SARBANES-OXLEY'S RULES OF PROFESSIONAL RESPONSIBILITY VIEWED THROUGH A SEXTONIAN LENS

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INTRODUCTION

In 1982, John Sexton published a seminal work on the corporate attorney-client privilege.[1] The article claimed the modest goal of seeking "only to frame for discussion important issues regarding the scope of the corporate privilege."[2] However, the article accomplished much more than that, critically analyzing the assumptions underlying the privilege and developing a framework for courts to apply in determining what communications to protect.

Twenty years after publication of Sexton's article, Congress passed the Sarbanes-Oxley Act ("Sarbanes-Oxley"),[3] which addresses a range of corporate governance issues. One of the provisions of Sarbanes-Oxley, section 307, establishes "Rules of Professional Responsibility for Attorneys." Section 307 imposes on attorneys an obligation to report wrongdoing by a client corporation or any agent thereof to the chief legal counsel for the company

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1. John E. Sexton, *A Post-*Upjohn *Consideration of the Corporate Attorney-Client Privilege*, 57 N.Y.U. L. REV. 443 (1982). A number of subsequent judicial decisions and law review articles have relied upon the arguments advanced in the piece. *See, e.g.*, Energy Capital Corp. v. U.S., 45 Fed. Cl. 481 (2000) (adopting Sexton's view of whose communications with counsel should be protected by the privilege); *In re* Bieter Co., 16 F.3d 929, 936 (8th Cir. 1994) (calling Sexton's article "the only significant scholarship . . . that analyzes the effect of *Upjohn* on the corporate attorney-client privilege"); First Chi. Int'l v. United Exch. Co., 125 F.R.D. 55, 57 (S.D.N.Y. 1989) (citing Sexton's functional approach to resolution of corporate attorney-client privilege questions); Rager v. Boise Cascade Corp., No. 88 C 1436, 1988 U.S. Dist. LEXIS 8888, at *6 (N.D. Ill. Aug. 1, 1988); Command Transp. Inc. v. Y.S. Line (USA) Corp., 116 F.R.D. 94, 97 (D. Mass. 1987).

2. Sexton, *supra* note 1, at 444. R

3. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.A. (West Supp. 2003)).

or the company's chief executive officer ("CEO"). It further requires that if appropriate action is not taken in response to the report, the attorney must report the evidence of wrongdoing to the company's board of directors or a designated committee thereof. On January 23, 2003, the Securities and Exchange Commission ("SEC") promulgated final rules setting forth minimum standards of professional conduct for attorneys.[4] The final regulations represented something of a retreat from the SEC's proposed regulations on the subject,[5] which were the subject of extensive comment and criticism by practicing attorneys and by the ABA.[6] Despite the retreat, there remain "fears that individuals within the corporate client will hesitate to consult with the corporate attorneys on crucial matters for fear of being reported to management."[7]

Section 307 of Sarbanes-Oxley addresses primarily an attorney's confidentiality obligation, an ethical obligation that is distinct from the evidentiary attorney-client privilege.[8] Nonetheless, the two doctrines have common roots, and the arguments and analyses advanced by Sexton regarding the privilege and its underlying assumptions provide a useful means for analyzing Congress' statutory provision and the SEC's approach to implementing the provision. His analysis is particularly useful because it provides a means to consider the provision objectively, outside the crossfire and hyperbole of the opposing sides of the current debate.

This article proceeds in three parts. Part I contains a brief overview of Sexton's article, focusing particularly on his analysis of the two assumptions underlying the corporate attorney-client privilege. Part II discusses section 307 of Sarbanes-Oxley and the rules adopted by the SEC to implement the statutory provision. Part III utilizes the analysis in the Sexton article to evaluate whether the Sarbanes-Oxley professional responsibility provisions and the SEC regulations represent a considered approach to minimizing corpo-

4. Standards of Professional Conduct for Attorneys Appearing and Practicing before the Commission in the Representation of an Issuer, 17 C.F.R. § 205 (2003).

5. Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71,670 (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. pt. 205).

6. *See infra* text accompanying notes 37-38. **R**

7. Stephanie R.E. Patterson, *Section 307 of the Sarbanes-Oxley Act: Eroding the Legal Profession's System of Self-Governance?*, 7 N.C. BANKING INST. 155, 157 (2003).

8. Although the two concepts are distinct, as a practical matter, "(1) clients do not understand the difference between the two concepts; (2) courts routinely confuse the concepts; and (3) lawyers either share in the confusion or fail to address the differences adequately." Kristi Belt & Geoffrey P. Kirshbaum, *Report of the Working Group on Confidentiality and the Limits on the Attorney-Client Privilege*, 41 S. TEX. L. REV. 37, 37 (1999).

rate wrongdoing or an unwise step that risks damaging the relationship between a corporation and its attorney.[9] Despite criticism of the SEC, I conclude that the SEC's Final Regulations are an appropriate initial response to concerns about corporate wrongdoing and do not constitute a threat to the attorney-client relationship.

I.
SEXTON'S CONSIDERATION OF THE ATTORNEY-CLIENT PRIVILEGE

The starting point for Sexton's analysis of the attorney-client privilege is the Supreme Court's 1981 decision in *Upjohn Co. v. United States*.[10] At the time the case came before the Court, federal circuit courts were unanimous in their view that corporations could invoke the attorney-client privilege, but were split regarding the scope of the communications protected by the privilege. Some circuits had adopted a control group test, the focus of which is whether

> the employee making the communication, of whatever rank he may be, is in a position to control or even to take a substantial part in a decision about any action which the corporation may take upon the advice of the attorney, or if he is an authorized member of a body or group which has that authority.[11]

Others adopted a subject-matter test, which privileged communications "where the employee makes the communications at the direction of his superiors in the corporation and where the subject matter upon which the attorney's advice is sought by the corporation and dealt with in the communication is the performance by the employee of the duties of his employment."[12]

Although the Supreme Court in *Upjohn* rejected the control group test, it did not embrace the subject-matter test. Instead, as Sexton describes it, the Court adopted a functional approach to the

9. This article is not intended to be a comprehensive analysis of section 307 and the SEC's regulations thereunder. Thus, I do not here discuss issues regarding the scope of the rules, such as what it means to "appear and practice before the Commission," so as to be subject to the rules or the SEC's authority to adopt the rules. I confine myself to a discussion of only those issues relevant to the heart of the confidentiality relationship between counsel and client.

