Sarbanes-Oxley Act, Section 307 - The Price of Accountability: How Will Section 307 Affect the Role of the Corporate Attorney

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SARBANES-OXLEY ACT, SECTION 307 – THE PRICE OF ACCOUNTABILITY: HOW WILL SECTION 307 AFFECT THE ROLE OF THE CORPORATE ATTORNEY?

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I. INTRODUCTION

Enron, WorldCom, Global Crossing, Adelphia Communications. By now, these companies are household names – but not because of their products or the services that they provide. They are household names because of their involvement in the scandals that have recently rocked the corporate and investment world. The scandals at Enron, WorldCom, Global Crossing, Adelphia Communications, and other companies caused the trust that consumers and investors had in corporations, CEOs, and employees to take a downward plunge. When choosing investments, investors rely on a company’s reputation as well as the “research, knowledge, and savvy of their brokers.”¹ However, “[u]ltimately,

and until now perhaps unknowingly, investors depend on independent auditors to practice honest accounting." 2 This trust in the reputation of companies, stockbrokers, and independent auditors led to the loss of millions of dollars for investors when the stock prices of the companies fell.

While there is no simple answer to what caused the demise of these companies, Senator Paul Sarbanes, one of the leading forces behind the Sarbanes-Oxley Act, has possible explanations. 3 These explanations include "a lack of accounting autonomy, blurring the line between auditor and employee, and a lack of executive responsibility and accountability." 4 Essentially, investors' trust had been misplaced, and accountants had "cooked the books." 5 Even more disconcerting is that many of the scandals occurred with the knowledge and help of company employees and corporate executives - and perhaps even corporate attorneys.

Congress and the Securities and Exchange Commission ("SEC") have since made efforts to enact legislation to not only restore that trust but also to restore the standards of honesty and corporate responsibility in companies across the United States. These efforts resulted in the Sarbanes-Oxley Act ("Act"), and the SEC was charged with enforcement of the Act. In seeking to rebuild the confidence of investors, customers, and people in both America and abroad, the Act imposes new regulations on corporations and their employees. Under Section 307, the Act specifically targets the actions of attorneys.

Why was this Act necessary and how did problems go unnoticed for so long? This Comment focuses on Section 307 of the Sarbanes-Oxley Act and endeavors to assess the implications of the rules and demonstrate what this legislation could mean for the future of corporate attorneys.

First, this Comment will give a brief background of what happened with Enron and other companies and the action taken by Congress and the SEC. Then, the Comment will examine Section 307 of the Sarbanes-Oxley Act, explaining the comments that were given to the SEC when it published the proposed rules, the regulations of Section 307 themselves, and the penalties for attorneys under Section 307. 6 Next, it examines the arguments for Section 307

2 Id. at 27-28.
3 Id. at 32.
4 Id. (citing Senator Sarbanes at H.R. Rep. No. 107-414, at 18 (2002)).
5 Id. at 34. When accountants "cook the books," the accountants make profits within the company's books appear to be higher than they actually are.
6 Because a thorough discussion would be outside the scope of this paper, this comment will only briefly describe the penalties for attorneys under Section 307. For a more in-depth discussion, see generally Chi Soo Kim and Elizabeth Laffitte, The Potential Effects of SEC Regulation of Attorney Conduct Under the Sarbanes-Oxley Act, 16 GEO. J. LEGAL ETHICS 707 (2003); The Evolving Legal and Ethical Role of the Corporate Attorney After the Sarbanes-Oxley Act of 2002: Panel 2: The Evolution of Corporate Governance, 52 AM. U. L. REV. 613, 621 (2003); David J. Beck, The Legal Profession at the Crossroads: Who Will Write the Future Rules Governing the
and the problems with the enactment of Section 307. Within the assessment of the problems will be an explanation of the issues concerning the attorney-client privilege. Finally, the Comment will draw conclusions on the implications that the Act will have for corporate attorneys in the future. After discussing all of these issues surrounding Section 307 of the Act, it will be clear that while many of the provisions may prevent some potential future corporate scandals, the Act may lead to more problems than it was created to solve.

A. The Crash Heard Around the World: The Fall of Enron and Other Corporations

"Enron is one of the world's leading energy, commodities and services companies." It divides its business into three areas: Wholesale Services, Energy Services, and Global Assets. The company was initially formed in 1985 due to a merger between Houston Natural Gas and InterNorth of Omaha, Nebraska.

In 15 years, Enron grew from an unknown corporation into America's seventh largest employer and boasted honors that included Fortune magazine's Most Innovative Company in America for six years, top quartile of Fortune Magazine's 100 Best Companies to Work For, and the All Star List of Global Most Admired Companies. Outwardly, the firm seemed to be profitable and growing - an image which soon proved to be a mirage; Enron's statements about its profits were lies. For example, in late 2000, Enron's stock was trading at about $90 per share. By late November 2001, Enron's credit rating had changed from investment-grade to junk, and it had $3.9 billion in debt. At this time, its shares had fallen to a price of $4.01 per share, and then two days later,

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\[\text{Conduct of Lawyers Representing Public Corporations?}, 34 \text{ St. Mary's L.J.} 873 (2003).\]


\[\text{Id.}\]

\[\text{Id.}\]


\[\text{Id.}\]

\[\text{Id.} \quad ("\text{The firm projected itself as a highly profitable, growing company - an image which quickly turned out to be an elaborate mistruth. Enron's statements about profits were shown to be untrue, with massive debts concealed so that they didn't show up in the company's accounts."})\]

\[\text{Zelizer, supra note 1, at 29.}\]

\[\text{Id.}\]
on November 28, the price fell below $1.\textsuperscript{15} Shortly after, Enron filed for bankruptcy.\textsuperscript{16} The collapse of the company came in December 2001 amid allegations of accounting fraud, shadow deals, and mismanagement of funds; the estimated damage was around $100 billion.\textsuperscript{17} Enron had “cooked the books,”\textsuperscript{18} and it would not be the last company to do so.

In April of 2002, WorldCom, a communication services company,\textsuperscript{19} announced that it was going to layoff 7,500 employees and cut revenue projections by almost $1 billion.\textsuperscript{20} In June, it cut another 20% of its workforce and sold its wireless unit.\textsuperscript{21} By the end of June, WorldCom stock dropped to under $1 per share, and the cause of this drop was disclosed – “it failed to report $3.8 billion in losses the previous year, effectively turning five quarters of losses into a profit.”\textsuperscript{22} “Analysts estimate that the decline in consumer confidence caused by the fall of the company resulted in shareholder losses of more than $2 trillion, while more than half a million telecom-related industry employees lost their jobs.”\textsuperscript{23}

Other companies suffered similar fates. Global Crossings’ financial misstatements caused over 9,000 employees to be laid off and a pension fund loss of over $66 million.\textsuperscript{24} The pension funds of Rite Aid employees shrank as the company lost $145 million.\textsuperscript{25} Tyco International’s top executives were indicted for accounting fraud while the stock dropped 80% in five months.\textsuperscript{26}

\textsuperscript{15} Timeline: Enron’s Rise and Fall. BBC News (February 4, 2002), at news.bbc.co.uk/hi/english/business/newsid_1759000/1759599.stm.
\textsuperscript{16} Zelizer, supra note 1, at 29.
\textsuperscript{17} Id.
\textsuperscript{18} Id. at 34. Enron used gross value instead of net value when it calculated its profits from contracts. It sold the same product repeatedly but included the full value of the product in revenue every time. Company executives created fake buyers to continue the appearance of the company’s revenue. \textit{Id.} at 34-35.
\textsuperscript{19} MCI Homepage, About MCI, at http://www.mci.com/about/index.jsp (last visited January 25, 2004).
\textsuperscript{20} Zelizer, supra note 1 at 30.
\textsuperscript{21} \textit{Id.}
\textsuperscript{23} Zelizer, supra note 1, at 30.
\textsuperscript{24} \textit{Id.}
\textsuperscript{25} \textit{Id.}
\textsuperscript{26} \textit{Id.} at 31.
In a Loyola Consumer Law Review article, Ethan Zelizer accurately states: "[i]nvestors are helpless without reliable information." Because of, and perhaps thanks to, the scandals of Enron, WorldCom, Global Crossings, and other corporations, investors and the government learned that these and other corporations were deceiving them, and it was no longer safe to place trust in the hands of the corporations who could abuse it so easily. These scandals, and the problems they caused, left Congress little choice but to promulgate legislation that would prevent future problems of this kind.

