THE ROLE OF ATTORNEYS IN CORPORATE GOVERNANCE

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTEREPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

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THE ROLE OF ATTORNEYS IN CORPORATE GOVERNANCE

Wednesday, February 4, 2004

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:01 a.m., in Room 2128, Rayburn House Office Building, Hon. Richard Baker [chairman of the subcommittee] presiding.

Present: Representatives Baker, Ose, Gillmor, Manzullo, Kelly, Shadegg, Ryun, Capito, Kennedy, Kanjorski, Sherman, Inslee, Moore, Lucas of Kentucky, McCarthy, Emanuel and Scott. Mr. Gonzalez was also present.

Chairman BAKER. [Presiding.] I would like to call this meeting of the Capital Markets Subcommittee to order. The committee meets today to consider the role of professional conduct of attorneys and their responsibility toward appropriate corporate governance. Unfortunate events all too public now, from Enron to WorldCom and others, have necessitated the committee's work in review of the role of accountants, corporate officers, board members, credit rating agencies, research analysts and others.

The hearing today is a continuation of that review of all responsible parties and today we will focus on the professional accountability of corporate attorneys in disclosing material violations of securities law. The SEC is now in the process of considering two significant modifications to current standards, one referred to as the "up the ladder" responsibility to disclose to the chief legal counsel or the chief executive of the corporation material breaches of professional conduct; secondly, to report the evidence to the company's audit committee and the independent director specifically, or to the board of directors if the counsel does not appropriately respond to the evidence.

Another recommendation which has seemed to draw more attention and comment is the obligation of an attorney to file a "noisy withdrawal" from representing the company, and simultaneously notifying the SEC as to the reasons for this action. Significant debate continues over the appropriateness of the "noisy withdrawal" requirement, and we are here today to receive perspectives as to the appropriate direction the committee should take in regard to the SEC's consideration of this important matter.

I would also point out for the conduct of the hearing that we do expect at 11 o'clock this morning to have a joint session of the Congress, of course requiring us to adjourn the meeting for that purpose. It would be my hope that we could proceed in a timely manner this morning, perhaps limiting opening statements as much as is possible and asking all witnesses to engage their testimony in 5 minutes or less in order to give the committee opportunity for some interchange before the hour comes for adjournment. It is unfortunate, but at the time this was planned, we did not know and were not aware of this development. I suggest that for the witnesses's convenience, because I would not want to keep you here unnecessarily while the joint session was proceeding.

With that statement, I would call on Mr. Kanjorski for his comments.

Mr. KANJORSKI. Thank you, Mr. Chairman.

We adopted the Sarbanes-Oxley Act during the last Congress after a rash of corporate scandals. This statute modified the regulation of auditors, business executives, corporate boards and research analysts. A key section of this law also revised the oversight of attorneys in our capital markets. This part of the law and its related pending regulatory proceedings at the Securities and Exchange Commission are the focus of today's hearing.

The regulatory system for our capital markets depends in large part on the effectiveness of a variety of independent gatekeepers. These skilled professionals include the lawyers and accountants who verify and analyze the disclosures and documents of publicly held companies. These experts, from my perspective, have a special obligation to behave ethically and follow the law. Professionals like lawyers also have a responsibility to police themselves. If, however, such professionals fail to effectively monitor their actions and those of their peers, we have an obligation to protect investors by taking action in Washington.

After examining the corporate scandals at Enron, WorldCom and other companies, we ultimately determined that securities lawyers played a role in these debacles and decided to alter the rules governing the profession. One year ago, the Securities and Exchange Commission adopted a regulation to implement the reforms affecting securities attorneys mandated by the Sarbanes-Oxley Act. This rule requires lawyers to report "up the ladder" evidence of material wrongdoing to a company's officers and, if necessary, a company's board. This regulation, which I strongly support, became effective last August.

When adopting the rule governing the professional responsibilities of securities lawyers, the Commission also extended the public comment period on a proposal to require a "noisy withdrawal" by attorneys who do not receive a satisfactory response from a company to internal reports of wrongdoing. This plan to require the notification by the attorney to the Commission of his or her withdrawal immediately met with strong opposition from many practitioners in the legal community. In response, the Commission put forward for review an alternate plan. This substitute would require the issuer, rather than the attorney, to report the withdrawal of a lawyer for professional reasons.

The two withdrawal-and-notification proposals presently pending before the Securities and Exchange Commission raise important questions that we should carefully examine today. Each one has the potential to alter the attorney-client privilege and could have a chilling effect on communications between management and counsel, making executives less likely to consult and speak frankly with lawyers. These proposals might also unintentionally reward those lawyers with lower ethical standards, who would stretch the law beyond its reasonable interpretations and never withdraw from a client. We should closely examine each of these concerns.

In their observations today, I hope that our distinguished witnesses will answer a question that I have about restoring the ability of victims of securities fraud to sue those who aid and abet issuers in defrauding the public. Prior to a 1994 decision by the Supreme Court, individuals had the right to pursue a private cause of action against lawyers and other professionals who helped public corporations to deceive the public.

Although we partially overturned this decision when passing the Private Securities Litigation Reform Act of 1995 to allow the commission under certain circumstances to bring cases against aiders and abettors of securities fraud, we may have failed to do enough to protect investors. After all, past leaders of the Securities and Exchange Commission from both political parties have stressed the integral role of private lawsuits in maintaining investor confidence.

Since 1994, however, the victims of securities fraud have been unable to bring claims against lawyers and other gatekeepers who abuse the public trust by aiding issuers in misleading shareholders. Rather than adopting either one of the pending alternatives for reporting an attorney's withdrawal from representation because of concerns about the client's potential or actual wrongdoing, it may make sense for the Congress to instead restore the right of individuals to pursue their legal claims in our courts.

In closing, Mr. Chairman, I commend you again for your sustained leadership in studying these matters. This timely hearing will help us to better appreciate the decisions facing the commission as it continues its work to bolster investor confidence, restore the integrity of financial statements, and rebuild trust in our securities markets.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 32 in the appendix.]

Chairman BAKER. I thank the gentleman for his statement. It is my understanding Members on my side do wish to file for the record their opening statements, but do not wish to be recognized at this time. I would ask, are there Members on your side, Mr. Kanjorski, who wish to be recognized for an opening statement? Mr. Gonzalez, did you have a unanimous consent request?

Mr. GONZALEZ. Sir, I will be submitting something for the record, and I appreciate the opportunity to do that, but I do not wish to speak at this time.

[The prepared statement of Hon. Charles A. Gonzalez can be found on page 31 in the appendix.]

Chairman BAKER. We welcome your insightful participation, Mr. Gonzalez. Thank you, sir.

If there are no further opening statements at this time, then I will proceed to recognize our first participant this morning, Ms. Linda A. Madrid, managing director, general counsel and corporate secretary, CarrAmerica Realty Corporation, appearing on behalf of the Association of Corporate Counsel. Welcome, Ms. Madrid.

STATEMENT OF LINDA A. MADRID, MANAGING DIRECTOR, GENERAL COUNSEL AND CORPORATE SECRETARY, CARRAMERICA REALTY CORPORATION, ON BEHALF OF THE ASSOCIATION OF CORPORATE COUNSEL

Ms. MADRID. Good morning, Mr. Chairman, Ranking Member Kanjorski, and other Members of the committee.

I am Linda Madrid, and I serve as managing director, general counsel and corporate secretary of CarrAmerica Realty Corporation. CarrAmerica is a commercial office REIT that is traded on the New York Stock Exchange.

I am pleased to appear on behalf of the nearly 16,000 members of the Association of Corporate Counsel, or ACC, and the more than 7,000 private organizational entities that they represent in over 47 countries. Because outside counsel are not eligible for membership, we understand the issues and concerns facing in-house counsel probably better than any other organization.

The comments I offer here today are those of ACC and do not reflect the positions of my employer, CarrAmerica Realty Corporation. My oral testimony summarizes a more detailed statement which I hope you will include as part of the permanent record.

Chairman BAKER. Without objection, all witnesses's testimony will be made part of the official record. Thank you.

Ms. MADRID. Thank you.

The passage of the Sarbanes-Oxley Act reflects an understandable response to recent and devastating corporate scandals. ACC strongly supports the law's intention to restore shareholder and investor confidence. Corporate counsel play the key role in helping management and the board enact governance reforms that ensure the company's ethical culture is supported by sound governance systems. Our members embrace their professional and fiduciary duties, which include reporting allegations up the ladder to the highest authority necessary to ensure that the client can and does remedy the legal problems caused by rogue employees or executives.

Lawyers who represent corporations owe their allegiance to the institution, not to any individual within it. It is a basic tenet of all professional rules, not just those of the SEC, that have been promulgated under section 307. Our members fully support section 307 reforms that help in-house lawyers to work closely with managers to instill compliance values and guarantee sound legal systems.

My full statement as to how companies and law departments are ensuring compliance with 307 rules has been included, but I am happy to report today that the majority of law departments that have implemented policies under 307 have gone beyond the SEC's requirements.

