed rules on December 17, 2002.[2] After considering the extensive public comments on the proposed rules, on January 29, 2003, the SEC adopted Final Rule:

[2] By December 17, 2002, the Commission had received 167 comments from practicing lawyers, law professors and judges regarding the proposed rules.

Implementation of Standards of Professional Conduct for Attorneys, 17 CFR Part 205.[3] The Final Rule does not address withdrawal, but focuses on *reporting* inside and, in some cases, outside the company. In a separate, contemporaneous release, the Commission proposed alternative "noisy withdrawal" rules — permitting or requiring attorneys to withdraw from representation of a company and report the fact of their withdrawal to the Commission and allowed 60 days for additional comments.[4]

II. CURRENT FINAL RULE

A. Reporting Up the Ladder

The Final Rule requires up the ladder reporting in certain circumstances, and permits, but does not require, reports outside the company in specified

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[3]*See* The Securities and Exchange Commission, *Implementation of Standards of Professional Conduct for Attorneys*, 17 CFR Part 205, Release Nos. 33-8185; 34-47276; IC-25919, (the "Final Rule"), issued January 29, 2003, available at http://www.sec.gov/rules/final/33-8185.htm

[4]All comments submitted in response to both the proposed and final releases, and cited in this article, can be seen at the SEC website http://www.sec.gov/rules/proposed/s74502.shtml. Simply put, the debate on "noisy withdrawal" in particular has emerged largely as one between academia, supporting noisy withdrawal, on the one hand, and practicing in-house and outside counsel, on the other, either opposing or expressing concern about required noisy withdrawal. Senator Edwards' amendment to Sarbanes-Oxley originated, in large part, with a letter from Professor Richard W. Painter, a law professor at the University of Illinois and one of 51 signatories to the comments submitted by 51 law professors on the proposed rule 205. *See* Comments of Susan P. Koniak, Roger C. Cramton and George M. Cohen (with list of Academics Who Are in General Agreement) dated December 17, 2002. Extensive comments, generally in opposition to noisy withdrawal, were submitted by over 70 law firms, the American Bar Association, and the American Corporate Counsel Association; Gary Young, *Professors Question Attack on SEC,* National Law Journal, Jan. 8, 2003.

circumstances. Under the Final Rule, an attorney who becomes aware of evidence of a "material violation,"as defined below, must adhere to the following steps:

Step One: Part 205.3(b)(1) requires that an attorney who is representing an issuer before the Commission, and who "becomes aware of evidence of a ***material violation*"** by the issuer, report the evidence of that material violation to either the CLO or *both* the CEO *and* CLO of the issuer. "Material violation" is defined broadly. It includes any "material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty[5] arising under United States federal or state law, or a similar material violation of any United States federal or state law." Final Rule, Part 205.2(i).

Some would say the trigger, requiring the attorney to begin the reporting up process, namely: "evidence of a material violation," is narrowly defined. Under Part 205(2)(e) of the Final Rule, "*Evidence of a material violation* means credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that

[5]"*Breach of fiduciary duty* refers to any breach of fiduciary duty or similar duty to the issuer recognized under an applicable federal or state statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust, and approval of unlawful financial transactions." Final Rule, Part 205.2 (d).

it is reasonably likely[6] that a material violation has occurred, is ongoing, or is about to occur."[7]

Step Two: Part 205.3(b) (3) requires that an attorney then report the matter to the audit committee of the board of directors, some other completely independent committee of the board of directors, or the entire board of directors, unless, within a "reasonable time" the attorney receives what she "reasonably believes" is an "appropriate response" from either the CLO or CEO.[8]

An "appropriate response" is defined as a response from which the attorney "reasonably believes" that: (1) no material violation has in fact occurred, is occurring or is about to occur; (2) that the issuer has taken

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[6]"To be 'reasonably likely' a material violation must be more than a mere possibility, but it need not be "more likely than not." Discussion to Part 205(2) (e) to Final Rule, p. 13.