10. 449 U.S. 383 (1981).

11. Sexton, *supra* note 1, at 451 (quoting City of Phila. v. Westinghouse Elec. Corp., 210 F. Supp. 483, 485 (E.D. Pa.), *mandamus denied sub nom.* Gen. Elec. Co. v. Kirkpatrick, 312 F.2d 742 (3d Cir. 1962)). R

12. *Id.* at 453 (quoting Harper & Row Publ'g, Inc. v. Decker, 423 F.2d 487, 491–92 (7th Cir. 1970), *aff'd per curiam by an equally divided court*, 400 U.S. 348 (1971)).

attorney-client privilege, focusing on the "perceived purpose of the privilege. In large part, the Court's inquiry resolves into a single question: Would application of the privilege under the circumstances of this particular case foster the flow of information to corporate counsel regarding issues about which the corporation seeks legal advice?"[13]

Sexton discerns two "problematic" assumptions underlying the Supreme Court's willingness to extend the attorney-client privilege to corporations and explaining its functional approach.[14] The Court assumes first, that

> application of the privilege in the corporate setting does, in fact, induce corporate clients to provide their attorneys with information that, absent the privilege, they would not provide, and second, that once attorneys inform corporate decisionmakers of the demands of the law, the decisionmakers will conform their behavior to those demands.[15]

His analysis of each assumption is useful to a consideration of section 307 of Sarbanes-Oxley.

The first assumption underlying the Court's view of the attorney-client privilege is that the privilege results in increased communication between corporate clients and their counsel. The first problem with this assumption, Sexton points out, is that corporations have little choice but to communicate with their attorneys, regardless of the privilege, given the extent to which their activities involve legal issues and the costs of not receiving necessary legal advice. He does not argue that the privilege yields no increase in communication, conceding that there may be some corporate actors for whom the privilege is meaningful. Nevertheless, Sexton acknowledges that, since the corporation may always waive its privilege, such individual actors have no guarantee that their communication will be protected.

Sexton found no empirical evidence to support the assumption that the corporate attorney-client privilege induces communication that would not occur but for the existence of the privilege; this lack of empirical support persists today. Indeed, much of the little empirical evidence that there is on this topic suggests that clients are either unaware of the privilege or misunderstand its scope, and that

13. *Id.* at 459.
14. *Id.* at 463.
15. *Id.*

the privilege is of much more concern and interest to lawyers than to clients.[16]

Even if the attorney-client privilege does increase the flow of information between a corporate client and its counsel, the question is whether that increased flow of information is beneficial. More precisely, why is this increased communication sufficiently important to justify a potential hindering of the administration of justice resulting from nondisclosure? The answer to this question lies in the Court's second assumption.

The second assumption underlying the Court's view of the corporate attorney-client privilege is that increased communication between the corporate client and its counsel is beneficial in that it will result in increased corporate compliance with the law. Sexton describes the Court as adopting a "voluntary compliance" model of corporate response to governmental regulation, under which "the corporation's attorney is strategically placed to facilitate the process of voluntary compliance: if she is given all the relevant information, she can inform corporate officials of their legal duties, and they, as law-abiding citizens, will execute them."[17]

As Sexton points out, however, although the activity of the Upjohn officials was consistent with this voluntary compliance model, the same cannot be said for corporate behavior in general. As the events which resulted in the enactment of Sarbanes-Oxley graphically illustrate, corporate officials often seem to be more interested in testing how much they can get away with under the law than with voluntarily complying with its mandates. Sexton describes this more realistic vision[18] as being consistent with a "regulatory model," in which "the corporation's attorney is strategically placed to help stymie enforcement."[19] Under such a model, anything that diminishes the public availability of information (including the privilege) harms the ability of the government and private attorneys-general to enforce the law. Importantly, as Sexton observes, the Court in *Upjohn* adopted a rule applicable to all cases, despite the fact that it had before it the highly unusual situation of

16. *See* Elizabeth G. Thornburg, *Sanctifying Secrecy: The Mythology of the Corporate Attorney-Client Privilege*, 69 NOTRE DAME L. REV. 157, 162–64 (1993) (reporting results of several studies of the privilege).

17. Sexton, *supra* note 1, at 468–69. **R**

18. Sexton is not willing to explicitly choose between the models, suggesting that "the reality of corporate behavior falls somewhere between the two." *Id.* at 471. He describes the choice not as one between models but as one of primary emphasis.

19. *Id.* at 469–70.

a corporation behaving in accordance with the voluntary compliance model.[20]

The operation of the attorney-client privilege not only harms the ability of the government and private attorneys-general to enforce the law, it also potentially denies opposing parties a fertile source of information.[21] Sexton believes this danger is especially troubling in the corporate context, where a corporation's records and documents often hold the strongest evidence of corporate wrongdoing.[22] If, because of the privilege, these "paper trails" are shielded from discovery, "adversaries of the corporation in litigation may lose more often than they should simply because of lack of information."[23] Litigation may be discouraged—leaving the public and legislature unaware of corporate abuses.[24] Although this "cost" of the privilege may be mitigated by the opponent's ability to obtain information from the corporation's employees if not from the paper trail,[25] tensions remain; unlike individual actors, corporations can "funnel" their information so it is not discoverable until it reaches the corporation's attorney—thus creating a privileged status for the information.[26]

Thus, Sexton argues that courts applying the *Upjohn* rule must delineate specific principles that "reflect and explicate the purposes of the privilege" in order to balance the benefits of the privilege with these potentially high costs.[27] The three shaping principles Sexton identifies are: (1) minimizing costs while maximizing benefits of the privilege, (2) creating predictability in the privilege's protection, and (3) establishing a presumption in favor of protecting communications if a precise balance of costs and benefits is not possible.[28] These three principles are intended to parallel the *Upjohn* Court's "functional" approach to the privilege.[29]

20. *Id.* at 471.