I would be happy to respond to any questions you may have regarding the law departments's efforts, as well as the unanticipated problems they have discovered through practical implementation. These include the concern that too much time is spent on process, and it will take away focus from the preventive counseling that is necessary, continuing problems with the definition and scope of many of the important aspects of the Act and its terminology, and the proliferation of conflicting attorney conduct rules by governmental agencies and state bars.

However, ACC strongly opposes mandatory reporting-out requirements, which the SEC has kept on the table for consideration. We believe that they will damage the underlying relationship between in-house lawyers and their clients. Mandatory reporting-out by lawyers inhibits legal compliance efforts because it discourages clients from welcoming lawyers into every aspect of the company's most sensitive of matters.

In-house lawyers are only effective if they are integrated and trusted members of corporate management teams. If lawyers are viewed as in-house cops whose regulatory duties to outside enforcement agencies outweighs the client's need for confidential counsel, then the attorney-client relationship will have been undermined in a manner that is both counterproductive to the purpose and intent of the Act, and a disservice to the effective protection of the public and the client.

Thank you for this opportunity. I would be happy to answer any questions.

[The prepared statement of Linda A. Madrid can be found on page 57 in the appendix.]

Chairman BAKER. Thank you very much.

Our next witness is Mr. Stanley Keller, partner in the law firm of Palmer and Dodge. Welcome, Mr. Keller.

STATEMENT OF STANLEY KELLER, PARTNER, LAW FIRM OF PALMER & DODGE, LLP

Mr. KELLER. Thank you, Chairman Baker, Ranking Member Kanjorski and other Members of the committee. I am pleased to have the opportunity to testify before the subcommittee on this important subject.

Because Linda is here speaking for in-house lawyers, I can speak for out-house lawyers, having spent over 40 years in private practice representing corporations, and many public corporations. I have been actively involved in the subject of this hearing, having chaired until last August the American Bar Association's Committee on Federal Regulation of Securities.

I was also actively involved in the ABA's Task Force on Corporate Responsibility, known as the Cheek Commission, as a special adviser. Just to round it out, I was actively involved as liaison to the ABA's Task Force on Implementation of Section 307 of the Sarbanes-Oxley Act. In that capacity, I had a primary role in preparing the comments of the ABA to the SEC.

Having said that, I do not appear here as a representative of the ABA, but note that just as background. Rather, I am here in my individual capacity. I refer you to a letter submitted by the ABA, as well as a letter from Peter Moser, who chaired the section 307 task force. I embrace those letters.

I would like to very quickly, given the time constraints, address just two points, and two related points: one, the significant changes that have taken place in corporate governance and lawyer professional responsibility since the enactment of what we fondly refer to as SOX; second, the issues surrounding the need for additional action, namely the SEC's proposed "noisy withdrawal" rule.

Let me make clear that when I speak about the "noisy withdrawal" rule, I am speaking about either alternative that is still on the table. To me, it makes no difference if the mandate is that the lawyer withdraw, whether it is the lawyer that ends up reporting that withdrawal or it is the company that then is put in the position of having to report that withdrawal. The problems, I think, are the same with either alternative, although one has a cosmetic appeal.

The two issues are related because attorney professional conduct rules are best understood and considered in the context of the enhancements that have already taken place in corporate governance and in lawyer responsibility. My written testimony lists those. I will not dwell on them, but just to check-off a handful, we really have a new corporate governance structure requiring a majority of independent directors and effective committees of the board, notably the audit committee and recommendations that have been embraced widely for improved corporate governance from various groups, including the ABA's task force on corporate responsibility.

The ABA's approval this past summer of revisions to the model rules of professional conduct enhance the lawyer's role in ensuring legal compliance. We have the SEC's "reporting up" rules. I would like to say that the SEC did an outstanding job in responding to the mandate from Congress in section 307, to adopt the "reporting up" rules.

Those rules, while I must admit 307 was not enthusiastically embraced when it was proposed, have had a beneficial impact and have been widely accepted and are being followed or being implemented, because they are consistent with the ethics rules that lawyers have been subject to and, if anything, they have brought renewed attention to the need to comply with professional responsibility requirements.

The SEC's effort to override inconsistent state rules so as to permit lawyers in appropriate circumstances to report out again is consistent with existing state ethics rules. As I said, there have been significant compliance efforts by law firms, by corporate law departments, continuing legal education efforts and the like.

The result of all of these efforts has been the creation of a system in which we can all take confidence. Lawyers who are aware of their responsibility and are vigilant, having had brought, if you will, to their attention what their responsibilities always have been, and who are now paying attention to them reporting up when there is a problem to a board with independent directors who are in a position to receive, consider and act upon those reports. I think this is a system that we should allow to operate, that addresses the problems.

In the face of these circumstances, the "noisy withdrawal" proposals bring with them serious risks of adverse consequences, not in the lawyer's interest, if you will, but rather in the interest of the client and access to effective legal representation, to the core values of our legal system, and to principles of corporate governance.

These adverse consequences, put very simply, are erosion of the attorney-client relationship by making the lawyer a potential adversary; two, encouraging or promoting early withdrawal by lawyers who have to be more concerned about their own exposure to a violation of federal law than just hanging in there, seeking corporate compliance by the client, and serving the best interest of the client and the investors of those clients.

Perhaps even worse, because of the serious nature of having to withdraw, we may find lawyers discouraged from looking at the hard issues, the hard questions, so as not to turn over the stone and see the problems which would then put then in the position of having to report and potentially to withdraw. To me, that would be contrary to the best interests of promoting legal compliance.

Finally, judgments on critical business decisions, where a mandatory rule would suddenly put the lawyers in the position of making those decisions, rather than boards of directors and independent directors who are charged with that responsibility and expected to fulfill that responsibility.

Let me conclude, and leave the rest to my written testimony, really with my conclusion that we should allow the measures that have been put in place to operate before we embark on these fundamental changes to the lawyer's role, with the potential serious consequences that can result from those changes.

Thank you, and I would be happy to respond to questions at the appropriate time.

[The prepared statement of Stanley Keller can be found on page 52 in the appendix.]

Chairman BAKER. Thank you, Mr. Keller.

Our next witness is Professor Richard Painter from the University of Illinois College of Law. Welcome, professor.

STATEMENT OF PROFESSOR RICHARD PAINTER, UNIVERSITY OF ILLINOIS COLLEGE OF LAW

Mr. PAINTER. Thank you, Mr. Chairman and Members of the committee.

Wherever possible, I believe it is best to leave regulation to the states, rather than to the federal government. There are, however, exceptions, and section 307 is one of them. I pointed out in the early 1990s my frustration that out of dozens of lawyers accused by federal banking regulators of aiding and abetting savings and loan fraud, not one was disciplined by a state bar association, at least that I know of. This was so despite the fact that many of these lawyers settled cases brought by federal regulators for $20 million, $30 million and even over $40 million. The fact is that state bar discipline is virtually meaningless for policing the practice of securities and banking law.

It is for this reason that I proposed in a 1996 law review article that Congress enact a statute requiring securities lawyers to report known illegal acts of corporate clients up the ladder to the client's full board of directors. It is also for this reason that I appealed to the ABA in 1998 to amend the model rules of professional conduct to require such "up the ladder" reporting, only to have the proposal rejected in favor of the prevailing view at the time that such matters ought to be left to the lawyer.

It is for this reason that I and 40 other law professors wrote SEC Chairman Harvey Pitt in March of 2002 to request that the Commission promulgate rules requiring "up the ladder" reporting. Finally, this proposal made its way to Congress and Congress in the summer of 2002 enacted section 307, which requires the SEC to promulgate the "up the ladder" reporting rule.

Section 307 and the SEC rules thereunder appear to be working. Just last month, the New York Times reported that because of section 307, outside lawyers for TV Azteca, Mexico's second-largest broadcasting company, reported to its board of directors the fact that the company was probably violating United States securities laws. For the most part, I support the SEC's final rules under section 307 and would be happy to go into detail with respect to that if you would like.

With respect to the SEC's proposed rules, which have not yet become final, the most controversial provision is, of course, the proposal for "noisy withdrawal." I would support a requirement that the lawyer withdraw from representing a client when they have reported to the full board of directors known securities law violations and the full board of directors refuses to obey the law. The amount of noise, however, should perhaps be left to the lawyer. Indeed, most lawyers, who do not want to find themselves in a position where they could be exposed to civil liability for their client's conduct, will take prompt steps once they have resigned to make sure that the fraud does not come to pass.

So with respect to that issue, I agree partially with the SEC's position that withdrawal should be required, but the "noisy withdrawal" proposal that has been so controversial is perhaps unnecessary.

I would then move on to other issues that I believe deserve our serious attention. One of these is the level of knowledge required to trigger section 307's reporting obligations to begin with. I believe the SEC's definition of "evidence of material violation" is exceedingly narrow and does not comply with the broad language of the statute. Second, the SEC needs to consider how easy or difficult it is for issuers to use the opt-out mechanism, which is a qualified legal compliance committee. The SEC should solicit commentary on how this aspect of the rule is working in practice.