B. Congress and the SEC Take Action

For nearly seventy years before the Enron scandal, securities laws provided several precautionary measures, including:

1. standardized rules governing corporate disclosures;
2. SEC reviews of corporate disclosures for accuracy, completeness, and compliance with accounting rules;
3. collections by credit rating agencies of as much information as possible to determine the creditworthiness of companies;
4. the creation of audit committees, made up of individual board members, to supervise audits; and
5. independent auditor to review and approve every company's financial statements.

However, these measures were not enough because they failed to inform anyone of the true financial state of Enron or the other companies; no one foresaw the problems that were in the near future.

The board of directors of these companies did not question the accounting practices, and the SEC had no reason to question the seemingly normal audit reports from top-notch accounting firms; thus, "the system was subject to abuse." This resulted in financial statements and annual reports failing to show how corporations made their profits, and credit agencies continued to issue more favorable ratings than these companies deserved.

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27 Id. at 32.
29 Id. at 33.
30 Id.
31 Id. at 35.
32 Id. at 33.
Once the situation got out of hand, Congress and the SEC developed plans to prevent further abuse of the system. After the collapse of Enron in December 2001, Representative Michael Oxley from Ohio began drafting a House version of the corporate-governance bill. On April 24, 2002, the House of Representatives approved House Bill 3763, the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002. On July 15, 2002, the Senate approved Senate Bill 2673, the Public Company Accounting Reform and Investor Protection Act of 2002. When deciding on the compromised version, the conference committee decided to keep most of the Senate provisions, which eventually became the Sarbanes-Oxley Act. Originally, neither bill included a provision that would regulate attorneys, but hours before the Senate approved the bill, several Senators added the text of Section 307, Rules of Professional Responsibility for Attorneys, to the Senate bill as an amendment.

When Senator John Edwards of North Carolina introduced the amendment that eventually formed the basis of Section 307 in the Sarbanes-Oxley Act, he gave a speech to the Senate in support of the proposed amendment. In his speech, he informed the Senate that he believed that the bill had forgotten about an important "player" in the corporate scandals. That "player" was the corporate attorney. "One of the problems we have seen occurring with this sort of crisis in corporate misconduct," Senator Edwards lamented, "is that some lawyers have forgotten their responsibility." With that said, the corporate attorney was pulled into the Sarbanes-Oxley Act through the creation of Section 307, entitled Rules of Professional Responsibilities for Attorneys.

II. SARBANES-OXLEY ACT, SECTION 307

On July 30, 2002, Congress enacted the Sarbanes-Oxley Act because corporations failed to "effectively police and enforce their existing policies and

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34 Id.
35 Id.
36 Id.
37 Id.
38 Id. at 465.
39 Id.
40 Id.
41 Id.
otherwise ensure good corporate governance."

The purpose of the Act is to "protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes." The Act applies to "all companies who are required to file reports with the Securities and Exchange Commission." Section 307 of the Act deals specifically with attorneys. This section:

mandates that the [Securities and Exchange] Commission issue rules prescribing minimum standards of professional conduct for attorneys appearing and practicing before it in any way in the representation of issuers, including at a minimum a rule requiring an attorney to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the issuer or any agent thereof to appropriate officers within the issuer and, thereafter, to the highest authority within the issuer, if the initial report does not result in an appropriate response.

Before examining the language of the final rules, it is necessary to discuss the proposed rules that the SEC released before it promulgated the final rules.

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Section 307 of the Sarbanes-Oxley Act of 2002 (the "Act") (15 U.S.C. 7245) mandates that the Commission: shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule –

(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 offers of the company (or the equivalent thereof); and

(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 . . . comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

Id. at *3 n.1; Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 (2002).
A. The Debate Begins – Comments on the Proposed Rules

Before it decided on the final regulations, the SEC asked for and received many comments on the proposed release.\(^{46}\) On November 21, 2002, the SEC published for comment proposed Part 205 – "Standards of Professional Conduct for Attorneys Appearing and Practicing before the Commission in the Representation of an Issuer."\(^{47}\) After the period for comment had expired, the SEC announced its final rule. The adopted final rule differed in certain respects to the original proposal.\(^{48}\) For example, "the triggering standard for reporting evidence of a material violation [was] modified to clarify and confirm that an attorney’s actions will be evaluated against an objective standard;"\(^{49}\) the documentation requirements for attorneys and issuers were removed;\(^{50}\) and the SEC added a "safe harbor" provision\(^{51}\) that will protect issuers, officers and directors of issuers, attorneys, and law firms.\(^{52}\) The Commission also decided to extend the comment period on the "noisy withdrawal" provision; it has yet to be adopted.\(^{53}\)

When the SEC provided the proposed rules for discussion, many of the comments voiced opposition to Section 307. Several commentators feared that such a rule would undermine the relationship and trust between attorneys and corporations and that the provision went against the rules of professional conduct in certain jurisdictions.\(^{54}\) Commentators who supported this provision

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\(^{46}\) Id. at *4-5.

\(^{47}\) Id. at *4.

\(^{48}\) See generally id. (explaining proposed rules, proposed rules that have been withdrawn, and comments on the proposed rules).

\(^{49}\) Id. at *6.

\(^{50}\) Id.

\(^{51}\) Id. at *134. Under the safe harbor provision, Part 205 does not create a private cause of action against an attorney, a law firm or an issuer, based upon their compliance or non-compliance with the part. The Commission is of the view that the protection of this provision should extend to any entity that might be compelled to take action under this part; thus, it extends to law firms and issuers.

\(^{52}\) Id.

\(^{53}\) Id. at *7. Under the noisy withdrawal provision, if an attorney withdraws from representation of a client after failing to receive an appropriate response to potential evidence of a material violation, the client is required to notify the Commission of the attorney's withdrawal as a "material event." Implementation of Standards of Professional Conduct for Attorneys, Securities and Exchange Commission, 68 Fed. Reg. 6296 (Feb. 6, 2003) (to be codified at 17 C.F.R. pt. 205).

\(^{54}\) Id. at *102. For example, several comments stated that permitting attorneys to disclose illegal acts to the Commission, in the situations delineated by the proposed rule, would undermine the relationship of trust and confidence between the lawyer and client, and may impede the ability of lawyers to steer their clients away from unlawful acts. Other comments expressed concern that this provision conflicts with, and would (in their eyes impossibly) preempt, the rules of profes-
stated that many of the states allow or require such disclosures.\textsuperscript{55} These commentators believed that this rule should “preempt any state ethics rule that does not permit disclosure.”\textsuperscript{56} Therefore, supporters of Section 307 believe that when the SEC regulations conflict with a particular state ethics rule, the SEC regulations should supersede the state rule.

In answering the concerns of some of the commentators, the SEC stated that “the vast majority of states already permit (and some even require) disclosure of information in the limited situations covered by this [provision] and the Commission has seen no evidence that those already-existing disclosure obligations have undermined the attorney-client relationship.”\textsuperscript{57} The SEC went further and responded to the comments that expressed concern that this provision would preempt state law ethics rules. The SEC referred commentators to Section 205.1 of the proposed regulation, which clearly stated that “Part 205 supplements state ethics rules and is not intended to limit the ability of any jurisdiction to impose higher obligations upon an attorney . . . .”\textsuperscript{58} The final rule handed down by the SEC states:

[T]his part does not preempt ethical rules in United States jurisdictions that establish more rigorous obligations than imposed by this part. At the same time, the Commission reaffirms that its rules shall prevail over any conflicting or inconsistent laws of a state or other United States jurisdiction in which an attorney is admitted or practices.\textsuperscript{59}

\textsuperscript{55} \textit{Id.} at *105. “At least four-fifths of the states now permit or require such disclosures as pertain to ongoing conduct.” Comments of Morrison & Foerster and eight other law firms; Edward C. Brewer, III, at 8.