21. *Id.* at 476.

22. *Id.* at 477.

23. *Id.*

24. *Id.* at 477 n.127.

25. *Id.* at 477 ("Any information obtained by an attorney from the employees of a corporation remains with those employees and is thus fully subject to discovery. Communications, not facts, are protected by the privilege.").

26. *Id.* at 478.

27. *Id.* at 480.

28. *Id.* at 480-86.

29. *Id.* at 486-87.

II.
SARBANES-OXLEY'S RULES OF PROFESSIONAL RESPONSIBILITY

The Sarbanes-Oxley Act of 2002, described as one of the "'most far-reaching reforms of American business practices'" since the New Deal,[30] was rushed through Congress in the summer of 2002 in response to widespread corporate scandals that seriously undermined investor confidence in the capital markets.[31] Because these scandals involved highly-ranked corporate executives and, at least in some cases, involved transactions and events known to corporate counsel,[32] it is not surprising that one of the areas Congress sought to address in Sarbanes-Oxley was the conduct of attorneys who become aware of corporate wrongdoing.

Section 307 of Sarbanes-Oxley, entitled "Rules of Professional Responsibility for Attorneys," establishes minimum standards for the professional conduct of attorneys. Added to Sarbanes-Oxley by a rider inserted into the legislation by floor amendment rather late in the process, the section provides that:

> Not later than 180 days after the date of enactment of this Act, the Commission shall issue rules in the public interest and for the protection of investors, setting forth minimum standards of professional conduct of attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule—
>
> (1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and

30. Michael A. Perino, *Enron's Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002*, 76 ST. JOHN'S L. REV. 671, 671 (2002) (quoting Elisabeth Bumiller, *Bush Signs Bill Aimed at Fraud in Corporations*, N.Y. TIMES, July 31, 2002, at A1).

31. *See* American Bar Association Task Force on Corporate Responsibility, *Preliminary Report of the American Bar Association Task Force on Corporate Responsibility*, at 2–3 n.2 (July 16, 2002), *available at* http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf (last visited Sept. 9, 2003) (on file with the *NYU Annual Survey of American Law*) (reporting on scandals involving WorldCom, Adelphia Communications, Tyco International, and Global Crossing Ltd., each of which had devastating effects on shareholders).

32. *See* John C. Coffee, Jr., *Proposed Sec. 307 Rules*, NAT'L L.J., Dec. 2, 2002, at B8 (observing that many in the post-Enron environment "believe that attorneys, at least as much as accountants, failed their responsibilities").

(2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors, comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

Proposed rules were issued by the SEC on November 21, 2002 ("Proposed Rules").[33] In accordance with section 307, these rules required "up-the-ladder reporting" by any attorney encountering evidence of a material violation of securities laws, breach of fiduciary duties, or similar violations by a client issuer. The Proposed Rules required an attorney to report any such material violation to the corporation's chief legal officer and CEO. If these officers fail to respond appropriately, the reporting attorney would have a further obligation to report the evidence of material violation to the corporation's board of directors, or to a committee of independent board members.[34]

In addition, the Proposed Rules contained a requirement of "noisy withdrawal," which would have required that outside counsel withdraw from representation in situations where the board or board committee does not respond appropriately to the attorney's report of wrongdoing, communicating to the SEC that such withdrawal occurred "for professional considerations."[35] This noisy withdrawal provision also included a requirement that counsel dis-

33. Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71,670 (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. pt. 205).

34. Though not required, an issuer may create a legal compliance committee to investigate reports made by attorneys of material violations. This committee must be comprised of at least one member of the issuer's audit committee, and at least two members of the issuer's board. All members must be independent. Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205.3(c)(1) (2003). One of the comment letters to the SEC's Proposed Rules suggested that many companies would be likely to avail themselves of the ability to establish such a compliance committee and that their doing so would make it less likely that the noisy withdrawal provision of the Proposed Regulations would need to be utilized. *See* Letter from Susan P. Koniak et al. to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Dec. 17, 2002), *available at* http://www.sec.gov/rules/proposed/s74502/skoniak1.htm (last visited Aug. 30, 2003) (on file with the *NYU Annual Survey of American Law*) [hereinafter Letter from 51 Law Professors].

35. As one comment letter on the Proposed Rule observed, the proposed "noisy withdrawal" requirement would require more than is generally understood by the concept of noisy withdrawal:

affirm any documents filed with or submitted to the SEC that counsel helped prepare and believes may be materially false or misleading.[36]

During the comment period on the Proposed Regulations, the SEC received over 150 comment letters.[37] Although these letters addressed a number of issues, including the scope of the proposed rules and the triggering standard for an attorney's obligation to report wrongdoing, the focus of most commentators was the rule's most controversial component—its noisy withdrawal requirement. In addition to concerns about the effect of a noisy withdrawal requirement on the attorney-client relationship, many commentators argued that the requirement exceeded the SEC's mandate under section 307.[38]

> Noisy withdrawal is generally understood to refer to situations in which a lawyer withdraws from an engagement while making clear to third parties that they can no longer rely on certain statements or opinions previously made by the lawyer. Noisy withdrawal is appropriate where a lawyer wishes to make sure that his services are not used to perpetrate or perpetuate a fraud. . . . The noisy withdrawal the Commission has proposed is much more. It is withdrawal accompanied by the lawyer's statement, albeit nominally coded, that his client is violating or is about to violate a law, that the lawyer has sought to get the client to stop but to no avail, and that the client's conduct, if left unstopped, will result in substantial financial injury to an issuer or its shareholders. The meaning of the message is unmistakable.

Letter from Cleary, Gottlieb, Steen & Hamilton to Jonathan G. Katz, Esq., Secretary, United States Securities and Exchange Commission (Dec. 18, 2002), *available at* http://www.sec.gov/rules/proposed/s74502/efgreene1.htm (last visited Aug. 30, 2003) (on file with the *NYU Annual Survey of American Law*) [hereinafter Cleary, Gottlieb Comment Letter].