Finally, Congress in section 307 gave the SEC quite broad authority beyond "up the ladder" reporting requirements. As I mentioned, I would not, if I were the Commission, use this authority and the political capital that the Commission might have on this issue, to fight over "noisy withdrawal," but rather turn to some other areas of concern. One of them that I mention in more detail in my written testimony is contingent fees in connection with corporate transactions. In the AOL-Time Warner merger, Time Warner's counsel, according to press reports, received a contingent fee of $35 million contingent on the deal closing. It would have only been around $5 million if the deal had not closed.

I am not going to imply in any way that Time Warner received anything other than the most competent and loyal representation of counsel, but I am seriously concerned about contingent fees in securities transactions where the lawyer gets paid far more if the deal closes than if it does not, and this is the same lawyer who is supposed to be looking out for problems with the deal where it may not be in the interests of their client.

In sum, while the "noisy withdrawal" debate has received much attention, I urge the SEC to consider requiring withdrawal without requiring noise, and then to move on to other more pressing issues in carrying out its congressional mandate.

Thank you, Mr. Chairman.

[The prepared statement of Richard Painter can be found on page 85 in the appendix.]

Chairman BAKER. Thank you very much.

Our next witness is Professor George M. Cohen, University of Virginia Law School. Welcome, sir.

STATEMENT OF PROFESSOR GEORGE M. COHEN, UNIVERSITY OF VIRGINIA LAW SCHOOL

Mr. COHEN. Thank you very much. Thank you, Mr. Chairman, and thank you for having me here.

I want to state my conclusions that I give in the testimony first, and then talk about some responses to some of the objections that lawyers have made to the existing and the proposed rules.

First, the rule as it exists I support wholeheartedly. I believe that it needs to be fixed in several respects. One, the "reporting up" trigger is a very difficult trigger, I think, for lawyers and anyone else to understand, and very difficult for the SEC to enforce. Let me read to you what the rule actually says. The rule says that you have to report evidence of a material violation, and the definition of "evidence of a material violation" is "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."

This kind of formulation, with its double negative, makes it very difficult for the SEC to enforce actions against lawyers who engage in wrongdoing. I think that that needs to be changed because if the initial trigger, which is the main purpose of section 307 and the SEC rules, does not work well, then the whole thing does not work well.

Secondly, there is a problem with the "appropriate response" definition, that is, that if a lawyer reports wrongdoing to the CEO or the chief legal officer of the court, the question is, does the lawyer get an appropriate response, because that determines whether or not the lawyer needs to go up the ladder to the board. The "appropriate response" definition contains what you might expect.

That is, if after an investigation it is determined that there is no problem, or if it is determined that there is a problem, but it is being fixed. But there is another possibility that is listed in the SEC rules, and that is, if a lawyer is hired to investigate the alleged wrongdoing and is able to assert or is willing to assert a so-called "colorable defense," then that is deemed to be an appropriate response.

I submit to the committee that that is not an appropriate response. It is an appropriate stance that one might take perhaps in litigation, but there is an important difference between lawyers' role as advocates in litigation and lawyers' roles as counselors in determining whether or not the company is more likely than not engaged in serious wrongdoing.

Finally, I think the rule needs to be changed to apply not only to individual lawyers, but to law firms. Firms are hired generally by corporations, not individual lawyers. The firm as a whole ought to be responsible. If the firm is not made responsible, there is a danger that work will be parceled out in such a way that no individual person, no individual lawyer will have sufficient knowledge of what is going on, what the big picture is.

The imputation of knowledge is a common feature of agency law, partnership law, and exists throughout the law. The SEC itself has used this idea under its former and still continuing authority under Rule 102(e). That should be adopted as part of the new SEC rules as well.

Secondly, I support wholeheartedly the "noisy withdrawal" rule that the SEC has proposed. I think that it is consistent with the traditional approach to this problem that has existed in the lawyer rules. In fact, the "noisy withdrawal" proposal is a creature not of the SEC, but of the ABA itself, which in its own comments to its own model rules says that there may be times when it is necessary for a lawyer to withdraw and also to disavow any documents or opinions that have proven to be false on further investigation. This is necessary in order for the lawyers to avoid becoming complicit in wrongdoing by corporations.

So the question is, if you go up the ladder and you have a board that is a corrupt board and insists on engaging in wrongdoing, how is the lawyer supposed to extricate himself or herself from being an assister, an aider and abettor in the wrongdoing? I think that the only way to do that, and I hope and expect that it would be in very rare circumstances, but I think that past experience suggests that it can happen, is that we ought to take a stance and say that if it does happen, that the board is engaged in wrongdoing and will not stop, that the lawyer ought to be required to make the noisy withdrawal. Whether or not the lawyer does it or the company does it, I do not have strong feelings about.

Third, I think that it is important to go beyond the SEC rules and fixing the SEC rules, to think about other ways to deal with some of the problems of lawyers assisting in corporate wrongdoing, the most important of which, in my view, is to restore private lawsuits, private damage suits for aiding and abetting liability, which were taken away by the Supreme Court decision in Central Bank in the mid-1990s, and were not restored, even though Congress had the chance to do it, in the Private Litigation Securities Reform Act. I think that that needs to happen. In some sense, the potential for liability for aiding and abetting is the most effective deterrent, the most effective regulator for lawyer behavior. I would urge Congress to restore the aiding and abetting cause of action.

Finally, I think that it is important to recognize that although the SEC is an important federal agency that regulates lawyers, it is not the only one. I think it would be wise for Congress to consider extending the SEC's rules to other lawyers who also appear before other federal agencies, both in the name of uniformity and consistency in an approach to the problem of corporate wrongdoing and lawyers' assistance in that wrongdoing.

I see that my time is up. I would be happy to answer questions and to talk about some of the other arguments I make in the testimony later on.

[The prepared statement of George M. Cohen can be found on page 34 in the appendix.]

Chairman BAKER. Thank you very much, sir.

Our next witness is Professor Thomas D. Morgan from George Washington University Law School. Welcome.

STATEMENT OF PROFESSOR THOMAS D. MORGAN, GEORGE WASHINGTON UNIVERSITY LAW SCHOOL

Mr. MORGAN. Thank you, Mr. Chairman, Members of the committee. I, too, appreciate the chance to be here with you today. You have heard from all of us, and we all agree that there is no right of any lawyer knowingly to assist a client, corporate or otherwise, to commit a crime or fraud. The problem is that there are a number of serious questions about how a given lawyer should be required to act in any particular concrete situation. But we all agree that the boundaries of appropriate zealous representation of a client end where knowingly assisting a crime or fraud begins.

The testimony that I have submitted to you, and that I will simply stand on, makes three important points. First, a comprehensive body of state and federal regulation already exists that renders doubtful the need for additional regulation. It includes, under some circumstances, a requirement of withdrawal and even permission of noisy withdrawal.

Second, the role of corporate attorneys in actually formulating corporate policy and in some cases even being aware of the intricacies of what the company is doing, very often tends to be much smaller than we sometimes think. Thus, the responsibility for much of the corporate wrongdoing is not likely to be significantly at the feet of attorneys. I leave the statement to develop that.

Third, federally mandated "noisy withdrawal" in the face of possible wrongdoing would potentially create more problems than it would solve. In the interest of time, I would like to focus my oral comments on that issue. Under current SEC standards, matters that an attorney is required to report within the client are quite broad. As Professor Painter suggested, the standard of knowledge is really quite low.

It includes matters about which the attorney may have very little knowledge, may not have worked on, may not even understand the subject matter area. Indeed, the attorney may not even be well equipped to evaluate the company's response. Yet, the lawyer may very conscientiously conclude that he or she must withdraw or does not want to continue representing the client.

What I suggest in my written testimony is that "noisy withdrawal" in those circumstances does not, will not provide investors with direct reliable information. I describe it as the professional equivalent of the parlor game of charades, the game in which people are asked to read content into otherwise ambiguous gestures. The problems of restoring investor confidence and of getting lawyers to give good legal advice and to respond appropriately in tough situations is just too serious for that kind of simplistic response.

I suggest to you that disclosure of ambiguous information to securities markets is not an unvarnished good. Accurate, easily understood information makes markets work better, but confusing, ambiguous information makes markets work less well. If investors are led to believe by the conscientious noisy withdrawal of a lawyer that they know facts about the company that later prove to be less significant than they once thought, real Americans are going to lose real dollars for no good reason.

Today, under existing regulation both of the SEC and of the states, attorneys can make disclosure to regulators, but their disclosures should be based on sound information, and before information goes to the markets, it ought to be confirmed and accurate and not simply be part of a single process.

Finally, Mr. Kanjorski asked us to talk about Central Bank. In response to Professor Cohen, I would simply suggest to you that moving to creating aiding and abetting liability for attorneys would not be a good idea. Under the Newby case, the Enron case in Texas, the judge has moved the law of primary violation of the securities law much more in the direction of saying that if a lawyer is actively involved in reporting inaccurate information to the public, the lawyer may be guilty of a primary violation. Simply creating a rule that ropes into every investor lawsuit every lawyer who might have touched the matter at some point in time, I would suggest to you is a great overreaction to the problem.

Thank you very much.

[The prepared statement of Thomas D. Morgan can be found on page 71 in the appendix.]

Chairman BAKER. Thank you, Professor Morgan.