[7]Practicing attorneys objected to the proposed trigger, arguing that an objective standard is too low a threshold to trigger reporting and argued for a subjective standard, requiring that counsel "actually believe" that a material violation has occurred, is occurring or is about to occur. The Commission, while rejecting this argument, stated that it intended the application of the objective standard to recognize that "there is a range of conduct in which an attorney may engage without being unreasonable," taking into consideration the attorney's skills, background, knowledge of the client, and availability of other attorneys with whom to consult. *See* Discussion to Final Rule, Part 205.2(e), discussing the definition of "evidence of a material violation," at p. 13. Senator Edwards, on the other hand, has reportedly remarked that the Commission's Final Rule formulation of this trigger essentially "gutted" the provision in Sarbanes-Oxley which he sponsored, because the threshold for reporting is "absurdly confusing." *See* Wagner, John, *Senator Critical of SEC,* News-Observer.com, Jan. 25, 2003

[8]Part 205.3(b)(4) permits the attorney to go to the board immediately, without reporting to the CLO or CEO, if he reasonably believes it would be futile to report the evidence of a material violation to them.

appropriate remedial measures if a material violation has occurred; or (3) the issuer has had counsel review the matter and has taken remedial steps recommended by that counsel, or has been advised that counsel may assert a "colorable" defense on behalf of the issuer in any proceeding relating to the supposed "material violation." Final Rule, Part 205.2(b)[9]

Step Three: Finally, having made the report to the board of directors, or committee thereof, if the attorney fails to receive an appropriate response from the issuer, the attorney must then explain his or her reasons for believing that the issuer has not made an appropriate response to the CLO, the CEO and the members of the board of directors to whom he or she previously made the report. Final Rule, Part 205.3(b)(9). At this point, under the Final Rule, the attorney has fulfilled his or her obligations.[10]

B. Reporting Out Permitted

Additionally, the final rule *permits*, but does not require, an attorney to "reveal to the Commission, without the issuer's consent, confidential

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[9]This portion of the Final Rule essentially tracks Section 307 of Sarbanes-Oxley and the Commission did not consider it to be controversial. *See* Discussion to Part 205.3(b) (3).

[10]Part 205.3(c) provides for an alternative reporting procedure where the issuer has previously established a Qualified Legal Compliance Committee (QLCC). A QLCC is defined in Part 205.2(k) and generally requires that the committee consist of one member of the audit committee and at least two other independent members of the board, with procedures for receiving confidential complaints and reporting material violations. If a QLCC is in place, an attorney may discharge her responsibilities completely by making an appropriate report to the QLCC, without regard to any response received from the issuer.

information ... to the extent the attorney believes reasonably 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 issuer or investors;" to prevent the issuer from committing perjury or other false statement, or to rectify the effects of a previous material violation where the attorney's services were used. Final Rule, Part 205.3(d) (2).[11]

II. NOISY WITHDRAWAL PROPOSALS STILL PENDING

A. Noisy Withdrawal *Required* Where Violation Ongoing or Imminent

Contemporaneous with the adoption of the Final Rule, the Commission issued again for public comment the most controversial provision, the required noisy withdrawal provisions.[12] The Proposed Rule, Part 205.3(d) (1), would *require* an attorney to withdraw from his representation of the issuer and notify

[11]The Commission recognized that this provision is inconsistent with the ABA Model Rule 1.6, but asserts that it "corresponds to the ABA's Model Rule 1.6 as proposed by the ABA's Kutak Commission in 1981-1982 and by the ABA's Commission of Evaluation of the Rules of Professional Conduct ("Ethics 2000 Commission") in 2000, and as adopted in the vast majority of states." *See* Discussion of Final Rule, Part 205.3 (d) (2) at page 33. The ABA House of Delegates rejected the Kutak Commission and Ethics 2000 Commission versions of Rule 1.6. Moreover, the form of Rule 1.6 adopted in the majority of states, *permits* an attorney to disclose client confidences to prevent a *criminal fraud*. *See* n. 92 to Discussion of Final Rule. No state's ethics provisions would permit disclosures to address "material violations" not amounting to fraud, particularly those relating to alleged violations of state or federal law or breach of fiduciary duty, as defined in this rule. In any event, the Commission intends that these rules preempt state ethics laws unless they impose "additional obligations on an attorney." Final Rule 205.1

[12]The Securities and Exchange Commission, *Implementation of Standards of Professional Conduct for Attorneys*, 17 CFR Part 205, Release Nos. 33-8186; 34-47282; IC-25920, issued Jan. 29, 2003, ("Proposed Rule")available at http://www.sec.gov/rules/proposed/33-8186.htp.

the Commission of his withdrawal, and that the withdrawal is for "professional reasons," where he has failed to receive an *appropriate response* to a report within the company, he believes that a material violation is *ongoing or about to occur*, and he reasonably believes[13] the material violation is likely to result in substantial injury to the financial interest or property of the issuer or investors.