36. Under the Proposed Regulations, in-house counsel are not required to resign their employment. They are, however, subject to the requirement to disaffirm any "tainted" submissions to the SEC.

37. *See Comments on Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys*, *at* http://www.sec.gov/rules/proposed/s74502.shtml (listing and containing links to comment letters received by the SEC) (last visited Aug. 30, 2003) (on file with the *NYU Annual Survey of American Law*).

38. *See, e.g.*, Letter from Joseph A. Grundfest et al. to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Dec. 23, 2002) (Corrected Version), *available at* http://www.sec.gov/rules/proposed/s74502/jagrundfest1.htm (last visited Aug. 30, 2003) (on file with the *NYU Annual Survey of American Law*). There is support for this belief in the legislative history to section 307. *See* 148 CONG. REC. S6555-57 (daily ed. July 10, 2002) (containing floor discussion clarifying that the provision contains no obligation for reporting outside of the corporation). It is clear from the SEC release accompanying the final rules that the SEC does not agree that it lacks the authority under Sarbanes-Oxley to impose a noisy withdrawal requirement. Nonetheless, it agreed that the complexity of the rule justified further consideration of the issue. *See* U.S. Securities and Exchange Commission, *SEC Adopts Attorney Conduct Rule Under Sarbanes-Oxley Act* (Jan. 22, 2003), *at* http://

The SEC issued its final rules implementing section 307 on January 23, 2003 ("Final Rules").[39] The Final Rules retain the "up-the-ladder" reporting requirement, providing that if attorneys who "appear and practice" before the Commission "in the representation of an issuer" learn of evidence of a material violation of securities law or breach of fiduciary duty or similar violation by a client company or by any officer, director, employee, or agent thereof, those attorneys must report that evidence to the issuer's chief legal officer or CEO.[40] The Final Rules confirm that the SEC looks to an objective standard in determining when evidence of a material violation is sufficient to require reporting; reporting is required only where "credible evidence" exists, "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."[41]

The Final Rules further require that if the corporate client's chief legal counsel or CEO does not respond appropriately to the evidence within a reasonable time, the attorney must report such evidence to the company's audit committee, another committee of independent directors, or the full board of directors.[42] If, because of the chief legal officer's initial response, the attorney reasonably

www.sec.gov/news/press/2003-13.htm (last visited Sept. 2, 2003) (on file with the *NYU Annual Survey of American Law*).

39. Standards of Professional Conduct for Attorneys Appearing and Practicing before the Commission in the Representation of an Issuer, 17 C.F.R. § 205 (2003).

40. *Id.* § 205.3(b). Although the Final Rules do not define specifically what is meant by a material violation, the SEC's release to the Final Rules explains that they do not do so "because that term has a well-established meaning under the federal securities laws and the Commission intends for that same meaning to apply here." Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6296, 6303 (Feb. 6, 2003) (to be codified at 17 C.F.R. pt. 205) (citing Basic, Inc. v. Levinson, 485 U.S. 224, 231–36 (1988); TSC Indus. v. Northway, Inc., 426 U.S. 438 (1976)).

41. Standards of Professional Conduct for Attorneys Appearing and Practicing before the Commission in the Representation of an Issuer, 17 C.F.R. § 205.2(e). In the view of the SEC, "reasonably likely" is a lower threshold than "more likely than not," but higher than "more than remote." *See* Disclosure in Management's Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations, Exchange Act Release No. 33-8182, [Vol. 79, No. 9] SEC Docket (CCH) ¶ 1,251, at 1,256 (Jan. 28, 2003). An attorney's skills, background, experiences, and other factors are relevant in assessing her reasonable belief.

42. 17 C.F.R. § 205.3(b)(3)(i-iii). If a reporting attorney receives a response she reasonably believes to be appropriate, she has no further reporting obligations.

believes "[t]hat no material violation . . . has occurred, is ongoing, or is about to occur," then the response is considered "appropriate."[43] The response is also "appropriate" if the attorney reasonably believes the issuer has taken adequate and proper remedial steps.[44]

Many of the comment letters to the Proposed Rules voiced concern about the difficulty of determining the attorney's "reasonable belief," and what might constitute "proper remedial steps."[45] The SEC adopted a definition of "reasonable belief" in its Final Rules that involves weighing all attendant circumstances, including the amount of the evidence of a material violation, the severity of the alleged violation, and the scope of the investigation into the report.[46] It made clear that a reasonable belief that the issuer had taken adequate and proper remedial steps could not be based solely on the assurances of an issuer that no material violation had occurred.[47]

The Final Rules contain a broad notion of what constitutes an appropriate response by the issuer. They provide that appropriate responses to an attorney's reporting include an issuer's directing its counsel to undertake an internal review, and implementing the attorney's suggestions after a reasonable investigation and evaluation of the evidence.[48] The retained attorney in charge of the evalua-

43. *Id.* § 205.2(b)(1).

44. *Id.* § 205.2(b)(2)–(3); *see also* Implementation of Standards for Professional Conduct for Attorneys, Exchange Act Release No. 33-8185, [Vol. 79, No. 9] SEC Docket (CCH) ¶ 1,351, at 1,357 (Jan. 29, 2003).

45. Implementation of Standards for Professional Conduct for Attorneys, Exchange Act Release No. 33-8185, [Vol. 79, No. 9] SEC Docket (CCH) ¶ 1,351, at 1,358 (Jan. 29, 2003); *see also* Letter from Alfred P. Carlton, Jr., President, American Bar Association to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Dec. 18, 2002), *available at* http://www.sec.gov/rules/proposed/s74502/apcarlton1.htm (last visited Sep. 7, 2003) (on file with the *NYU Annual Survey of American Law*) [hereinafter Letter from ABA]; *Comments of the Corporation, Finance and Securities Law Section of the District of Columbia, File No. S7-45-02*, *available at* http://www.sec.gov/rules/proposed/s74502/cfslsdcbar040703.htm (last visited Sept. 8, 2003) (on file with the *NYU Annual Survey of American Law*) (criticizing various actions suggested for attorneys under the proposed Rule).