I would like to start with you, and for the sake of the committee's conduct, I will announce that we will try to adhere to the 5-minute rule strictly today to give as many Members the opportunity because of the 11 o'clock joint session.

I think in order to determine the appropriateness of the revisions, one has to first establish the role of the corporate counsel within the structure, much like the committee did in viewing the role of the accountants and their fiduciary duty to shareholders. We had CPAs appear before the committee. When asked, to whom do you feel ultimate responsibility? They made the statement it is a shared responsibility between management and shareholders, which I found disappointing; that their role was to provide a true and accurate picture of financial condition so shareholders could assess the value of that holding.

If we determine that the role of corporate counsel is to ensure that corporate conduct does not engage in unintentional or intentional violations of law for the protection of the shareholder, that seems to create a higher standard of accountability than if we simply view it as an attorney-client relationship working on behalf of that executive to isolate that executive from any statutory or criminal liabilities.

To that end, if in your example it is unclear, uncertain, outside the area of specialization, and he acted, that would be in the shareholders's disinterest, I believe was your conclusion. On the other hand, where there is a three-act play, an opening, an explanation and a conclusion, it is clear. You have gone to the board; you have done all appropriate action. Isn't there some point at which a withdrawal appropriately should be made, when there is clear knowledge that all appropriate responses have been without remedy? Is this a moving target where one standard, as you describe it, does not fit all, but there are cases where such a withdrawal might be advisable?

Mr. MORGAN. Yes, Mr. Chairman. I do not think there is any question there are cases where it might be desirable, and where under current regulation it is appropriate and indeed, as Professor Cohen suggested, it is consistent with current state regulations that a lawyer should withdraw. Indeed, any lawyer who puts his or her reputation behind a situation that they know to be dishonest and fraudulent is clearly violating the rules today.

Chairman BAKER. It would appear to me that reestablishing that professional accountability would not be adverse to public interest, wherein you have established, and you are leaving it to the attorney; we are not prescribing the elements, the material facts that must be engaged in order for the step to be taken. We are merely establishing the fiduciary standard for your conduct.

I am not sure that the "noisy withdrawal" rule as currently constructed achieves the goal it is intended to achieve. But I have seen circumstances where I think it should have been appropriate and it was not taken, and shareholder interests were dissipated as a result of that failure to act. There has not been a corresponding responsibility for the attorney who did not engage in proper conduct. That really goes to the heart of my concerns about it.

Did anyone just want to jump in? Yes, Professor Painter?

Mr. PAINTER. I believe you are exactly right, Mr. Chairman. The lawyer for the corporation represents the corporation, which is run by its board of directors, not its officers, but its board of directors. That is why the "up the ladder" reporting is so critical. Directors have the right and the responsibility to know about violations of the law.

Second, the lawyer is also an officer of the corporation. The lawyer has some public obligation. If the lawyer knows the client refuses to obey the law, and they have exhausted all remedies with the board of directors, the lawyer should be required to resign. I support that part of the SEC's rules. The amount of noise involved can be a debatable question, but the lawyer should get out of there, and any intelligent lawyer will get out of there because they will be sued. We do not really need to overturn Central Bank of Denver to make it possible to sue lawyers in these situations.

If the company goes bankrupt, the trustee comes in and sues the lawyers. We saw that in the savings and loan cases. Indeed, the civil liability regime for the past 10 or 15 years has been way ahead of the ethics rules on this point. It was the civil liability regime that was really the sole disciplining factor for the bar until Congress decided in section 307 to step in and mandate SEC ethics rules, which was the right thing to do.

Chairman BAKER. Thank you.

Yes, Mr. Keller?

Mr. KELLER. May I just comment briefly? I think there is no question that there are circumstances when lawyers are well advised to withdraw. But I think the issue is whether you do more harm than good in trying to define any kind of bright-line rules as a matter of federal regulation or federal legislation, given the complexity of situations that we are confronted with.

We know when someone announces they are going to rob a bank that there is a clear violation of law. But very frankly, in the area we deal with, disclosure concerns, breach of fiduciary duties, there are subtle complex issues. That is why the regime that permits lawyers, indeed encourages lawyers, to take those actions helps; a regime that backs up the failure to act reasonably within a range of reasonableness, through being exposed to liability. Aiding and abetting liability exists. It is sanctioned by the SEC. You also can be a primary violator. That provides the kind of incentives, if you will, for proper conduct. I just do not think that this is an area susceptible to a bright-line test.

Chairman BAKER. Thank you sir. My time has expired.

Mr. Kanjorski?

Mr. KANJORSKI. In lieu of section 307, I am curious as to how great a problem the witnesses's feelings are as to how much of a problem exists today as compared to prior to 307. Are we beating a dead horse, that we need additional rules? Or is there any evidence out there that there is a failure to comply with either ethical codes or standards that were implied in section 307?

Mr. KELLER. As I indicated in my remarks, I think there has been a dramatic impact as a result of 307. Most every law firm in the country, I assume every in-house legal department, has put in place procedures to implement the SEC rules adopted pursuant to 307. There is a great deal of attention. This is part of what I think has been the overall impact of the Sarbanes-Oxley Act, which is reminding people and getting their attention back to what their fundamental responsibilities were.

Mr. KANJORSKI. Mr. Keller, I am going to direct it to you. We have a little difference between Professor Cohen and Professor Morgan in terms of aiding and abetting, whether we should go back and let the marketplace work out with the legal system on this problem. If you had to make a choice as a private practitioner to go back and reinstate the legal liability of aiding and abetting to investors or other individuals, as opposed to extending the "noisy withdrawal," which would you choose?

Mr. KELLER. I would choose to let the law evolve as it is evolving in the Newby case, because the problem is the disproportionality of the exposure based upon the conduct and the financial interest, and the chilling effect of automatically being named in the proliferation of lawsuits which Congress sought to address in the Private Litigation Securities Reform Act would have on the ability of lawyers to counsel clients zealously and in the best interest of the client, as opposed to protecting their own interest. So I would let the common law evolve, given the anti-fraud rules that are now in place.

Mr. KANJORSKI. Professor Morgan, you indicated that there are instances where lawsuits can be brought by the trustee of a bankrupt estate, but how about in those situations where the fraud is successful?

Mr. MORGAN. Perhaps I do not understand the question.

Mr. KANJORSKI. The lawyer participates in a fraudulent transaction, but the corporation does not fail. There is no lawsuit by those people injured for aiding and abetting.

Mr. MORGAN. I was not intending to speak to the question of bankruptcy.

Mr. KANJORSKI. You mentioned in your response that there are in fact lawsuits that can be brought for aiding and abetting. You cite as an example a trustee in bankruptcy of a bankrupt corporation can bring an action. That is true, but what if the corporation does not go bankrupt? What if the fraud actually succeeds and the corporation makes a great deal of benefit, but at someone else's cost where a lawsuit for aiding and abetting in fraud would give that person a chance to recover?

Mr. MORGAN. There are two answers. One, to the extent the lawyer can be shown to have aided and abetted fraud, and there is a suit for fraud, the victim of the fraud can recover today.

Mr. KANJORSKI. That would only be if the attorney is directly involved in fraud, not aiding and abetting, as I understand it.

Mr. MORGAN. At least not under the federal securities laws. The question is, what is going to constitute a primary violation? The point that I was trying to make and that Mr. Keller reiterated was that under the Newby case, the law is moving more in the direction of saying that such a suit is available to a person who is injured by direct activity of the lawyer, as opposed to simply the lawyer having been involved at some point in time in the activities of the company.

What many of us are concerned about is that lawyers will be swept into a large undifferentiated mass of people who will be accused of aiding and abetting, but who have no primary responsibility. That is the concern.

Mr. KANJORSKI. I understand that, but why can't we put a filtering mechanism of the review of peers, and the suit does not have merit to proceed against the lawyer unless the peers decide that it was very clear that he had information, knowledge, and participated? We are doing a black and white situation here. I say why can't we move to a little bit of a gray area to reinforce and restore the aiding and abetting obligation or standard. As I understand it, the objection would be made now if a lawyer is named in a lawsuit as an aider and abettor. It would be stricken under existing law.

Mr. MORGAN. What happens today is that they will accuse him of being a primary violator. If the law as stated in the Newby case becomes the law, becomes generally accepted, then we will have moved in the direction that I think you are seeking to move. What some of us are saying is that we think the law is moving in the direction that you prefer, and that a general move toward aiding and abetting liability would not be desirable. Whether there is an interim step is a question about which I guess we would just simply have to look at the language that is selected.

Mr. KANJORSKI. Thank you. If I could take one more second, Mr. Cohen, I think, has something to add to this discussion.

Mr. COHEN. Yes, I do. Let me just say something about aiding and abetting. First of all, it is important to remember, one, aiding and abetting is a crime. It is a federal crime if there is sufficient criminal intent. Now, it is hard to prove criminal intent, but it has always been a crime to aid and abet. It has always been an ethical violation to aid and abet. The SEC currently has the authority to prosecute aiding and abetting. So to me, the idea that lawyers cannot figure out what aiding and abetting is, they have been living with aiding and abetting forever. So I do not find that a valid argument.