\textsuperscript{56} \textit{Id.} at *105-06. Comments of Susan P. Konicki et al., 27, 31-32.

\textsuperscript{57} \textit{Id.} at *109 (notes deleted). For more discussion on attorney-client privileges, see infra Part IV(A).

\textsuperscript{58} \textit{Id.} at *110.

\textsuperscript{59} Implementation of Standards of Professional Conduct for Attorneys, Securities and Ex-
Thus, Section 307 will not preempt any ethical rules that have stricter rules than the section, but if there is any conflict between a state ethical rule and Section 307, then Section 307 will prevail.

The primary controversy in the proposed rules concerned the “noisy withdrawal” provision. “Under certain circumstances, [the] provisions permitted or required attorneys to effect a so-called ‘noisy withdrawal’ by notifying the Commission that they have withdrawn from the representation of the issuer, and permitted attorneys to report evidence of material violations to the Commission.”60 This would create a requirement upon attorneys to “report out” to the SEC if the material violation was not taken care of through the “reporting up” procedure. The Commission believed it was important to assess the Section 307 rules requiring attorney withdrawal and that the attorney give notice to the Commission when the corporate officers and directors failed to respond to violations that were reported to them.61 However, a debate broke out over this particular proposed provision in Section 307. While the SEC decided not to adopt the “noisy withdrawal” provision, it viewed this provision as important, thus it decided to extend the comment period on “noisy withdrawal” and asked for suggestions on a proposed alternative to the provision.62 The SEC did go forward with publishing its final rules on the other provisions.

B. The Sarbanes-Oxley Act

The effective date of the final rules was August 5, 2003. When the final rules came out, Section 307 remained the section that covered attorneys, but Section 307 is labeled as Part 205 in the Federal Register.

First, Section 205.3(b) of the final rule of the Act, entitled Implementation of Standards of Professional Conduct for Attorneys, states that when an attorney is representing an issuer, the attorney has a duty to “report evidence of a material violation.”63 Section 205.3(b)(1) further states:


60 Id. at 6296.

61 Id. at 6297.

62 Id. The alternative provision states: “Under this proposed alternative, in the event that an attorney withdraws from representation of an issuer after failing to receive an appropriate response to reported evidence of a material violation, the issuer would be required to disclose its counsel’s withdrawal to the Commission as a material event.” Id.

63 Implementation of Standards of Professional Conduct for Attorneys, Securities and Exchange Commission, 68 Fed Reg. 6296. 6305 (Feb. 6, 2003) (to be codified at 17 C.F.R. pt. 205). A “material violation” is not specifically defined in the proposed rules or in the final rules. In fact, Professor Karmel, Professor of Law at Brooklyn Law School, stated in a panel: “I don’t know what’s a material violation and what’s not a material violation of the securities laws. In fact, the word ‘materiality’ is used throughout the securities laws. It’s usually a disclosure threshold.” The Evolving Legal and Ethical Role of the Corporate Attorney After the Sarbanes-Oxley
If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report such evidence to the issuer's chief legal officer (or the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or the equivalents thereof) forthwith. By communicating such information to the issuer's officers or directors, an attorney does not reveal client confidences or secrets or privileged or otherwise protected information related to the attorney's representation of an issuer. 64

There are further requirements for the chief legal officer. Section 205.3(b)(2) states:

The chief legal officer (or the equivalent thereof) shall 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, is ongoing, or is about to occur. If the chief legal officer (or the equivalent thereof) determines no material violation has occurred, is ongoing, or is about to occur, he or she shall notify the reporting attorney and advise the reporting attorney of the basis for such determination. Unless the chief legal officer (or the equivalent thereof) reasonably believes that no material violation has occurred, is ongoing, or is about to occur, he or she shall take all reasonable steps to cause the issuer to adopt an appropriate response, and shall advise the reporting attorney thereof. 65

Additionally, if the corporation has established a qualified legal committee, then the chief legal officer has the option of reporting the evidence of the material violation to the qualified legal committee. 66

The rules also give additional steps that attorneys must take in reporting material violations in 205.3(b)(3). If an attorney does not believe that the chief legal officer or chief executive officer has appropriately responded to the material violation within a reasonable amount of time, the attorney must report the

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65 Id. at 6307.

66 Id.
material violation to "the audit committee of the issuer’s board of directors;" "[a]nother committee of the issuer’s board of directors consisting solely of directors who are not employed, directly or indirectly, by the issuer and are not, in the case of a registered investment company, ‘interested persons;’" or "the issuer’s board of directors."67 Furthermore, pursuant to 205.3(b)(4), "[i]f an attorney reasonably believes that it would be futile to report evidence of a material violation to the issuer’s chief legal officer and chief executive officer . . . the attorney may report such evidence” to the audit committee, a qualified legal compliance committee (QLCC), or the board of directors.68

The rules also state that having an attorney investigate possible material violations does not relieve an officer or director of a corporation from a duty to respond to the attorney.69 Thus, these provisions require the attorney to continue reporting up the ladder until some action is taken in connection with the material violation.

The above rules, all related to “reporting up,” are not as controversial as many of the other provisions and are not provisions with which some attorneys and non-attorneys will disagree because it is clear that there needs to be some procedure for reporting potential violations and preventing cover-ups of potential violations.70

Section 205.3(d)(2) states:

An attorney appearing and practicing before the Commission in the representation of an issuer may reveal to the Commission, without the issuer’s consent, confidential information related to the representation to the extent the attorney reasonably believes necessary:

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67 Id. at 6307.
68 Id. at 6307-08.
69 Id. at 6308.
(i) 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;

(ii) To prevent the issuer, in a Commission investigation or administrative proceeding from committing perjury . . . ; suborning perjury . . . ; or committing any act . . . that is likely to perpetrate a fraud upon the Commission; or

(iii) To rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interest or property of the issuer or investors in the furtherance of which the attorney’s services were used.\(^71\)

This section allows the attorney to disclose certain confidences related to appearing and practicing before the SEC when representing the corporation; however, it does not require the attorney to disclose the confidential information.\(^72\)

The next step after knowing what the rules are under Section 307 is discovering how the SEC will enforce these regulations for scandals that occur post implementation of the Sarbanes-Oxley Act. What will happen to attorneys who do not follow the guidelines and provisions of Section 307?

C. Penalties for Attorneys Under Section 307

Violating Section 307 will subject an attorney to civil penalties, but the rules do not allow for private actions against an attorney; only the SEC may bring an action against violating attorneys.\(^73\) While the attorney can be subjected to disciplinary action by the SEC, the attorney will not be subjected to such an action if the attorney complies with the SEC rule in good faith.\(^74\) The SEC can “‘deny, temporarily or permanently, the privilege of appearing or practicing before it in any way’ for unethical conduct or securities law violation.”\(^75\) In fact, there is a chance that the SEC could not only bar an attorney from practice but also impose a fine.\(^76\)

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\(^{72}\) Id. This provision concerns an attorney-client privileges issue that will be discussed infra, Part IVA.


\(^{74}\) Id. at 719-20.

\(^{75}\) Id. at 725.