46. *See* 17 C.F.R. § 205.2(m); Implementation of Standards for Professional Conduct for Attorneys, Exchange Act Release No. 33-8185 [Vol. 79, No. 9] SEC Docket (CCH) ¶ 1,351, at 1,358 (Jan. 29, 2003).

47. Implementation of Standards for Professional Conduct for Attorneys, Exchange Act Release No. 33-8185 [Vol. 79, No. 9] SEC Docket (CCH) ¶ 1,351, at 1,358 (Jan. 29, 2003). The Commission did note that an issuer's assurances may be relevant in a determination of reasonable belief, but making those assurances dispositive would relieve the issuer from taking additional investigative or remedial steps. *Id.*

48. *Id.*

tion must have been retained with the consent of the issuer's board of directors, the committee to whom the report will be made, or a legal compliance committee.[49] Additionally, if a "colorable" defense can be asserted consistent with an attorney's ethical obligations, it would be appropriate for the issuer to direct its defense counsel to assert that defense in any judicial action regarding the alleged violation.[50] The SEC specifically noted that in delineating what are appropriate responses to alleged material violations, the intention was not to "impair zealous advocacy, which is essential to the Commission's processes."[51]

The Final Rules do not contain the noisy withdrawal requirement contained in the Proposed Rules. Instead, the SEC extended the comment period on this requirement in light of "the significance and complexity of the issues involved."[52] At the same time it proposed for comment an alternative to the noisy withdrawal requirement. The alternative requires that the attorney who does not receive an appropriate response to his reporting of a material violation withdraw from representation, notifying the issuer that the withdrawal is for "professional considerations," and that the issuer, rather than the attorney, has an obligation to publicly disclose the attorney's withdrawal.[53]

Finally, the Final Rules permit an attorney, without client consent, to reveal confidential information related to the representation to the extent the attorney reasonably believes necessary to prevent the issuer from a material violation likely to cause substantial injury to shareholders, to prevent the issuer from committing an illegal act, or to rectify the consequences of a material violation or illegal act in which the attorney's services have been used.[54]

49. 17 C.F.R. § 205.2(b)(3).

50. *Id.* § 205.3(b)(6)(ii); Implementation of Standards for Professional Conduct for Attorneys, Exchange Act Release No. 33-8185 [Vol. 79, No. 9] SEC Docket (CCH) ¶ 1,351, at 1,358 (Jan. 29, 2003).

51. Implementation of Standards for Professional Conduct for Attorneys, Exchange Act Release No. 33-8185 [Vol. 79, No. 9] SEC Docket (CCH) ¶ 1,351, at 1,358 (Jan. 29, 2003) (quoting Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71,670, 71,673 (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. pt. 205)).

52. U.S. Securities and Exchange Commission, *SEC Adopts Attorney Conduct Rule Under Sarbanes-Oxley Act* (Jan. 22, 2003), *at* http://www.sec.gov/news/press/2003-13.htm (last visited Sept. 2, 2003) (on file with the *NYU Annual Survey of American Law*).

53. *Id.*

54. 17 C.F.R. § 205.3(d)(2)(i-iii).

III. SARBANES-OXLEY THROUGH A SEXTONIAN LENS

The attorney's ethical obligation to keep client confidences and the evidentiary attorney-client privilege are separate concepts and the information they protect is not coextensive. For example, certain information learned by the attorney in the course of his representation of a client may be confidential, but not protected by the attorney-client privilege, which only protects information an attorney receives from the client.[55] Similarly, whereas the evidentiary privilege only protects communications that occur during the course of a professional relationship, the obligation of confidentiality also protects information obtained before or after such a relationship.[56]

Nonetheless, the two doctrines emanate from the same concern. That is, both are designed to foster a client's honesty with her attorney on the belief that such honesty is necessary for effective attorney representation of the client. With respect to the attorney's ethical obligations, the ABA has observed that the Model Rules of Professional Conduct ("Model Rules") "seek to ensure that clients, including organizations, have access to independent and effective representation by counsel. An integral part of independent and effective representation is that lawyers must preserve client confidentiality subject to limited exceptions when necessary to prevent significant harm."[57] Similarly, the attorney-client privilege is rooted in the desire to "promote freedom of consultation of legal advisers by clients."[58] As expressed by the Ninth Circuit, the purpose of the

55. *See* ABA ANNOTATED MODEL RULES OF PROF'L CONDUCT R. 1.6 cmt. 91 (2d ed. 1992) ("[T]he fiduciary obligation of confidentiality encompasses more than the attorney-client privilege since it can include the client's confidences and secrets even if the same information may be discoverable from other sources."); Belt & Kirshbaum, *supra* note 8, at 38.

56. *See, e.g.*, United States v. Moscony, 927 F.2d 742, 748-49 n.7 (3d Cir. 1991).

57. Letter from ABA, *supra* note 45, at 4.

58. 8 JOHN HENRY WIGMORE, EVIDENCE IN TRIALS AT COMMON LAW § 2291 (John T. McNaughton ed., Aspen 1961); *see also* Upjohn Co. v. United States, 449 U.S. 383, 389 (1981) (The purpose of the privilege "is to encourage full and frank communications between attorneys and their clients and thereby promote broader public interests in the observance of law and the administration of justice."); Hunt v. Blackburn, 128 U.S. 464, 470 (1888) (The privilege "is founded upon the necessity, in the interest and administration of justice, of the aid of persons having knowledge of the law and skilled in its practice, which assistance can only be safely and readily availed of when free from the consequences or the apprehension of disclosure.").

privilege is "to encourage clients to confide fully in their attorneys without fear of future disclosure of such confidences."[59]

Because the two doctrines have similar aims, Sexton's discussion of the assumptions underlying the attorney-client privilege is useful in assessing the SEC's attempt to implement the congressional command of section 307 of Sarbanes-Oxley.