B. Noisy Withdrawal *Permitted* Where Violation *Not* Ongoing

Proposed Rule 205.3(d) (2) addresses the situation where the attorney has received no appropriate response to his report of a material violation, but the violation is *no longer* occurring. Under those circumstances, if the attorney "reasonably believes" that a material violation has occurred and "is likely to have resulted in substantial injury to the financial interest or property of the issuer or of investors," the attorney *may* withdraw, notify the Commission and take the other steps outlined in Part 205.3 (d)(1). Similarly, in-house counsel

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[13]The use of the term "reasonably believes" is critical. That term is defined as requiring a *subjective belief* by the attorney that a material violation is ongoing or about to occur *and* that it is likely to result in substantial injury. The Commission defined "reasonably believe" as meaning "that an attorney believes the matter in question and ... the circumstances are such that the belief is not unreasonable." Final Rule, Part 205.2(m). The Commission explained that the "definition is based on the definition of 'reasonable belief' or 'reasonably believes' in Rule 1.0(i) of the ABA Model Rules of Professional Conduct..... Because the definition no longer is used in connection with the definition of 'evidence of a material violation,' the proposed rule's attempt to *exclude the subjective element in 'reasonable belief' has been abandoned*." *See* Discussion to Final Rule, Part 205.2(m) at p. 20. [Emphasis supplied]

may take similar steps to disavow misleading documents provided to the Commission.

C. Alternative Noisy Withdrawal Proposal

The Commission has also sought comment upon an alternative noisy withdrawal provision which differs from the primary Proposed Rule in three important respects:

1. First, *noisy* withdrawal *by the attorney* is never required*;*

2. Second, before withdrawal is *required,* the Proposed Rule requires a higher evidentiary standard — the attorney must "reasonably *conclude"* that there is *"substantial* evidence of a material violation that is *ongoing"* and "likely to cause substantial injury to the interests of the issuer or investors[14]; and

3. The *issuer* or client would be required to report the withdrawal of its attorney — or make the noise — to the Commission, not the lawyer. The attorney, retained or employed, would be *permitted* to report the withdrawal to the Commission if the company does not. Proposed Rule Part 205.3(f)

While some are guessing that some form of the "alternative" noisy withdrawal provision may wind up being the final rule,[15] those who have opposed

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[14]An attorney employed by the issuer would be required to withdraw from participation in the matter which is the subject of the violation and advise the issuer that its response was inappropriate. Proposed Rule 205.3(d)(1)(B).

[15]*See, e.g.*, Bilodeau, Otis, *SEC Signals Lawyers Still in Crosshairs,* LEGAL TIMES, Jan. 28, 2003 (reporting that "several observers suggested that [the alternative] was likely to win the commission's eventual approval" and that "legal experts say this procedure might alleviate potential conflicts with state bar rules, as well as ethics rules in some foreign jurisdictions.")

mandatory noisy withdrawal provisions see the alternative as a distinction without a difference from the primary proposal, since, either way, if a lawyer is not satisfied with how the company handles a complaint, someone has to report a problem to the Commission.[16] The law professor advocates of a required noisy withdrawal rule have taken the position that this alternative is an acceptable one, so long as attorneys are *required* to tell the SEC about their withdrawal if the company does not, in essence, giving the company the first shot at it, but otherwise keeping the required noisy withdrawal provision.[17]

CONCLUSION

It is clear from the flood of commentary on all of the proposals that practicing attorneys as a rule do not support mandatory "noisy withdrawal" provisions in any of the forms currently proposed, viewing them as unnecessary given present state ethics rules which are in place and regarding them as a substantial revision of the rules which have traditionally governed the

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[16]Comments from 79 Law Firms (including the authors' firm Preston Gates) dated April 7, 2003, at page 3, pointing out that "as a practical matter, the chilling effect of a *required* notice of attorney withdrawal to the Commission will be equally adverse, *whether that that notice is required to be given by the issuer or the attorney.*"; Comments from American Bar Association, dated Apr. 2, 2003, at 7, observing that "placing too much authority in the hand of an attorney to force company disclosure by withdrawing, distorts the proper allocation of roles between companies, acting through their boards and independent directors, and their attorneys."