As to the Newby (Enron) case, I agree with the result in that case, but I think that, to go back to Professor Morgan's point about making sure that we want to clarify the law, Newby was not predicted by many securities lawyers ahead of time, the result. In fact, Professor John Coffee from Columbia had written a statement before that case was decided saying he did not think there could be a primary violation found.

So yes, you can stretch the law and call things primary violations that used to be called secondary violations, but why should you do that? We had a history under the securities laws, several decades of case law defining what aiding and abetting was. That was overturned in Central Bank. So there is a history. There is an understanding of what that means, and I do not think we should need to resort to subterfuge in expanding what primary violations are in order to have an effective rule.

Chairman BAKER. The gentleman's time has expired.

Ms. Kelly?

Mrs. KELLY. Thank you, Mr. Chairman.

There is one consideration here. There is an elephant in this room that has not been mentioned, so I am going to mention it. That is the shareholders. Because what any attorney does with regard to a corporation, anything that they do has to be focused on the shareholders. Whether the corporate people are focusing there or not, I believe there is a duty that the attorneys need to focus on what the effect is on the shareholders.

Professor Cohen, I am interested in what you said about making a mandatory corporate waiver statutory. Did I get that right? Would you like to talk about that a little bit? I am interested in what you were saying there.

Mr. COHEN. If you are referring to the "noisy withdrawal" proposal, I think what I was referring to there was that the SEC initially came out with a "noisy withdrawal" proposal that would require the lawyer who had reported the wrongdoing up to the board and was rebuffed, to make the noisy withdrawal. There was a firestorm about that and a lot of objections about that. So the SEC then came out with a revised proposal whereby rather than the lawyer making the noisy withdrawal, the company would have to make a filing with the SEC that stated that the lawyer, this law firm or lawyer, had resigned and explain the circumstances under which the resignation was made. So that is what I was referring to as the alternative proposal. What I was saying was that I think either proposal is fine, but I think that there should be some kind of noise at that point, whoever makes it.

Mrs. KELLY. No, that is not exactly what I was going after, but let me just continue on in that vein since you brought it up. In essence, that becomes then really a quiet withdrawal, because then it becomes a discussion between the corporation and the SEC, if I understand what you are saying.

Mr. COHEN. Yes, the corporation would have to make a disclosure to the SEC. Of course, it is possible that the corporation would not do that or would not say very much, but the theory is that as long as the SEC is alerted to some possibility, then the SEC could make a judgment about whether it is desirable to investigate further and the like. That is the theory behind it.

Mrs. KELLY. In general, inasmuch as most lawyers in corporations are there to help corporations comply with the law, an adjunct of that is to help corporations find where there is a loophole in the law. That is the conundrum we face. So basically, if I understand this panel correctly, most of you are not interested in the SEC pursuing a "noisy withdrawal." Is that correct?

Mr. COHEN. I believe so.

I am not in favor of it. It looks like I am not the only one.

Mr. PAINTER. I have very mixed views on it. I think it is nowhere near as harmful as opponents of the "noisy withdrawal" proposal have said. Indeed, it is an opt-out rule. If you do not like it, under the SEC rules you simply set up a qualified legal compliance committee, and then all the reporting goes to the committee and there is no "noisy withdrawal" requirement anymore. So the company can opt out. I do not think it is anywhere near as bad as it has been described.

On the other hand, I see a lot of attention being focused on this issue, rather than some other potentially much more serious issues. I mentioned contingent fees in connection with merger deals and so forth. So I think the commission might want to re-phrase the rule in a manner that is somewhat more acceptable to its opponents, if necessary, because it is not that big a deal in the end. People will find out if the lawyer resigns. The Commission will find out. The underwriters will find out and start snooping around. I am not so sure we need a telephone call to the Commission saying, "I have withdrawn for professional reasons, hint, hint," I am not sure that is necessary.

Ms. MADRID. If I may, I would have to say that there are a lot of theoretical issues, but the fact of the matter is there are many, many lawyers who are inside of corporations every day trying to figure out how to do this. I think that with a noisy withdrawal, there are very serious consequences that can flow from that. Fundamentally, the trust relationship between the inside counsel and the management team is critical to ensuring that there is sound corporate governance, and that there is legal activity.

To the extent that inside counsel are essentially cops, this is going to discourage management from including lawyers in on the conversations. If we start with the assumption that lawyers are going to help the management work through issues and find legal mechanisms and not loopholes, but really sound corporate decisions, having a "noisy withdrawal" we believe would really discourage that type of activity.

Mrs. KELLY. My time is up, but I would like to follow that up with written questions. Will you keep the hearing open?

Chairman BAKER. Certainly.

Mrs. KELLY. Thank you.

Chairman BAKER. I thank the gentlelady.

Mr. Scott?

Mr. SCOTT. Thank you very much, Mr. Chairman.

I think there is certainly an important role that we must have for the attorneys in any of the ethics conflicts of interest, but I would also think that we must not overreach, that there is a balance with the "noisy withdrawal."

I have a two-point question. First, Ms. Madrid, there is a requirement in the Sarbanes-Oxley legislation that requires the first attorney, the "up the ladder" provision. What is your appraisal of that? How well has that performed and do you have any evidence that it has helped in the governance area?

Ms. MADRID. What we know from our membership is that, soon after the enactment of Sarbanes-0xley and the effectiveness of rule 307, the in-house counsel and the in-house law departments very quickly responded to the requirements. There were written requirements that were prepared in many, many law departments across the country. There was training that was delivered.

We understand that while there is still some confusion and ambiguity in terms of what the requirements are in the "reporting up" within the legal departments, I think that we find that the lawyers who bring this information or evidence to the chief legal officer, that that is an appropriate mechanism to work through these issues.

Mr. SCOTT. Thank you.

The other part of my question, I believe it was you, Professor Painter, you talked about contingency fees as probably the most serious issues, as opposed to "noisy withdrawal" and some of the other things. You used the example of the AOL Time Warner merger, the spread of maybe $30 million, from $5 million to $35 million. How would you restructure that? What recommendations would you offer us to deal with how we can more effectively restrict contingency fees in a way that would be in the best interests of the American shareholder?

Mr. PAINTER. First, it is not a widespread practice at this stage, to charge the contingency fee in that manner on the corporate transaction. That was one of several incidents, but it is not a common practice. But it was an enormous contingency fee for an enormous transaction, which has turned out not to be in the interests of counsel's client.

As I say, I have no evidence that there was inadequate representation there, but I do believe that in a securities transaction where it is the job of the lawyer to look for problems with the deal and to say no when there are problems, that it is not good for the lawyer to be paid several times more if the deal closes than if it does not. Accountants are not put on a contingency fee. Lawyers should not be. Investment bankers are, but investment bankers have a different function.

Lawyer contingency fees primarily have been used in the plaintiffs's lawyers area. I have other concerns. That is a different issue about excessive contingency fees in that area. But I think the spreading of contingency fees into corporate transactions is something that ought to be watched very carefully. There are a lot of other ways, whether it is hourly rates or other more traditional methods of billing the client that most law firms adhere to, and we do not need to see more of those types of contingent-fee arrangements.

Mr. SCOTT. Thank you.

Chairman BAKER. Does the gentleman yield back?

Mr. SCOTT. Yes.

Chairman BAKER. Mr. Manzullo?

Mr. MANZULLO. I just have a couple of questions. Do in-house corporate attorneys qualify for key person liability insurance coverage?

Ms. MADRID. Yes. I am sorry. Is the question in terms of D&O liability or another type of policy?

Mr. MANZULLO. Yes, that is correct. Go ahead.

Ms. MADRID. What we know is that today that is in flux. The insurance companies are taking varying positions and are modifying policies currently. It is unclear, at least from the perspective of the insurance companies, whether the attorneys when delivering professional advice to the corporation, they would be included in the D&O coverage.

This is an area that is probably going to, I would imagine, be getting a lot of attention in the near term. Frankly, these issues had not been coming up before, and now with attorneys being named as defendants in these types of cases, the issues are now coming to the forefront.

Mr. MANZULLO. Lawyers always sue anybody available, including other lawyers. In the past when a lawyer has been sued individually in the corporation, isn't there an obligation on the part of the corporation to indemnify, unless there was malfeasance? When I practiced law, if I gave bad advice and it worked to the injury of a client, I was liable for malpractice. Should that be any different in a corporation?

Ms. MADRID. As a general counsel, I would hope that we would have coverage. I think that what we are finding, however, is that the insurance companies may be taking a different view. You may have professional liability policies within a company that really are for third-party claims with respect to others that you may have provided professional advice to, as opposed to providing professional advice to the insured itself, that being the company as embodied through either its board of directors or its officers.

Mr. MANZULLO. I don't see any difference in whether you are employed on a retainer, on an hourly, or a member of the corporation as an employee. The obligation is that there has to be responsibility for giving bad advice. That can happen to anybody, and that is why you have insurance. I am just a little bit surprised it may be in flux. Are you telling me that you do not know if corporate attorneys now are covered by malpractice insurance?