A. *Assumption That Confidentiality Will Increase Communications*

The same assumption regarding confidentiality that underlies the attorney-client privilege has been advanced with respect to the attorney's confidentiality obligation. "[T]o have access to effective legal representation and obtain the best legal advice, clients need to feel free to confide all relevant information to counsel without undue concern that counsel will be required to disclose those confidences to others, particularly government agencies."[60]

The first question is whether there is any concern that the up-the-ladder reporting requirement will have a chilling effect on attorney-client communication. The simple answer is no. The only effect of Sarbanes-Oxley in this regard is to explicitly require of counsel what the Model Rules already permit.[61] Model Rule 1.13 provides that if a lawyer becomes aware that someone within the corporate client is engaging in (or intends to engage in) a violation of law that is likely to result in substantial injury to the corporation, the lawyer shall take steps to protect the client's best interests. Counsel is authorized under the Rules to take a number of actions, including "referring the matter to higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act on behalf of the organization as determined by applicable law."[62]

59. *In re* Fischel, 557 F.2d 209, 211 (9th Cir. 1977).

60. Letter from ABA, *supra* note 45, at 8; *see also* Terry Carter, *Going Before the SEC: ABA, Others Criticize Proposed Lawyer Regs*, ABA J. eREPORT (Dec. 20, 2002), *at* http://law.gsu.edu/ccunningham/PR/ABAReport-SEC-Dec20-02.htm (last visited Sept. 24, 2003) (on file with the *NYU Annual Survey of American Law*) ("Lawyers can best advise their clients when clients share information fully and openly. When clients fear their secrets are unsafe, they may not seek or obtain the legal advice that heads off behavior that harms the public.") (quoting M. Peter Moser, Chair of the ABA Task Force on Implementation of Section 307 of the Sarbanes-Oxley Act of 2002).

61. STEPHEN GILLERS & ROY D. SIMON, REGULATION OF LAWYERS: STATUTES AND STANDARDS, at xxvi (2002) ("As of fall 2001, more than 40 states and the District of Columbia have adopted all or significant portions of the Model Rules.").

62. MODEL RULES OF PROF'L CONDUCT R. 1.13(b)(3) (2002).

Although up-the-ladder reporting is only voluntary under the Model Rules and the standards that would permit such reporting are different from the standards contained in the Final Rules,[63] clients already know such reporting is possible in the case of violations of law. Since client reaction is hardly likely to depend on the particulars of the reporting standard, if any chilling were likely, it would already be occurring. Yet, there is an absence of any empirical evidence suggesting that the Model Rules in their current form have any chilling effect. Even if the Sarbanes-Oxley regulations represented a more substantial change to the current rules, there is no reason to believe that *internal* reporting should create such a chilling effect, especially in the context of Final Rules that contain a very broad notion of what constitutes an appropriate response to an attorney's initial report of wrongdoing.[64]

Although the Final Rules do not contain a noisy withdrawal requirement, the possibility of enacting such a requirement is still under consideration by the SEC. Thus, it is also important to consider whether there is a legitimate concern over whether the noisy withdrawal provision of the proposed regulation would have a chilling effect. Although not all members of the legal profession are opposed to requiring attorneys to report outside of the corporate client,[65] the ABA took the position that noisy withdrawal would interfere with the relationship of trust and confidence between attor-

63. Under the Model Rules, actual knowledge of a violation is required and the violation must be one that would likely result in substantial harm to the corporation. *See id.* R. 1.13(b). In its release accompanying the Proposed Rules, the SEC expressed its belief that the actual knowledge standard is not broad enough to protect the public interest. *See* Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71,670, 71,682 (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. pt. 205) (soliciting comments).

64. *See supra* notes 48–51 and accompanying text. The wisdom of mandating up-the-ladder reporting is another matter. Apart from concerns related to the attorney's confidentiality obligation, it may be, as some have argued, that mandatory up-the-ladder reporting is too inflexible an approach and that attorneys should be free to work with clients to come up with alternative compliance and reporting procedures.

65. Letter from Schiff Hardin & Waite to Jonathan G. Katz, Secretary, U.S. Securities and Exchange Commission (Dec. 18, 2002), *available at* http://www.sec.gov/rules/proposed/s74502/schiffhardin1.htm (last visited Sept. 2, 2003) (on file with the *NYU Annual Survey of American Law*) ("'[S]ome of the [signatories to the letter] believe that in certain circumstances a lawyer should be required to do more than report to the client's board of directors . . . .'") (quoting Letter from Richard W. Painter et al. to Harvey Pitt, Chairman, Securities and Exchange Commission (Mar. 7, 2002)). The Painter letter, written several months before the enactment of Sarbanes-Oxley, requested that the SEC implement an up-the-ladder reporting requirement. *Id.*

ney and client, thus undermining the ability of attorneys to effectively represent their clients.[66] It expressed the fear that

> some issuers might not even consult qualified attorneys regarding close issues of whether or not to disclose information in a filing or otherwise because the attorney might engage in a noisy withdrawal even though all that may have been involved was a matter of business judgment as to the materiality of certain information.[67]

However, for the reasons discussed by Sexton, this concern is exaggerated. First, as he notes, corporations have little choice but to communicate with counsel regardless of the possibility of noisy withdrawal. The client's decision to communicate is affected by business considerations, not the existence of privilege or a confidentiality obligation.[68]

Second, in the context of the attorney-client privilege, Sexton observed that the corporation's ability to waive the privilege means that there is never a guarantee that the communications of its individual actors will be protected. That same lack of guarantee exists in this context. The possibility of attorney withdrawal—indeed, a form of noisy withdrawal—already existed under the Model Rules prior to the adoption of Sarbanes-Oxley. Model Rule 1.16(a)(1) requires lawyers to withdraw from client representation if the representation will result in a violation of the rules of professional conduct or other law.[69] Further, Model Rule 1.2(d) prohibits a lawyer from assisting a client in conduct the lawyer knows is criminal or fraudulent,[70] and a comment to this rule explicitly provides that "[i]n some cases, withdrawal alone might be insufficient. It may be necessary for the lawyer to give notice of the fact of withdrawal and to disaffirm any opinion, document, affirmation or the like."[71]

66. Letter from ABA, *supra* note 45, at 6, 26. Other comments were less committal, suggesting it was not clear whether the noisy withdrawal provision would make clients more likely to follow their lawyer's advice or less likely to seek advice in the first place. *See, e.g.*, Cleary, Gottlieb Comment Letter, *supra* note 35.