\(^{76}\) See Panel 2, supra note 70, at 633.
While there is no private civil liability, Professor Richard Painter, a Professor of Law at the University of Illinois Urbana-Champaign School of Law, believes there may still be liability exposure for an attorney.77 "[W]here you run into liability is when the company goes bankrupt, and you've got a trustee in there who looks around for people who breached their duty to the company. Those are just malpractice actions alleging that you were negligent."78 Thus, he believes that "absolutely, there is liability exposure."79

However, even with these options, in the past the SEC has been reluctant to sanction attorneys, preferring instead to leave the regulation of attorney conduct to state bars.80 In the aftermath of Enron and other corporate scandals and with the implementation of Sarbanes-Oxley, it remains to be seen whether the SEC will continue to leave regulation to state bars, or if it will choose to play a larger role in regulating and reprimanding attorney conduct.

The Comment next discusses the arguments in favor of Section 307. Following the argument in favor will be a discussion of the problems that arise from the implementation of Section 307, where the Comment will give more consideration to the attorney-client privilege and other criticisms that have been leveled against Section 307.

III. ARGUMENTS FOR SECTION 307

The support for regulations pertaining to lawyers stems from a belief that the rules will hold corporate attorneys to a higher standard of ethical conduct and make them more accountable for the actions of their corporate clients. This accountability is what some argue is necessary to prevent another round of corporate scandals.81 For supporters of the rules, prevention is the key, and they have argued that, up until now, existing regulations on attorney conduct have been unsuccessful and a uniform set of standards is needed.82

When these proponents of a uniform set of standards succeeded and the Sarbanes-Oxley Act was passed with Section 307, it started a dialogue between the supporters and the opponents of the Act, and both the pros and cons of the Section were discussed and evaluated. This section of the Comment focuses on the arguments in favor of Section 307.

Supporters of Section 307 believe that prior to the Act, lawyers were not required by federal securities law to report any violations or fraud committed by

77 Id.
78 Id.
79 Id.
80 Kim & Laffitte, supra note 73, at 725.
81 See generally Robertson & Tortora, supra note 70.
82 Id. at 786.
corporations. "[T]he Model Rules give attorneys substantial latitude since Rule 1.13 only requires that ‘the lawyer shall proceed as is reasonably necessary in the best interest of the organization.’" Implementation of the Act with Section 307, therefore, will increase the ethical responsibilities and duties of attorneys, and perhaps this will help prevent future corporate scandals.

An argument made in favor of providing rules and requirements for attorneys is that in the Enron and other corporate scandals, some accountants, analysts, and traders had lawyers helping them when they broke the law. These lawyers "structur[ed] bogus deals, vouch[ed] for nonexistent ‘sales,’ [and] wr[ote] whitewash reports to keep the sheriff fooled and away." While the accountants, analysts, and traders were held accountable, the lawyers seem to have escaped responsibility for the role that they played in the downfall of Enron and the other corporations. Law firms did not have to go in front of Congress and answer questions about their role in the corporate scandal. The SEC did not appear to launch any investigations into the responsibility of law firms and attorneys. The Justice Department eventually stated that it would scrutinize the conduct of attorneys, but thus far, there has been no announced result from this scrutiny, from the Justice Department or the press.

In order to prevent future corporate scandals such as Enron, it is clear that some changes are needed. The rules in place before Enron and the other corporate scandals were not enough. Section 307 holds lawyers accountable for reporting material violations to directors and boards in hopes that a repeat of Enron will not occur. Lawyers need to know that they share responsibility in what happens inside a corporation and that society will hold them accountable alongside executives, employees, and accountants if they help their clients engage in a cover up of material violations. Section 307 of the Sarbanes-Oxley Act ensures not only that lawyers cannot actively help corporations engage in fraudulent practices but also that lawyers cannot close their eyes and pretend they know nothing – thinking that what they do not see, they do not know, so they cannot get into trouble. Future corporate attorneys should take a more ac-

83 Id. at 787.
84 Id.
85 Id.
86 Koniak, supra note 70, at 1237.
87 Id.
88 Id.
89 Id.
90 Id. at 1238.
91 Id.
tive role in looking at corporate documents to ensure that a company has not mismanaged company funds and has not attempted to cover it up.

Some optimists believe if corporations know of the obligations of attorneys under the rules, then the corporations "will be less likely to pursue potentially illegal behavior, knowing that lawyers are . . . acting as 'adult supervision.'" Executive and employees of corporations will know that because of the new guidelines, attorneys will be held to certain standards and will therefore take a more active role in corporate matters. This means the executives and employees will be more likely not to engage in fraudulent practices because they know attorneys will catch them.

Another argument for providing enforcement for attorneys in the form of Section 307, is that at this time, "auditors are regulated by the Public Company Accounting Oversight Board (PCAOB), . . . while securities analysts are subject to regulation by the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE)." Traditionally, only state bar associations have regulated lawyers. "Such guild-like regulation has little incentive to be aggressive, to fund enforcement, or to place the interests of the public above those of its members." It is believed that Section 307 is needed as a way to succeed where state bar associations have failed—that is, effectively regulating attorneys.

In addition, imposing the Section 307 obligations on attorneys "may be socially desirable." It could force corporations and their executives to ask for advice before action, which will lead them to comply with the law. The goal is to prevent future Enron occurrences by providing an incentive for corporate executives to seek advice before they get themselves into trouble, allowing attorneys to provide guidance and advice that will stop corporate fraud before it starts.

An argument for reporting up is that it will serve as a deterrent. Because "decisions made by one person still need to be implemented by others," once a corporate executive or other employee has caused a material violation to occur, others who are expected to go along with the material violation are likely to consult an attorney. "Knowledge that others are necessarily likely to learn of the original actor's conduct and then to consult with counsel about its legality

92 Frankel, supra note 70.
93 Coffee, Jr., supra note 70, at 1302-03.
94 Id. at 1303.
95 Id. at 1308.
96 Id. (discussing a well-known article by Professors Kaplow and Shavell).
97 Id. "Requiring noisy withdrawals and up-the-ladder reporting also has a deterrent value . . ." Id.
98 Id.
may deter the original actor.”

Even if there is less communication between employees or executives and attorneys, the knowledge that “sooner or later” the attorney will find out and that the attorney will be required to report the material violation (or even the possibility of a material violation) up the ladder should deter some illegal actions. This same argument has also been advanced for the yet to be adopted noisy withdrawal rule.

Even with all of the benefits that Section 307 can provide, most notably the overreaching goal of preventing another corporate scandal such as Enron, there are many who believe that the problems Section 307 will cause outweigh any benefits that it may bring.

IV. PROBLEMS WITH SECTION 307

For opponents of Section 307, implementation of Section 307 could potentially cause more problems than the Act was created to prevent. While many problems could occur, one of the main concerns about Section 307 is the effect that the Section could have on the attorney-client privilege.

A. The Foundation of the Attorney-Client Relationship: Attorney-Client Confidences

In order to better understand the reason for this concern, it is important to first look at the origination and policy reasons behind the attorney-client privilege and then move on to consider the possible effects the Section will have on the privilege.

1. Creation of Attorney-Client Privilege

“[A]ttorney-client privilege is the oldest evidentiary privilege recognized in Anglo American common law.” It actually began in Roman law where the loyalty that the lawyer owed to his client disqualified him from serving as a witness in the client’s case. The privilege and rule of confidentiality continued in English common law because of the client’s right to have his secrets protected. In America, the privilege continued to exist, but its scope and

99 Id.
100 Id. at 1309.
101 Id.
103 Id.
104 Id. at 475.
breadth were not well defined. At first, the only clear thing about the privilege was that it was available when legal advice was "related directly to pending or anticipated litigation." As this country's judicial system grew and became more defined, so too did the attorney-client privilege. The United States Supreme Court and Dean John Henry Wigmore's treatise on evidence were two influences on American history that led to the development of the attorney-client privilege as we know it today.

Wigmore's original treatise provided a policy basis for the privilege, as well as a definition of the privilege, which is now the basis for the current definition of privilege:

(1) Where the legal advice of any kind is sought (2) from a professional legal adviser in his capacity as such, (3) the communications relevant to that purpose, (4) made in confidence (5) by the client, (6) are at his instance permanently protected (7) from disclosure by himself or by the legal adviser, (8) except the client waives the protection.