Ms. MADRID. What I can tell you is that under D&O policies that have been issued to corporations, we have found that insurance companies are taking the position that in-house counsel may not be a covered insured under certain policies. As you know, many of the policies have different languages; they have different exclusions. Each one would be read individually, but we certainly are finding among the insurance industry a position that attorneys may not be covered under D&O policies. We obviously would hope to find a different opinion on that, but certainly we are seeing it today.

Mr. MANZULLO. So if there is an action that is brought by the shareholders against a member of the board of directors, who is relying up legal advice of the in-house corporate counsel, the member of the board of directors would be eligible for D&O coverage, but not the attorney giving the advice. Is that correct, under some circumstances?

Ms. MADRID. Under some circumstances.

Mr. MANZULLO. But in that circumstance, if the judgment is in excess of D&O coverage against the member of the board of directors, doesn't he have a right to be indemnified by the attorney personally for the excess?

Ms. MADRID. No, I do not believe that would be the case.

Mr. MANZULLO. So the member of the board who acts, I am not talking illegally, but acts improperly, based upon the bad advice of the attorney would have no recourse against that attorney. If the attorney were not a member of the corporation, it is obvious that he would. But the fact that the attorney works for the corporation insulates him from a lawsuit by a fellow employee?

Ms. MADRID. No, I do not believe he is insulated, but he may not have insurance. That would be the issue. Today what we are finding is that even when insurance policies are being triggered, they are being triggered only for defense costs, and not indemnification in terms of any liability.

Mr. MANZULLO. Okay. Thank you.

Chairman BAKER. I thank the gentleman.

Mr. Emanuel?

Mr. EMANUEL. Thank you, Mr. Chairman.

To the professors on the panel and if others want to reply, they can obviously come in. On a slightly different issue in dealing with some of the issues that we on this committee have looked at, as well as in the Senate, in looking at the issue of tax shelters and the role of attorneys in advising on tax shelters. In some of the recent articles, much of the focus has been on the accounting industry. A lot of this would not be allowed to continue if it was not for some of the legal advice and some of the counsel being given by outside attorneys.

Have you conducted any research on the role of attorneys in the tax shelter business? What is the outcome of that research? This is to anybody; don't all jump at once. It is a jump-ball question.

[Laughter.]

Mr. COHEN. I have not looked at what has been going on with tax opinions. What I have looked at a little bit is the "advice of counsel" defense, which tends to be interpreted differently in different areas of the law. That is something that I think one ought to be very skeptical about because one of the problems with the "advice of counsel" defense is the more likely that a court is to recognize such a defense, the more likely it is that lawyers are going to have an incentive to give a kind of "get out of jail free" card to people who are asking for that advice, and that more clients are going to demand that kind of advice.

I think the premise of the "advice of counsel" defense is that, well, if people act in good faith and go to see a lawyer and they happen to get bad advice, then they ought not to be penalized as harshly for that. But I think the problem is that once you recognize the defense, you undermine the premise for the defense being given in the first place. That is one area that I think needs to be studied further.

Mr. PAINTER. One other issue with respect to tax opinions is that if an accounting firm provides the tax opinion, and the IRS finds out that the tax opinion is wrong, the IRS can say to the accounting firm, "I want a list of the people to whom you provided this tax shelter to." They go to the law firm and the law firm starts claiming the attorney-client privilege. I do not believe that the mere identity of the clients that you have provided tax advice to should be subject to the privilege; that people ought to be able to take this work, put it in a law firm and claim an attorney-client privilege where the IRS cannot even find out who the law firm has been advising. That has become a serious problem that has been litigated in the courts.

Mr. MORGAN. This is an area, as you know Mr. Emanuel, that the IRS has recently addressed.

Mr. EMANUEL. That was my follow-up question.

Mr. MORGAN. I must admit that I have not prepared any analysis of those regulations. It is an area that clearly needs review because there is a real risk that people will be tempted to give opinions that, as Professor Cohen says, look like they are providing security or reliable information, and in fact turn out to not be reliable. Beyond that, I really do not want to go on the record about something that I have not researched yet.

Mr. EMANUEL. I appreciate that. That has been the main focus, as you know, Mr. Chairman. You and I have talked.

Mr. KELLER. I just wanted to point out that, going back quite a number of years now, the American Bar Association came out with a very strict ethical position imposing very strict rules on lawyers rendering tax shelter opinions. I think it was recognition that it is important, as a professional matter, to hold lawyers to high standards in rendering those opinions.

I think there are issues now that need to be reviewed in terms of in fact who is the lawyer representing. Are they representing those who are peddling the tax shelter or are they representing those who are purchasing the tax shelter? We are seeing litigation evolving that will tell us the propriety of the behavior that has taken place.

Mr. EMANUEL. If you go back to Sarbanes-Oxley and some of the reforms given the last 2 years in corporate behavior, a lot of focus has been on the accounting industry and investment banking. But the truth is, the legal profession was equally a participant in some of the, in my own view, flimsy tax shelter advice. They are issuing one opinion, overcharging clients for the same opinion that they were Xeroxing and faxing around. They were a participant.

A number of accounting firms have recently announced that they are going to shut down those departments with that service. I think we need to be as vigilant on the legal profession as we have done in the other financial services sectors in making flimsy or questionable tax shelter advice.

The truth is, besides what the accounting industry has done, you could not go forward if the green light was not provided by the legal firm. So whether they are at the steering wheel or not, they definitely have been sitting in the car seat encouraging people to hit the gas. We need to be vigilant here, because the tax shelter and the tax code, and you talk about the IRS's ability to enforce. I am not against people trying to find if they can pay less in taxes, they can do that, but there has been a question of where the professional ethics stands in issuing this advice in the profession.

Chairman BAKER. The gentleman's time has expired.

I am sorry. Would you want to respond quickly, sir?

Mr. PAINTER. I just want to say that I think the IRS is vigorously pursuing this issue. It is very important for this body to back up the IRS and not to have a scenario where special interests simply run to the Congress to try and get Congress to undermine the IRS.

We had similar experiences with the Securities and Exchange Commission a number of years ago that former Chairman Leavitt wrote about in his book. I think it is very important for this Congress to back up regulators, whether it is the SEC or the IRS or other agencies who pursue professionals who are acting irresponsibly.

Mr. EMANUEL. Thank you.

Thank you, Mr. Chairman.

Chairman BAKER. The gentleman's time has expired.

Mr. Gonzalez?

Mr. GONZALEZ. Thank you very much, Mr. Chairman. Again, thanks to you and Ranking Member Kanjorski, as well as to the Chairman and Ranking Member Frank, for allowing me this opportunity.

It really was my question during the hearings that we had in fashioning our own House version of the legislation that addressed the role of attorneys, which was of course taken up by Senator Edwards over in the Senate. So here we find ourselves today.

But for Professor Cohen, what I am hearing, and correct me if I am wrong, is we have the attorneys withdrawing now. Isn't that sufficient? Isn't that wonderful? In my opinion, it is not. The objective is stockholder and shareholder confidence, investor confidence, right?

Then we have to determine how we arrive at that, so we work backwards. That is the SEC. The SEC has to be knowledgeable of what is going on out there in order to impose the rules and regulations so that we have that kind of confidence. So how do they get that information? We are working backwards. How do we get it?

I am going to give you two examples. Let us use Enron and the creation of the SPEs and everything that is out there now, whether it is being litigated in the civil environment or whether it is criminal. One scenario is we have a "noisy withdrawal." The other scenario is we do not have a "noisy withdrawal." Under those two scenarios, you tell me which best serves the interest of the public, and that is to make sure that we have an informed SEC.

Anybody, it does not matter in what order.

Mr. KELLER. Can I suggest that when the question is posed that way, it sounds as though the answer is obvious. But that is taking the issue, I think, out of an overall context, because as I tried to note in my remarks, it seems to me we have to keep in mind the role that lawyers play, both as part of the core value of our legal system and the right to independent counsel. Independent counsel, if you will, is the bulwark against oppressive regulation, oppressive government, wrong charges and what have you. That is an important principle I think we would all agree to preserve.

We also have lawyers who indeed every day, and I do this, are the policemen. We are working towards compliance. Our securities law system is very much a self-regulatory system. Yes, we have enforcement and we have civil actions. That keeps people in check, but that is limited, based on the vast array of what is going on. We are the people who are working towards fostering legal compliance. It is important that lawyers be kept in the middle of that process. Yes, held to be accountable; held to professional responsibility.

So I think you need to assess the "noisy withdrawal" situation against the broader value. It is part of the total picture. Those who promote it will admit that it is the rare circumstance. There is a distinguished former general counsel of the SEC who said it is a once in a lifetime event. Yes, you can find the one case where it would make a difference, but I would suggest that that one case is far outweighed by the ongoing countless times when lawyers are counseling legal compliance; where the ability to do so would be eroded by the problems that would be created by "noisy withdrawal." So I think it is question of balance.

The ABA professional rules recognize that confidentiality, trust and confidence of clients and their lawyers is a core value. It is not immutable, however. There are exceptions. It is carefully tailored and its balancing those exceptions the way the professional rules have done that is important.

Mr. PAINTER. Congressman, in the scenario you describe, I believe that not only is withdrawal required, but a noisy withdrawal is what definitely should take place. A lawyer who does not make a noisy withdrawal in that context is very likely to expose himself to liability and enforcement actions and the like, regardless of what the SEC's rule is under section 307.