67. Letter from ABA, *supra* note 45, at 26.

68. *See* Thornburg, *supra* note 16, at 165 (discussing result of New York survey finding that business considerations and the corporate employee's relationship with a particular attorney had more to do with open communication between client and counsel than the attorney-client privilege); Melanie B. Leslie, *The Costs of Confidentiality and the Purpose of Privilege*, 2000 WIS. L. REV. 31, 31 (2000) ("Clients want the best legal advice. Most are therefore strongly motivated to tell lawyers the truth. This is especially true of corporate clients.").

69. MODEL RULES OF PROF'L CONDUCT R. 1.16(a)(1) (2002).

70. *Id.* R. 1.2(d).

71. *Id.* R. 1.2 cmt. 10.

Thus, just as the threat of up-the-ladder reporting currently exists, so also does the threat of noisy withdrawal; if there were to be any chilling of communication, it would already be occurring.

Finally, the Proposed Rules did not contemplate that a noisy withdrawal would follow immediately and inexorably upon a client's consulting counsel on an issue. An attorney must first report up the ladder and determine that appropriate action has not been taken before engaging in a noisy withdrawal.

It is true that the noisy withdrawal provision of the Proposed Regulations is somewhat broader than the withdrawal and communication rules that exist under current law. How much broader is open to debate. The SEC in its release to the Proposed Rules recognized that the noisy withdrawal requirement can create potential conflicts with state rules regarding disclosure of confidential information.[72] However, law professors with expertise in determining the professional responsibilities of attorneys confronted with client fraud have concluded that the SEC noisy withdrawal proposal "is largely consistent with the rules of professional ethics of most states."[73] Again, client reaction is not likely to depend on the particulars of the reporting standard. However, to the extent that Sexton is correct that predictability is an important principle in attaining the objectives of privilege, and to the extent the SEC regulations operate inconsistently with rules of professional conduct that attorneys are subject to, they may create problems for attorneys, and therefore uncertainty for clients.

A third question relates to the potential chilling effect created by the fact that the Final Rules permit an attorney to disclose outside of the corporation when necessary to protect the interests of the corporation and its shareholders. Although this permission

72. Implementations of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71,670, 71,673 (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. pt. 205). The release to the Proposed Rules also states that the "up-the-ladder reporting" requirement does not impact the attorney-client privilege because the corporate entity is the attorney's client. Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release Nos. 33-8150; 34-46868; IC-25829; File No. S7-45-02, [Vol. 78, No. 19] SEC Docket (CCH) ¶ 2,621, at 2,634 (Dec. 18, 2002).

73. Letter from 51 Law Professors, *supra* note 34 (explaining that "first, withdrawal is required in all states when continued representation would assist a client's crime or fraud; second, notification of that withdrawal along with disaffirmance of documents or representations that are tainted by the ongoing or prospective violation, i.e., a noisy withdrawal, is permissible in virtually all states").

goes beyond what is currently required under the Model Rules,[74] it is consistent with the New York Lawyer's Code of Professional Responsibility[75] and with recommendations of the ABA's Task Force on Corporate Responsibility.[76] Thus, although the Final Rules create a potential conflict, they arguably do not create any greater problem of predictability than that which already exists by virtue of the ongoing attempt to change the state rules.

B. Assumption That Increased Communication Increases Corporate Compliance with Law

Sexton describes the Supreme Court's approach to the attorney-client privilege as being consistent with a voluntary compliance model. Recall that the privilege's functional purpose is to facilitate a freer flow of information from client to attorney, allowing the attorney to better inform corporate decision-makers of the demands of the law.[77] The same is true of the confidentiality obligation. As the ABA recognized, "lawyers have an important role in assisting clients to comply with the law."[78] Once decision-makers are informed of the demands of the law, they will conform their behavior accordingly.

The up-the-ladder reporting requirement is entirely consistent with the notion that the purpose of facilitating communications between client and counsel is allowing counsel to inform corporate decision-makers of the demands of the law so that they may act in accordance with those demands. The reporting requirement pre-

74. For example, the Proposed Rules allow for disclosure of privileged communications where the allegedly illegal act has already occurred, whereas the Model Rules do not.

75. N.Y. COMP. CODES R. & REGS. tit. 22, § 1200.19 [DR 4-101] (2003) (permitting lawyers to disclose the intention of a client to commit a financial crime and the information necessary to prevent the crime).

76. ABA Task Force on Corporate Responsibility, *Preliminary Report of the American Bar Association Task Force on Corporate Responsibility* (July 16, 2002), *available at* http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf (last visited Sept. 9, 2003) (on file with the *NYU Annual Survey of American Law*).

77. The ABA has observed that "[a]n important collateral benefit of this confidentiality policy is that it enhances the ability of lawyers to counsel legal compliance." Letter from ABA, *supra* note 45, at 8.

78. *Id.* at 4; *see also* Letter from 77 Law Firms to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Dec. 18, 2002), *available at* http://www.sec.gov/rules/proposed/s74502/77lawfirms1.htm (last visited Aug. 30, 2003) (on file with the *NYU Annual Survey of American Law*) [hereinafter Letter from 77 Law Firms] ("The basic force for conformance of business conduct to legal norms is a strong and independent Bar that enjoys the trust and confidence of its clients.").

cisely ensures that counsel will report to those responsible for taking appropriate action. It ensures that those in decision-making authority are aware of any actions on the part of the company that are in violation of the federal securities laws or that constitute a breach of fiduciary duty. As the ABA observed in its comment letter to the SEC on the proposed regulations,

> when a lawyer representing an issuer becomes aware of material violations of law that are likely to substantially injure the organization, the lawyer has a clear duty to take appropriate remedial action including, in some cases, a duty to bring the matter to the attention of the highest authority in the organization if the violation has not been remedied.[79]

I would also argue that the noisy withdrawal requirements contained in the proposed regulations are not inconsistent with this approach. There is no question that we expect corporations to police misconduct within the organization and that this kind of self-regulation is desirable. The voluntary compliance model, however, works only when companies actually conform their behavior in accordance with the law. Sole reliance on an up-the-ladder reporting requirement assumes that the board to whose attention the violation of law is brought has the ability and the will to address the problem.