Wigmore identified four elements that must be present in order to have an attorney-client privilege:

(1) The communication must originate in a confidence that they will not be disclosed; (2) This element of confidentiality must be essential to the full and satisfactory maintenance of the relation between the parties; (3) The relation must be one which in the opinion of the community ought to be sedulously fostered; and (4) The injury that would inure to the relation by the disclosure of the communications must be greater than the benefit thereby gained for the correct disposal of litigation.

The acceptance of Wigmore's arguments helped to pave the way for attorney-client privilege in our current legal system. The second major influence on the development of the attorney-client privilege was the Supreme Court, specifically:

105 ld.
106 Id.
107 Id. at 475-76.
108 Id. at 476 (citing 4 JOHN HENRY WIGMORE, EVIDENCE § 2317 (1st ed. 1904)).
109 Id. at 477 (citing 4 JOHN HENRY WIGMORE, EVIDENCE § 2317 (1st ed. 1904)).
110 Id. at 478.
In 1888, the Supreme Court described the policy grounds for the privilege as "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 consequences or the apprehension of disclosure."\textsuperscript{112}

Lance Cole, author of a Villanova Law Review article, believes there are several important points that are implicit in this Supreme Court decision.\textsuperscript{113} First, "laypersons cannot function in our legal system without the expert advice that can be obtained only from those with special training in law."\textsuperscript{114} The Court also stated that the judicial system could not function properly if laypersons did not feel comfortable obtaining the advice of legal experts, because it is the knowledge of the legal experts that keeps the system functioning.\textsuperscript{115} Finally, laypersons will not seek the advice of legal experts if the system creates obstacles or if they think that there will be adverse consequences if they obtain legal counsel.\textsuperscript{116}

Furthermore, the Supreme Court has not limited the privilege to only criminal cases. In a leading case shaping corporate attorney-client privilege, \textit{Upjohn Co. v. United States},\textsuperscript{117} the Court stated that "full and frank disclosure by the client is required in order for the attorney effectively to serve the client as either adviser or advocate."\textsuperscript{118} The Court found that the privilege was available to corporate clients as well as to individuals.\textsuperscript{119}

This and other decisions of the Supreme Court concerning the attorney-client privilege helped to lay the foundation for the argument that has arisen today between proponents and opponents of the Sarbanes-Oxley Act.\textsuperscript{120} The question is whether the provisions of the Sarbanes-Oxley Act will erode the protections afforded to clients – individual and corporate – under the attorney-client privilege.

\textsuperscript{111} \textit{Id.}
\textsuperscript{112} \textit{Id.} at 479 (discussing Hunt v. Blackburn, 128 U.S. 464, 470 (1888)).
\textsuperscript{113} \textit{Id.}
\textsuperscript{114} \textit{Id.} at 479-80.
\textsuperscript{115} \textit{Id.} at 480.
\textsuperscript{116} \textit{Id.}
\textsuperscript{117} 449 U.S. 383 (1981).
\textsuperscript{118} Cole, supra note 102, at 485. \textit{See also id.} at 495 n.71.
\textsuperscript{119} \textit{Id.} (citing Upjohn Co. v. United States, 449 U.S. at 396-97 (1981)).
\textsuperscript{120} For more information concerning other Supreme Court decisions that affected the attorney-client privilege, \textit{see generally} Cole, supra note 102.
2. Attorney-Client Privilege and Section 307

While there are many different sides to the argument over the erosion of attorney-client privileges by the Act, one group that has fought against the provisions of the Act that affect attorney-client privilege has been the American Bar Association (ABA). "One important function of the organized bar is to help write the ethical rules that govern the legal profession."

In a speech to the Senate before the bill passed, Senator John Edwards criticized both the SEC and the ABA for failing to address the responsibilities of corporate attorneys. He believed that the ABA should have taken a leading role in reforming and redefining corporate attorney conduct — something they did not do.

In 1977 and 1997, the ABA performed a review of the ethical rules that govern the legal profession by setting up commissions. The Kutak Commission was created in 1977, and the second commission, the Ethics 2000 Commission, was formed in 1997. It was this latter commission, the Ethics 2000 Commission, that had the chance to take the leading role in reforming and redefining corporate attorney conduct, but it did not significantly change the provision of the Model Rules concerning up-the-ladder reporting. The legislature decided to use the Act to take action and make the up-the-ladder reporting rule go beyond the Model Rule requirements.

Under the Model Rule the lawyer is required to act only if the violation is likely to cause "substantial injury to the organization." Under the Sarbanes-Oxley a duty to act is triggered by evidence of any material violation. Under the Model Rules referral to the highest authority is permissive and need be considered only if "warranted by the seriousness of the matter." Under Sarbanes-Oxley referral to higher authority is mandatory in the absence of a lower-level appropriate response to the evidence.

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122 Wheeler, supra note 33, at 466.
123 Id.
124 Davis, supra note 121, at 1282.
125 Id.
126 Id. at 1287.
127 Id. at 1288.
128 Id.
The problem with the Act is that it could possibly require the lawyer to withdraw if the client does not admit to past violations of securities laws for which it has no reasonable defense.\textsuperscript{129} This mandatory withdrawal incriminates the client, and clients who do not want to confess will most likely not be candid with their attorneys.\textsuperscript{130} Most lawyers would not withdraw under such circumstances if their services had not been used in committing the violation, and if a lawyer did withdraw, "he or she would be ethically obligated not to disclose the specific circumstances."\textsuperscript{131} "Thus the SEC has created a disclosure event that would not otherwise exist and required an extent of disclosure that is ethically impermissible for the lawyer."\textsuperscript{132} The point behind this argument is that the independence of the bar would be maintained if the Act provided that client confidences did not have to be disclosed.\textsuperscript{133} In his essay on this subject, Evan Davis, a partner at Cleary, Gottlieb, Steen & Hamilton, states that he does not believe that the independence of the bar should be compromised "even for such an important purpose as to help public confidence in corporate accounting and reporting."\textsuperscript{134}

Additional concern about attorney-client privilege can be found in an Oklahoma Law Review article, \textit{Securities Law: Section 307 of the Sarbanes-Oxley Act: Irreconcilable Conflict with the ABA's Model Rules and the Oklahoma Rules of Professional Conduct}, that states that "a legitimate concern exists that the SEC rules under section 307 may have a chilling effect on communications between an attorney and the attorney's primary contacts within a represented corporation."\textsuperscript{135} The article posits that officers and employees in a corporation will not be as forthcoming about matters pertaining to the corporation with the attorney if they fear that Section 307 will force attorneys to report everything to a higher corporate authority.\textsuperscript{136} This creates a problem because attorneys cannot provide help for corporations and cannot prevent corporate scandals from occurring if they do not receive complete and accurate information from officers and employees within the corporation.\textsuperscript{137}

Finally, an Alison Frankel article in \textit{American Lawyer} makes one last important point about the possibility of Section 307 chilling relationships be-

\textsuperscript{129} \textit{Id.} at 1289.

\textsuperscript{130} \textit{Id.} at 1290.

\textsuperscript{131} \textit{Id.}

\textsuperscript{132} \textit{Id.}

\textsuperscript{133} \textit{Id.}

\textsuperscript{134} \textit{Id.} at 1292.

\textsuperscript{135} Wheeler, \textit{supra} note 33, at 485.

\textsuperscript{136} \textit{Id.}

\textsuperscript{137} \textit{Id.}
tween attorneys and their clients. "[W]e have no idea of how many scandals didn’t happen because a client felt comfortable speaking in absolute candor to a lawyer, and because the lawyer was able to provide advice without worrying about his own civil liability."\(^{138}\) This is an important point to consider, because it shows that Section 307 could have the opposite effect intended — instead of preventing scandals, it could create more.