[17]*See* Comments of Susan P. Koniak, Roger C. Cramton and George M. Cohen (with list of Academics Who Are in General Agreement) dated Apr. 7, 2003.

relationship between lawyers and their clients.[18] Some have even argued that permitting or requiring "noisy withdrawal" is outside the power given to the SEC or intended by the Congress in passing Sarbanes-Oxley.[19] The advocates

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[18]*See ,e.g.,* Comments from 79 Law Firms (including Preston Gates) dated Apr. 7, 2003; Comments of the American Corporate Counsel Association dated April 7, 2003; Comments of the American Bar Association dated April 2, 2003; *see also* Comments of the Securities Industry Association dated December 18, 2002 ("The noisy withdrawal provisions strike at the heart of the attorney-client relationship with enormous implications, not the least of which could be to undermine an issuer's willingness to consult counsel."); Comments of Business Law Section of New York State Bar Association date Dec. 18, 2002 ("The Proposed Rules threaten to undermine the stability of the attorney-client relationship by mandating conduct by lawyers that could lead to wholesale revelations of previously protected attorney-client communications and of legal advice ostensibly given in confidence. These requirements will undoubtedly have a chilling effect on attorney-client communications and on the willingness of securities issuers to seek and obtain effective legal advice at the time they need it most."); Comments of Corporations Committee, Business Law Section of the State Bar of California dated Dec. 16, 2002 ("We believe ... that the "reporting out" mechanisms established in the Proposed Rules could well put attorneys in the position of essentially being accusers of, rather than advisors to, clients. For that reason, the client may very well find it safer to avoid consulting counsel on close or controversial legal questions — precisely the ones for which legal counsel can be most critical.")

[19]Section 3(a) of Sarbanes-Oxley, gave the Commission authority to "promulgate such rules and regulations, as may be necessary or appropriate in the public interest or for the protection of investors, and in furtherance of [the] Act." Nevertheless, some have pointed out that the floor debate seems to indicate that the sponsors of the bill did not intend to require reporting out. This point is directly argued in the Comments of the Corporation Committee, Business Law Section of the State Bar of California dated December 16, 2002. The Comments point out that during floor debate, Senator Enzi, for example, pointed out that Senator Edwards' amendment "*would not require the attorneys to report violations to the SEC,* only to corporate legal counsel or the CEO, and, ultimately, to the board of directors." Charges that the amendment might require a breach of the attorney client privilege Senator Enzi characterized as "ludicrous" because any required reporting would be "*all internal-within the corporation* and not to an outside party." (citing 148 Cong. Rec. S6555; also citing Comments of Senator Corzine 148 Cong. Rec. S6566) The Comments also note that if Congress intended to require reporting out, it knew how to do so since it required accountants to report out in Section 10A of the Securities and Exchange Act of 1934. *See also* Comments of Dechert, Inc. dated Dec. 18, 2002, at n.2 citing the comments of Senator Sarbanes in his question to Senator Edwards: "It is my understanding that this amendment, which places responsibility upon the lawyer ... to report up the ladder, only involves going up within the corporate structure. He doesn't go outside the corporate structure. ... Is that correct?" In relevant part, Senator Edwards' response was, "Mr. President, my response to the question is the only obligation this amendment creates is to report to the client ... There is no

of imposing such new requirements on attorneys argue that such controls are necessary to prevent future harm to the investing public. They argue that accountants and other securities professionals have been subjected to the same disclosure obligations and those lawyers should not be treated differently. In any event where any noisy withdrawal provisions are ultimately imposed, it is clear that such provisions have the potential to change significantly the relationship between corporate lawyers and their clients.

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obligation to report anything outside the client-the corporation." (citing 148 Cong. Rec. S6557, daily ed. July 10, 2002)