However, as Sexton recognized in his article, voluntary compliance does not always occur. It may be that "[i]n the vast majority of cases counsel enjoy the confidence of their clients and, given access to the facts by their clients, succeed in persuading their clients to refrain from actions that harm the investing public."[80] But counsel is not always successful in ensuring voluntary compliance, meaning that it is necessary to have some secondary defense against misconduct, a backup regulatory mechanism that operates when voluntary compliance fails. Failure in this context means that counsel's reporting to those with decision-making authority does not result in appropriate action to conform with the law. When such failure occurs, the Proposed Regulations opt for a noisy withdrawal requirement as a means of securing compliance. When the lawyer is unable to secure voluntary compliance on the part of her client, the Proposed Regulations provide a means to allow the SEC to step in.

Moreover, even in those cases where noisy withdrawal is not actually used, the fact that it remains a possibility may have a positive impact. The threat of noisy withdrawal makes it more likely

79. Letter from ABA, *supra* note 45, at 4.
80. *See* Letter from 77 Law Firms, *supra* note 78.

that up-the-ladder reporting will have the desired effect of leading to adequate remedial action. "On the other hand, if everyone knows that all an attorney can do, if the board persists, is to exit quietly without any signal to anyone, the illegal conduct may continue indefinitely and cause irreparable harm to the company, its shareholders and investors."[81] Thus, however rarely it is used, the noisy withdrawal is "nonetheless an important part of the entire regulatory structure."[82]

The Final Regulations attempt to retain the benefit of the noisy withdrawal through a less intrusive means, requiring that the issuer disclose the fact of counsel's withdrawal from representation. This represents an interesting approach, one that still relies on a voluntary model of compliance, but raises the stakes somewhat for companies that fail to comply with the disclosure obligation. If effective, it would provide a means of achieving the goals of increased corporate compliance with law without the dangers of chilling communications.[83] If a board of directors has evidence of wrongdoing placed squarely before it and there is a clear affirmative disclosure obligation, the resistance of boards to opposing illegal management action may be overcome.[84]

CONCLUSION

Whatever one thinks of the SEC's approach to the implementation of section 307 of Sarbanes-Oxley, Sexton's analysis of the corporate attorney-client privilege provides a vehicle for evaluating claims that the new law will harm the relationship of trust and confidence between client and counsel.

One of the shaping principles identified by Sexton is the need to tailor the privilege "precisely to protect only the information it was designed to protect."[85] This requires that, as far as possible, we must apply the privilege in a manner that maximizes benefits and minimizes costs. Recognizing that it will not always be possible to effectively balance costs and benefits, another of Sexton's shaping

81. Letter from 51 Law Professors, *supra* note 34.

82. *Id.*

83. It may address another concern as well. One commentator has suggested that one possible effect of the "Draconian obligation to withdraw" is that attorneys may "rationalize nonreporting in the first instance." Coffee, *supra* note 32, at B8.

84. *See* Letter from 51 Law Professors, *supra* note 34 (observing that recent scandals have reinforced the lesson that boards of some companies "are either kept in the dark by management or are reluctant to oppose management actions that are or may be illegal").

85. Sexton, *supra* note 1, at 480. R

principles would resolve balances in favor of protecting attorney-client communications. What does this mean in the context of our prior discussion of Sarbanes-Oxley section 307?

As a starting point, it is important to understand that the information being discussed here may be "information that, if revealed, could forestall major financial hardship for thousands, in some cases millions, of investors."[86] As Sexton realized, in the corporate context, shielding this best source of evidence of such wrongdoing has the danger of discouraging litigation and leaving the public and the legislature unaware of corporate abuses.[87]

However, the information we are talking about being in the lawyer's possession "comes from clients who have developed relationships of trust with their lawyers, which in turn enables their lawyers to exert considerable influence in leading their clients to comply with the federal securities laws."[88] If in fact the effect of the SEC's rules is that fear of disclosure prevents clients from confiding in counsel, and clients "instead proceed without the advice of counsel, the public will inevitably be harmed in some cases where it need not have been."[89] Thus, our desire is to protect investors without discouraging maximum compliance with the law.

The discussion in Section III suggests that the up-the-ladder reporting requirements of the Final Regulations do no violence to our desire to encourage communications between client and counsel and to allow attorneys to effectively advise clients in a manner that will encourage their compliance with the law. It is true that some have criticized the reporting standards in the Final Rules,[90] but those arguments do not establish a fear of chilling communication.

Although I am not convinced by the argument that the noisy withdrawal requirement would chill communication, and believe it to be an effective back-up for those situations when self-regulation fails, it may be the case that less intrusive back-up mechanisms exist. Given that this area of the regulations treads on issues already addressed by the Model Rules, and given that it does so inconsistently, a less intrusive alternative may be called for. However, it may ultimately be determined that the noisy withdrawal represents the best

86. Cleary, Gottlieb Comment Letter, *supra* note 35.
87. Sexton, *supra* note 1, at 478. R
88. Cleary, Gottlieb Comment Letter, *supra* note 35.
89. Letter from 77 Law Firms, *supra* note 78.
90. *See, e.g.*, Patterson, *supra* note 7 (criticizing, inter alia, requiring attorneys to report evidence of "similar violations" without defining what is meant by that term); Letter from 77 Law Firms, *supra* note 78.

supplement to up-the-ladder reporting. In either event, more consideration of alternative approaches seems desirable in light of Sexton's goals, which suggest that the SEC acted responsibly in enacting its Final Regulations.