The issue of attorney-client privilege is not the only concern for those who oppose Section 307. There are many other concerns that together with attorney-client privilege issues give support to the proposition that the Section may greatly outweigh any potential gain that it may have in preventing corporate scandals.

B. Problems, Problems, and More Problems: Other Problems with Section 307

Some critics are concerned that the Section does not provide enough regulation. For example, one problem with Section 307, as discussed by Susan P. Koniak, Professor of Law at Boston University School of Law, is that Section 307 does not go far enough; as the amendment went through the government’s rulemaking process, "[t]he SEC retreated."\(^{139}\) Professor Koniak believes that the "saga is not yet over . . . [the] ending leaves lawyers free to continue helping major corporations deceive the investing public. The ending guarantees us more Enrons — lots more."\(^{140}\)

Professor Koniak also finds fault with the trigger for the attorney to report up.\(^{141}\) She believes that the SEC’s attempt to clarify the reporting up standard failed.\(^{142}\) For her, whether the standard is objective or subjective, it is "incomprehensible."\(^{143}\) "[W]hat it seems to require for enforcement is proof that a prudent lawyer would have to have concluded that the law was reasonably likely to have been violated,"\(^{144}\) which "is equivalent to requiring the agency to show

\(^{138}\) Frankel, supra note 70.

\(^{139}\) Koniak, supra note 70, at 1238.

\(^{140}\) Id.

\(^{141}\) See id. at 1274-75. Under the final rule, a lawyer must report, first to the CEO or the chief legal officer "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." Implementation of Standards of Professional Conduct for Attorneys, Securities and Exchange Commission, 68 Fed. Reg. 6296, 6321 (Feb. 6, 2003) (to be codified at 17 C.F.R. pt. 205.2(e)).

\(^{142}\) Koniak, supra note 70, at 1275.

\(^{143}\) Id.

\(^{144}\) Id.
that the lawyer actually concluded (knew) the law was being violated."\textsuperscript{145} Even if the confusion over the standard can be resolved, demonstrating what a person actually knew may be harder to prove than many think, which returns the corporate world to where it was before the Sarbanes-Oxley Act - no rules and no enforcement for the misdeeds of attorneys, other than state imposed rules and sanctions.

The bottom line for Professor Koniak is that Congress passed the Sarbanes-Oxley Act in an effort to make the SEC hold lawyers accountable.\textsuperscript{146} But not everything is as it seems. "The SEC proposed something that looked tough, but wasn't,"\textsuperscript{147} In her view, the SEC's rules are not as tough as they initially set out to be and do not hold lawyers as accountable.\textsuperscript{148} She concludes by saying, "the SEC says the fight is not over yet. But the first two rounds [with the ABA] surely didn't go its way. We have been here before."\textsuperscript{149}

Not everyone believes, as Professor Koniak does, that the SEC rules did not go far enough. In fact, most believe that the rules went too far, as evidenced by the amount of material and commentary regarding problems with Section 307 since the SEC's release of both the proposed and final rules. In fact, one commentator went so far as to say that now, "an attorney representing clients before the Securities and Exchange Commission also has another title: corporate snitch."\textsuperscript{150} Is that too harsh? Many of those who find problems with the Act would likely answer no.

In a Continuing Legal Education session sponsored by the Delaware Valley American Corporate Counsel Association, some lawyers saw the reporting up rule as potentially dangerous because "any lawyer of an outside or inside firm has potential to go to [the] board of directors or the SEC based on their own interpretation of the law and facts."\textsuperscript{151} While many material violations may be discovered this way, false alarms that could potentially damage a corporation's, a director's, or even an attorney's reputation could also occur.

The session also discussed the noisy withdrawal provision, and because this provision has been such a problem, the SEC has not yet adopted it. Michael A. Bloom, a bankruptcy lawyer with Morgan Lewis & Bockius as well as a legal ethicist,\textsuperscript{152} stated:

\textsuperscript{145} Id.
\textsuperscript{146} Id. at 1278.
\textsuperscript{147} Id.
\textsuperscript{148} See id.
\textsuperscript{149} Id.
\textsuperscript{150} Wheeler, supra note 33, at 461.
\textsuperscript{151} Nann, supra note 6, at 3.
\textsuperscript{152} Id.
The noisy withdrawal provision "fundamentally goes against the grain of everything we were taught in our first-year legal ethics and responsibility course, where they talked about this duty of confidence to our client," Bloom said. "Here we are re-defining that duty with considerable concern being well articulated by organized bars across the country that this is [a] not necessary, and [b] not a good thing."\(^{153}\)

Furthermore, after considering reporting up and reporting out/noisy withdrawal, Professor Roberta S. Karmel, Professor of Law at the Brooklyn Law School, noted that she also sees "a lot of problems with the rule."\(^{154}\) One problem is that Section 307 applies to "attorneys acting as attorneys, but it also applies to all other persons within a corporation who happen to be attorneys."\(^{155}\) That means that someone can be in a department that is completely unrelated to the practice of law, and if that person is an attorney and becomes aware of a material violation, that person has the same obligations as the corporation's in-house counsel under the provisions of Section 307.\(^{156}\) This could be problematic in two ways. First, employees in a corporation who are attorneys, even if they no longer practice law, must become familiar with the regulations and act accordingly. Not only are they now required to do their job and do the job of the corporate attorneys, but also some of them may not know that they fall under the guidelines simply because they hold a law degree. Second, the fact that they fall under the regulations may deter some attorneys who are considering a career change from deciding to work in corporations. Who wants to become a corporate attorney when there is the likelihood of having strained relationships with your clients, your attorney-client privileges may be affected, you have to contend with the possibility of choosing between SEC rules or state rules, and even if you manage to perform your duties to the best of your ability, there is still a chance that a material violation can get by you and get you into trouble?

Professor Karmel also believes that the Act "puts into statutory form two previously controversial proposals: first, it . . . give[s] the SEC the authority to regulate the professional practice of securities attorneys and thereby federalizes the regulation of the bar in certain respects."\(^{157}\) "This goes considerably beyond the securities laws."\(^{158}\) Professor Karmel states that this seems to give the SEC the power to control attorneys who become aware of the material viola-

\(^{153}\) Id.

\(^{154}\) The Evolving Legal and Ethical Role of the Corporate Attorney After the Sarbanes-Oxley Act of 2002: Panel 2: The Evolution of Corporate Governance, supra note 70, at 623.

\(^{155}\) Id. At the time Professor Karmel was speaking, Section 307 was still Proposed Rule 205.

\(^{156}\) Id.

\(^{157}\) Id. at 621.

\(^{158}\) Id.
tions within the company.\textsuperscript{159} She believes that the SEC is trying to turn lawyers into whistleblowers.\textsuperscript{160}

Another problem she observes is that "[t]he whistle-blowing provisions ... go beyond the requirements of Sarbanes-Oxley and are contrary to legal ethics in many states. The SEC intends to determine attorney-client privilege questions."\textsuperscript{161} This creates a problem in two different areas. First, attorneys will face conflicting legal ethics rules between the Sarbanes-Oxley Act and the various states, and the attorneys will have to either make the decision of which set of ethics to follow or the states may have to change their own ethics rules to clarify what attorneys must do in certain situations. Second, as discussed previously in \textit{supra} Part IV(A) of this Comment, the provisions in the Sarbanes-Oxley Act could potentially force attorneys to break attorney-client privileges, violating an integral part of the American legal system that has been around since the creation of our judicial system.\textsuperscript{162}

Stuart Kaswell, Senior Vice-President and General Counsel of the Securities Industry Association,\textsuperscript{163} seems to agree with Professor Karmel that the SEC has sought to turn lawyers into cops for the SEC.\textsuperscript{164} He claims that Congress did not see a whistle-blowing provision, or noisy withdrawal provision, for that matter, as necessary.\textsuperscript{165} Mr. Kaswell cites legislative history to show that the Act was not meant to change attorney-client privilege.\textsuperscript{166} But nevertheless, the rules seem to do so.