That is the reason why I have decided I was going to take the middle position on this. What the SEC must do is require the separation of the lawyer-client relationship in a circumstance where your client refuses to obey the law. You are required to terminate at least the securities side of the representation, if you are advising him on securities law and they won't obey the securities laws. This requires the resignation of the lawyer.

Once you have severed the lawyer-client relationship, I believe the lawyer is highly likely to take the step the lawyer needs to take to prevent the fraud from taking place. They have only downside in this situation, and not up-side if the client goes ahead and perpetrates the fraud.

So it is for that reason I have taken the position that it is not as big a deal either way, the actual SEC "noisy withdrawal" requirement as it is being made out to be. I am not opposed to the requirement, and indeed, as I said, it is optional. The client can opt-out simply by setting up a qualified legal compliance committee under these rules. So I do not understand all the fuss.

On the other hand, I am not so sure it is an issue that the SEC should continue to fight over when there are many more important things than the amount of noise in the withdrawal. But the withdrawal absolutely should be required.

Chairman BAKER. The gentleman's time has expired.

I want to insert into the record a statement from Mr. Peter Moser, who was unable to appear today. He is chief counsel to Piper Rudnick, but serves on the ethics committee and the task force of the American Bar Association on compliance with section 307 of Sarbanes-Oxley.

[The following information can be found on page 91 in the appendix.]

I also want to express my appreciation to each of you for your courtroom conduct today. You were not only informative, you were more importantly timely. To assure you that no enforcement action or liability will attach because of your participation here today, the committee will maintain the record open for at least 5 days to allow those who have more questions to formally submit those to you for additional response.

This is the beginning of the committee's exploration in this area and we do need to take care that the end result of our efforts is to assure shareholders that corporate governance is meeting the highest possible standard, while at the same time not unreasonably constraining appropriate business decisions for the overall best advantage of that corporate structure.

We do appreciate your participation and look forward to working with you in the days ahead.

Our meeting stands adjourned.

[Whereupon, at 11:22 a.m., the subcommittee was adjourned.]

A P P E N D I X

February 4, 2004

Prepared, not delivered
Opening Statement

Chairman Michael G. Oxley
Committee on Financial Services

Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

"The Role of Attorneys' In Corporate Governance"
February 4, 2004

I want to thank Chairman Baker for holding this important hearing today.

In the wake of the numerous business scandals over the past three years, this Committee has led the way in reforming our capital markets and improving corporate governance. We have examined – with some success, I might add – the accounting profession, the corporate financial reporting system, Wall Street research analysts and investment bankers, the structure of the capital markets system, credit rating agencies, corporate officers and directors, mutual funds, hedge funds, and New York Stock Exchange specialists.

All of our efforts have a singular goal – to strengthen the capital markets system while enhancing investor protection.

We now turn our attention to the duties and responsibilities of attorneys in promoting corporate governance.

The active participation of attorneys in perpetuating corporate fraud has been well-documented, and indeed, is quite troubling. Attorneys were violating not only the profession's code of ethics, but they were also breaking the law. This attorney misconduct led to a legislative remedy in the Sarbanes-Oxley Act requiring attorneys to report securities law violations "up the ladder" to the general counsel and the chief executive officer and, if necessary, the board of directors. While the SEC has implemented this sensible requirement as set forth in the Act, the Commission clearly went beyond congressional intent in proposing the noisy withdrawal mandate, but has since scaled back the provision.

I am pleased with our prestigious panel of witnesses this morning – representing a variety of perspectives on these contentious issues – and I look forward to a lively debate.

I yield back.

The Honorable Rahm Emanuel
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
February 4, 2004

Statement for hearing on *"the Role of Attorneys in Corporate Governance"*

Mr. Chairman,

Thank you for holding this important hearing on the role of attorneys in corporate governance. I would also like to thank our distinguished witnesses for sharing their views with us today.

The corporate scandals at Enron, WorldCom and Sprint raised serious questions about the role of attorneys in facilitating securities fraud and in the creation of abusive tax shelters. This hearing will focus on the new standards of professional conduct for attorneys promulgated by the SEC, as directed by Congress as part of the Sarbanes-Oxley law. The "up the ladder" reporting requirement is an important rule that will enhance the accountability of both attorneys and corporations. Most importantly, it will have a deterrent effect on improper behavior.

The proposed "noisy withdrawal" rule is well-intentioned, but may put attorneys in the untenable position of running afoul of state laws and state codes of professional responsibility on attorney-client privilege issues. I am interested in hearing our panel's views today both on the proposed rule and on the alternatives that have been promoted.

I also believe it is critical to address the role of attorneys in the creation, marketing and implementation of abusive tax shelters for corporations and wealthy individuals that are depriving the U.S. Treasury of billions in revenue each year. With federal revenues at their lowest level since the Truman Administration, the tax gap reaching $310 billion, and an increasing burden falling on middle-class families to pick up the slack, it is imperative that Congress act aggressively against tax shelter promoters.

The Senate Permanent Subcommittee on Investigations held a series of hearings on tax shelters in November 2003. The evidence presented at those hearings showed how some of the most 'respected' accounting firms, law firms, and investment banks continue to form alliances and devote significant resources toward the creation of hundreds of tax shelters that have no economic substance or business purpose aside from tax avoidance.

Attorneys play a key role in the creation of tax shelters. By providing opinion letters that "bless" the transactions, law firms offer an imprimatur of legitimacy to transactions that would otherwise raise serious questions. Under current law, opinion letters protect tax shelter purchasers with an affirmative defense against certain penalties if the IRS later denies the tax shelter. Thus, the tax shelter buyer has nothing to lose. If the shelter is invalidated, the buyer simply pays the taxes that would have been owed anyway.

I commend the Senate Finance Committee and the Treasury Department for their recent proposals to address tax shelters, including the recommendation that opinion letters receive greater scrutiny.

As I have discussed with Chairman Baker and Ranking Member Kanjorski, our Subcommittee can play an important role in shutting down tax shelters that deprive the U.S. Treasury of billions of dollars every year. I look forward to working with my colleagues on both sides of the aisle to address the willful role of accountants, lawyers and financial professionals in the tax shelter industry.

Thank you, Mr. Chairman. I yield back the balance of my time.

February 4, 2004

Opening Statement by Congressman Paul E. Gillmor

House Financial Services Committee
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Hearing entitled "The Role of Attorneys in Corporate Governance"

Thank you, Mr. Chairman, for holding this important hearing and for your continued leadership in reviewing all the many factors that may have contributed to the corporate scandals in recent history at Enron and other major American corporations.

As a result of the Sarbanes-Oxley Act of 2002, spearheaded and passed by this committee to prevent future corporate malfeasance of such a magnitude, the Securities and Exchange Commission (SEC) was required to promulgate rules establishing minimum standards of professional conduct for attorneys. Section 307 specifically required the SEC to issue rules (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 "up the ladder," to the chief legal counsel for the chief executive officer of the company; and (2) requiring the attorney to report the evidence to the company's audit committee, a committee of independent directors, or to the board of directors if the counsel or officer does not appropriately respond to the evidence.

I am pleased with the SEC's response to these requirements with their proposed "up the ladder" rule that took effect on August 5, 2003, however, I look forward to hearing further debate today on their "noisy withdrawal" proposal. I am sympathetic to remaining concerns with the requirements of this proposal, directing an attorney that is dissatisfied with a company's response to a report of evidence of material violations to make a "noisy withdrawal" from representing the company and notify the SEC that the attorney had withdrawn "for professional reasons."

I would like to hear a fuller discussion on the concerns with this proposal specifically regarding the impact it may have on the corporation's relationship with their legal counsel and the possibility of information being withheld.

Thank you again, Mr. Chairman, for bringing us together today on this important issue. I look forward to an informative discussion.

Statement of Congressman Charles A. Gonzalez
Hearing on the Role of Attorneys in Corporate Governance

Thank you Mr. Chairman. I want to first thank Chairman Oxley and Ranking Member Frank for holding this hearing. I requested a hearing on this topic last year, and I appreciate the responsiveness to the Committee on this issue. As you know, this Committee was the first to act on this issue during the Sarbanes Oxley process when it attached in the Spring of 2002 an amendment I offered to what later became the Sarbanes Oxley law calling for a study of this issue.

Mr. Chairman, I became interested in this topic during this committee's hearings into the Enron scandal where it became apparent to me that major law firms were, along with Arthur Anderson and Enron management, actively engaged in efforts to conceal the true economic value of Enron to its own shareholders. The Enron scandal laid bare in my view fundamental questions about the ethical standards of my own profession-- the law.

As a former Judge I spent many years actively engaged on professional responsibility issues involving attorneys, and I am concerned that the legal profession in its increasing focus on the bottom line has lost many of the ethical norms that once made it a respected profession. Additionally, I am concerned that State Bars who hold the primary responsibility to police the legal profession have become too lax. For example, to my knowledge no attorney in Texas that was involved with the Enron matter has had his license put seriously under review as a consequence of that scandal, despite the fact that the special purpose entities that were fundamental to the fraud at the company were largely constructed by attorneys. It was also shocking to me that one firm in the midst of the collapse of that company accepted work from Ken Lay to review the legality of some of the special purpose entities that they had helped to create. Not surprisingly they certified their own work.