\textsuperscript{159} \textit{Id.}

\textsuperscript{160} \textit{Id.} at 622.

\textsuperscript{161} \textit{Id.} at 623-24.

\textsuperscript{162} See \textit{supra} notes 102-38 and accompanying text.


\textsuperscript{164} \textit{The Evolving Legal and Ethical Role of the Corporate Attorney After the Sarbanes-Oxley Act of 2002: Panel 2: The Evolution of Corporate Governance, supra} note 6, at 626 (agreeing with Professor Karmel that the SEC "saw fit to propose something much further and that is to go . . . to the SEC").

\textsuperscript{165} \textit{Id.} at 627.

\textsuperscript{166} \textit{Id. See} 148 \textit{CONG. REC. S6555} (daily ed. July 10, 2002) (statement of Senator Enzi) (proclaiming that the amendment would not require attorneys to report violations to the SEC and would not empower the SEC to cause attorneys to breach their attorney/client privilege). \textit{See} n.52.
Mr. Kaswell believes that the SEC rules will adversely change the relationship between attorneys and their corporate clients.\footnote{The Evolving Legal and Ethical Role of the Corporate Attorney After the Sarbanes-Oxley Act of 2002: Panel 2: The Evolution of Corporate Governance, supra note 6, at 627.} He thinks that lawyers will be seen as the enemy – someone from whom to hide secrets. Corporations, fearing that attorneys will get them into trouble rather than save them from trouble, will be afraid to tell lawyers about any potential problems or material violations.\footnote{Id.} Instead of turning to lawyers in times of trouble, corporations will be turning away from their lawyers, potentially causing the problem to become much worse than it would have been if the advice of the attorneys had been sought.

There is no doubt that there are many, many more problems that could occur, and while this paper does not delve into all of them, some are worth mentioning at least in passing. The Alison Frankel article in the American Lawyer, published in late 2002, after the release of the proposed rules but before the passage of the SEC's final rules, lists several potential consequences of the attempt at reform, including "federal incursion into lawyer regulation," "increased risk of law firm liability;" and "erosion of client confidence in lawyers."\footnote{Frankel, supra note 70.} The article states that the rules have the potential to "turn lawyers into watchdogs who will have to worry about covering their own backs even as they worry about clients."\footnote{Id.}

Frankel's American Lawyer article also discusses a very important point: "The power to regulate lawyers has always rested with states. But if Congress has empowered the SEC, what's to stop other federal agencies from asserting regulatory power and enacting rules for lawyers?"\footnote{Id.} Frankel gives the example that a lawyer working on an initial public offering for a telecommunications company may have to "keep in mind the ethical guidelines of the SEC, Federal Communications Commission, and the state bar."\footnote{Id.} Frankel believes that "the potential for confusion is dizzying."\footnote{Id.} The question is who is in charge of attorneys? When corporations look to attorneys for guidance, to whom can the attorneys look?

Frankel agrees with Professor Karmel and Mr. Kaswell that there could be a potential change in the relationship between lawyers and clients and claims that there will be more stress placed on the relationships between attorneys and

\begin{thebibliography}{9}

\bibitem{} The Evolving Legal and Ethical Role of the Corporate Attorney After the Sarbanes-Oxley Act of 2002: Panel 2: The Evolution of Corporate Governance, supra note 6, at 627.
\bibitem{} Id.
\bibitem{} Id.
\bibitem{} Id.
\bibitem{} Id.
\bibitem{} Id.
\bibitem{} Id.
\end{thebibliography}
corporations.\textsuperscript{174} While optimists believe that lawyers may curtail illegal behavior by acting as "adult supervision,"\textsuperscript{175} others think that clients will stop being honest with their attorneys.\textsuperscript{176} This could potentially become a disastrous situation for attorneys and the SEC; the rules could have the opposite effect of what the SEC intended. "If clients are worried about consulting their lawyers in delicate situations, or aren't honest with their lawyers, we could see more ill-considered or even illegal client behavior than before – just the opposite of what reformers intend."\textsuperscript{177}

Another potential problem that combines the aforementioned problems of affecting attorney-client privileges, chilling relationships between attorney and client, and turning attorneys into cops and whistleblowers, is that Section 307 could force lawyers to become gatekeepers. "The term 'gatekeeper' has frequently been used to describe the independent professionals who serve investors by preparing, verifying, or assessing the disclosures that they receive."\textsuperscript{178} Usually, gatekeepers are independent, and if they do not consent to what is asked of them by the corporation, the corporation "may be unable to effect some transaction or to maintain some desired status."\textsuperscript{179}

There are two main reasons why attorneys did not traditionally assume a predominant role of gatekeepers before corporate scandals. First, attorneys usually have multiple roles within a corporation: "(1) advocate; (2) transaction engineer; and (3) disclosure supervisor – or gatekeeper," but opponents of the new rules point out that imposing gatekeeper duties on attorneys "would compromise the attorney's loyalty to the client, thereby subordinating the attorney's primary role to the secondary role of gatekeeper."\textsuperscript{180} Imposing these duties on attorneys

\begin{itemize}
\item \textsuperscript{174} \textit{Id.}
\item \textsuperscript{175} \textit{Id.}
\item \textsuperscript{176} \textit{Id.}
\item \textsuperscript{177} \textit{Id.}
\item \textsuperscript{178} Coffee, Jr., \textit{supra} note 70, at 1296. Examples include:
\begin{itemize}
\item (1) [T]he auditor who provides its certification that the issuer's financial statements comply with generally accepted accounting principles;
\item (2) the debt rating agency that evaluates the issuer's creditworthiness;
\item (3) the securities analyst who communicates an assessment of the corporation's technology, competitiveness, or earnings prospects;
\item (4) the investment banker who furnishes its "fairness opinion" as to the pricing of a merger; and
\item (5) the securities attorney for the issuer who delivers an opinion to the underwriters that all material information of which the attorney is aware concerning the issuer has been disclosed properly.
\end{itemize}
\item \textsuperscript{179} \textit{Id.} at 1296-97.
\item \textsuperscript{180} \textit{Id.} at 1297.
\item \textsuperscript{180} \textit{Id.} at 1302.
\end{itemize}
means that attorneys will have to function much like an auditor. That is, "[they] will have to exercise a measure of independence that is perhaps uncomfortable if [they] [are] also the close counselor of management in other matters, often including business decisions[,]" "[they] will have to be acutely cognizant of [their] responsibility to the public who engage in securities transactions that would never have come about were it not for [their] professional presence[;]" "[they] will have to adopt the healthy skepticism toward the representation of management which a good auditor must adopt[;]" and finally, "[they] will have to do the same thing the auditor does when confronted with an intransigent client – resign." Second, public policy has preferred that communications between the attorney and client are open and unrestricted in order to ensure that the client freely communicates with the attorney. Imposing gatekeeper obligations on attorneys may go against public policy and harm attorney-client communications, particularly if the SEC decides to adopt the noisy withdrawal provision.

How different would the rules be if the SEC adopted the noisy withdrawal provision? The difference between what pre-Sarbanes-Oxley law was versus what the obligations would be if the noisy withdrawal obligation is adopted is that before the Sarbanes-Oxley Act,

an attorney arguably could stand aside and not object when the issuer made a disclosure violation of which the attorney was aware but did not actively assist. If a noisy withdrawal were mandated, however, at least some instances would arise in which the attorney could not remain passive without violating this rule.

This noisy withdrawal provision is controversial for several reasons, but the main contention of opponents of this provision is that they fear that implementation of the provision will have an adverse impact on attorney-client privilege and attorney-client confidence. For example, if an attorney must "report out" and abide by the noisy withdrawal provision, the attorney may potentially have to reveal conversations between his client and him that would normally be protected by attorney-client privilege; an attorney will be faced with having to sever attorney-client privilege to withdraw and report the material violation to the SEC.

181 Id. at 1299.
182 Id.
183 Id. at 1302.
184 Id. at 1307.
185 Id. at 1303-04.
There are additional problems with the noisy withdrawal provision. First, although an attorney may withdraw from representation of the client, this does not eliminate the attorney's liability. Attorneys can still be held liable if it seems that the attorneys have not done enough to ensure compliance with the regulations.

Further, the noisy withdrawal option only works when the lawyer's written work product is necessary for the completion of the business transaction and where the opposing party takes the hint from the disaffirmance. Finally, where the transaction is a completed initial public offering, for instance, it is very difficult to have an effective disaffirmance because investors' decisions already have been made in reliance on the lawyer's work product. Accordingly, exposure to civil, criminal, and regulatory liability remain under . . . the noisy withdrawal option[].

Related to the issue of the noisy withdrawal provision, there is one possible implication that the Sarbanes-Oxley Act could have that the SEC and attorneys may not have considered. Even though the final provisions do not require this, the chief legal officer who reports up but "finds management unresponsive to exposure of material wrongdoing may simply have no practical alternative but to walk out the door." Mark S. Dodge, General Counsel to Paisano Publications, Inc., shared his experience with this situation in a Corporate Legal Times article. He hopes that his story will demonstrate that "the possibility of having to resign over an ethical conflict is one of the great risks of serving as general counsel." In 1982, Dodge became general counsel of Financial Corp. of America (FCA), a NYSE-listed financial services company. When he joined the company, the chairman and CEO was Charles Knapp. In 1984, the new regulatory leadership forced Knapp out, and when he left, he asked Dodge to help him

187 Id.
188 Id. at 134.
189 Mark S. Dodge, Do You Have the Guts to Resign?, CORPORATE LEGAL TIMES, Oct. 2003, at 68.
190 See id.
191 Id.
192 Id.
193 Id.
form a private merchant bank called Trafalgar Holdings. Dodge accepted the offer and joined Knapp’s firm as executive vice president and general counsel.

Over time, it became clear to Dodge that Knapp had some serious character flaws—he had an obsession with showing the business community that he was “back,” he began stretching the truth as a way to secure clients and generate fees, and he came up with an idea to raise $15 million in a Securities offering to fund an investment vehicle called Trafalgar Partners. During a vacation, Dodge decided to resign, but upon returning to work, he discovered that Knapp planned to get Dennis Holt, a successful businessman, to invest in Trafalgar Partners. Dodge explained to Holt the “true situation” at Trafalgar, and Holt decided not to fund the investment.

Soon after this incident, Dodge was asked to draft the disclosure document for Trafalgar Partners, the private placement memorandum (PPM), and as he was doing so, he included the “appropriately truthful language about the company’s track record and current financial condition.” Knapp revised the document, including inaccurate information, and Dodge told him that he would not “be party to a securities offering document that was, in [his] judgment, materially deceptive.” Knapp ordered him to include his inaccurate language. Dodge resigned on the spot, and to this day, he has never regretted his decision to quit. He now uses his story as a lesson for other corporate attorneys.

One could take Mr. Dodge’s story further and surmise that these new regulations may actually deter future attorneys and young attorneys from practicing corporate law because they fear getting caught up in the rules and regulations. It is understandable that many attorneys will be wary of voluntarily engaging in a practice area where they may have to undertake the responsibility that material violations are corrected. Furthermore, they now know they can be held liable if they fail to take care of those violations, and then they will probably face the decision of having to possibly betray attorney-client privileges. At

194 Id.
195 Id.
196 Id.
197 Id.
198 Id.
199 Id.
200 Id.
201 Id.
202 Id.
203 See id.
this point, it is too soon to tell whether this is a realistic concern – one which could slow the influx of attorneys becoming corporate attorneys.

The bottom line is that there is an important question for everyone – attorneys, corporate executives, Senators, and Congressmen – to consider: Would the Sarbanes-Oxley Act have made any difference in what happened with Enron, WorldCom, and other corporations involved in corporate scandals? \(^{204}\) Alison Frankel’s *American Lawyer* article mentioned *supra* cites Martin Lipton of Wachtell, Lipton, Rosen & Katz, who is sure that the new provisions will not prevent another corporate scandal. “‘The most difficult thing for a lawyer is having the wrong client,’ he says. ‘I don’t think these new rules will prevent people who are bent on doing something wrong from achieving it.’” \(^{205}\) If the new rules will not prevent an Enron situation from occurring again, where does that leave the corporate and investment world?

V. CONCLUSION

Supporters of the Sarbanes-Oxley Act hope to prevent future occurrences of Enron, WorldCom, and other corporate scandals. Critics of the Act believe that any benefits of Section 307 will be outweighed by the numerous problems it will cause. Even after an analysis of the possible implications of the rules, at this time it is still difficult to predict how the Section will affect the future role of attorneys. Only time will tell whether the Act prevents or causes more corporate scandals; whether relationships between attorneys and corporations are strained in such a way that executives no longer trust attorneys to advise them for fear of attorneys discovering material violations; whether attorneys will have to sever attorney-client privileges while following the provisions of Section 307; or whether attorneys will become whistleblowers, cops, and gatekeepers for the SEC.

Moreover, if the SEC ever adopts the noisy withdrawal provision, the problems mentioned here may be exacerbated. Mandating a noisy withdrawal/reporting out step may be going too far. Rather, attorneys should report potential violations up the ladder to the CEO, and then, if necessary, to the board of directors in order to prevent corporate scandals. Going any further than these two requirements, such as reporting out to the SEC, or making a noisy withdrawal, requires further consideration, especially given the possible effects on the attorney-client privilege. The attorney-client privilege is too important to the practice of law and clients to be diluted by legislation such as Section 307 of the Sarbanes-Oxley Act. It is not clear that the benefits of such an act would outweigh the potential costs of betrayal of confidence. It is important that clients feel comfortable revealing information to their attorney, and it is hard for attorneys to do their job without all of the necessary information.

\(^{204}\) See generally Frankel, *supra* note 70.

\(^{205}\) *Id.*
Furthermore, why should it be the attorney’s job to act as a cop, whistleblower, or watchdog for the SEC? An attorney should be diligent in his or her job, which can include looking closely at all corporate documents and investigating anything that seems out of the ordinary. Making an attorney suspicious of every document that crosses his or her desk creates problems for both the attorney and the client. The attorney will waste energy that may be well spent in other areas looking for material violations that do not exist, and the client-corporation will feel as if it is being treated as a criminal. In fact, mandating that an attorney do more than a reasonable diligent job seems to turn the attorney into a prosecutor for the SEC, rather than counsel for the corporation. That is not the job most corporate attorneys envision when accepting positions as corporate counsel. Otherwise, they would go to work directly for the SEC.

Perhaps by taking the time to see how the most recent rules affect the world of corporate attorneys and corporate scandals, it will be easier to see what the next step should be. Attorneys who fall under the regulations will be the best judges of how well, or how poorly, Section 307 works. If they believe that the Section is detrimental to the role that they play in the corporation, then attorneys should reconsider the regulations in place. If, on the other hand, the regulations do not seem to work and corporations continue to abuse the system, it may be time to realize that Section 307, and thus, perhaps attorneys, have no correlation to corporate scandals and enforcement of the Section should be abandoned. Or it could indicate that it may be time to enforce stricter versions of the rule, perhaps even adopting a noisy withdrawal provision.

With the corporate scandals and the subsequent passage of the Sarbanes-Oxley Act occurring so recently, it is difficult to predict accurately what might happen in the future. What can be said, however, is that Section 307 of the Sarbanes-Oxley Act will affect attorneys, and most likely corporations, both positively and negatively. The question will be whether the positive effects outweigh the negative effects. Exactly how it affects the corporate and investment world will surely determine the next step that Congress and the SEC decide to take.

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