Mr. Chairman, Section 307 of the Sarbanes Oxley Act has made in my view an important contribution to raising ethical standards in the legal profession. I look forward to the testimony of today's witnesses to see how we can best ensure that corporate shareholders are guaranteed minimal professional standards from the corporate attorneys that ultimately represent their interests. I yield back my time.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON THE ROLE OF ATTORNEYS
IN CORPORATE GOVERNANCE

WEDNESDAY, FEBRUARY 4, 2004

Mr. Chairman, we adopted the Sarbanes-Oxley Act during the last Congress after a rash of corporate scandals. This statute modified the regulation of auditors, business executives, corporate boards and research analysts. A key section of this law also revised the oversight of attorneys in our capital markets. This part of the law and its related pending regulatory proceedings at the Securities and Exchange Commission are the focus of today's hearing.

The regulatory system for our capital markets depends in large part on the effectiveness of a variety of independent gatekeepers. These skilled professionals include the lawyers and accountants who verify and analyze the disclosures and documents of publicly held companies. These experts, from my perspective, have a special obligation to behave ethically and follow the law. Professionals like lawyers also have a responsibility to police themselves. If, however, such professionals fail to effectively monitor their actions and those of their peers, we have an obligation to protect investors by taking action in Washington.

After examining the corporate scandals at Enron, WorldCom and other companies, we ultimately determined that securities lawyers played a role in these debacles and decided to alter the rules governing the profession. One year ago, the Securities and Exchange Commission adopted a regulation to implement the reforms affecting securities attorneys mandated by the Sarbanes-Oxley Act. This rule requires lawyers to report "up the ladder" evidence of material wrongdoing to a company's officers and, if necessary, a company's board. This regulation, which I strongly support, became effective last August.

When adopting the rule governing the professional responsibilities of securities lawyers, the Commission also extended the public comment period on a proposal to require a "noisy withdrawal" by attorneys who do not receive a satisfactory response from a company to internal reports of wrongdoing. This plan to require the notification by the attorney to the Commission of his or her withdrawal immediately met with strong opposition from many practitioners in the legal community. In response, the Commission put forward for review an alternative plan. This substitute would require the issuer, rather than the attorney, to report the withdrawal of a lawyer for professional reasons.

The two withdrawal-and-notification proposals presently pending before the Securities and Exchange Commission raise important questions that we should carefully examine today. Each one has the potential to alter the attorney-client privilege and could have a chilling effect on communications between management and counsel, making executives less likely to consult and speak frankly with lawyers. These proposals might also unintentionally reward those lawyers with lower ethical standards who would stretch the law beyond its reasonable interpretations and never withdraw from a client. We should closely examine each of these concerns.

In their observations today, I also hope that our distinguished witnesses will answer a question that I have about restoring the ability of victims of securities fraud to sue those who aid and abet issuers in defrauding the public. Prior to a 1994 decision by the Supreme Court, individuals had the right to pursue a private cause of action against lawyers and other professionals who helped public corporations to deceive the public.

Although we partially overturned this decision when passing the Private Securities Litigation Reform Act of 1995 to allow the Commission under certain circumstances to bring cases against aiders and abettors of securities fraud, we may have failed to do enough to protect investors. After all, past leaders of the Securities and Exchange Commission from both political parties have stressed the integral role of private lawsuits in maintaining investor confidence.

Since 1994, however, the victims of securities fraud have been unable to bring claims against lawyers and other gatekeepers who abuse the public trust by aiding issuers in misleading shareholders. Rather than adopting either one of the pending alternatives for reporting an attorney's withdrawal from representation because of concerns about the client's potential or actual wrongdoing, it may make sense for the Congress to instead restore the right of individuals to pursue their legal claims in our courts.

In closing, Mr. Chairman, I commend you again for your sustained leadership in studying these matters. This timely hearing will help us to better appreciate the decisions facing the Commission as it continues its work to bolster investor confidence, restore the integrity of financial statements, and rebuild trust in our securities markets.

The SEC's Rules Governing Lawyers: Where to Go from Here?[1]

Testimony of George M. Cohen
Edward F. Howrey Research Professor
University of Virginia School of Law

Before the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives
February 4, 2004

Hearing on
The Role of Attorneys in Corporate Governance

1. Introduction

I have been asked to discuss the merits of the SEC's adopted and proposed Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer.[2] I will begin by providing some background information about the regulation of lawyers generally. I will then offer an assessment and critique of several of the SEC rules' more important provisions. I then discuss the SEC's noisy withdrawal proposal. Finally, I will recommend further steps Congress and the SEC might take to improve the effectiveness of corporate lawyer regulation.

I will state my conclusions up front. I strongly support section 307 of the Sarbanes-Oxley Act,[3] and applaud the SEC's careful and detailed efforts to implement Congress's directives. I am, however, concerned that the SEC's rules, as drafted, will be difficult to enforce and may wind up having far less effect on corporate lawyer behavior Congress might have hoped. Fixing the rules that the SEC has already promulgated should be the biggest priority. I also support the SEC's noisy withdrawal proposal and urge this Committee to encourage the SEC to adopt it.

I need not recount the sorry history of corporate wrongdoing we have witnessed in the opening years of the twenty-first century. We are still living with the consequences, unraveling

[1]These remarks draw in large part on Roger C. Cramton, George M. Cohen, & Susan P. Koniak, Legal and Ethical Duties of Lawyers after Sarbanes-Oxley, Vill. L. Rev. (2004) (forthcoming). In the interests of brevity, I have omitted most footnotes and have not indicated which passages are quoted directly from the article.

[2]17 C.F.R., Part 205.

[3]15 U.S.C. §7245.

the causes, and punishing the perpetrators of Enron, Global Crossing, WorldCom, Tyco, Adelphia, and other scandals. Not only that, new scandals continue to surface, even on a global scale (witness Parmalat).

These scandals have raised serious questions about the integrity, acuity, and prudence of lawyers who facilitate and document business transactions and approve required financial disclosures. We have seen strong evidence that lawyers in these scandals structured bogus deals, vouched for nonexistent "sales," and whitewashed reports to keep regulators and potential plaintiffs at bay. Yet lawyers have to date have largely escaped responsibility. And they have received far less scrutiny for their role in recent corporate wrongdoing than accountants, corporate managers, and boards of directors.

But in enacting the Sarbanes-Oxley Act of 2002, Congress included section 307, a provision notable for its recognition of the important role corporate lawyers play in ensuring compliance with the law, as well as the need for federal oversight of this role to protect the investing public. Section 307 directed the SEC to promulgate "minimum standards of professional conduct for attorneys appearing and practicing before the SEC in any way in the representation of a issuers." Section 307 went even farther. It specified that one of those "minimum standards" require lawyers to "report evidence of a material violation of the securities laws or a breach of fiduciary duty or similar violation by the company or any of its agents to the chief legal officer or the chief executive officer of the company (or the equivalent thereof)." If the chief legal officer or chief executive officer fails to provide an "appropriate response" to the evidence, the lawyer would be required to "report the evidence to the audit committee, another independent committee, or the full board of directors." Almost a year ago, on January 29, 2003, the SEC adopted rules pursuant to section 307, which became effective on August 5, 2003.

2. Lawyer Regulation: Form

To evaluate the importance and the impact of the SEC rules, it is important to separate out two questions: who should regulate corporate lawyers, and what should the content of those regulations be. I will briefly address both.

Lawyers have long been regulated by state disciplinary authorities run by state courts. The law that applies in disciplinary hearings is the ethics code adopted by that particular state. Typically, the ethics rules are based on the Model Rules of Professional Conduct or the Model Code of Professional Responsibility, both promulgated by the ABA. But it is important to recognize that the ABA's version of the ethics rules has no force of law by itself. The relevant state authority must adopt these rules, and need not follow the ABA's version. That fact is particularly important for discussing corporate fraud, because until recently, the ABA's ethics rules on confidentiality have diverged from the actual ethics rules adopted by most states.

Although state disciplinary authorities handle some types of lawyer wrongdoing (particularly by sole practitioners and lawyers at small firms) fairly well, they are not effective regulators of the lawyers who do corporate transactional work at large firms for large, publicly traded corporate clients. State disciplinary authorities lack the resources and the expertise to successfully prosecute disciplinary actions against these lawyers, who are sophisticated, well-financed, and ready to defend their actions with a full and potent arsenal. As a result, we have seen few, if any, disciplinary actions brought in connection with large corporate scandals, either past or present. And that is true despite strong evidence of lawyer wrongdoing in a number of cases.

The impotence of state disciplinary authorities to regulate large firm corporate lawyers is an important, if underappreciated, fact, though Congress did recognize this fact in passing section 307.[4] One of the major objections lawyers have made to federal regulation, including section 307 and the SEC rules, is that lawyers are already regulated by state ethics rules. If, however, state disciplinary authorities cannot effectively reach corporate practice by lawyers in large firms, these objections ring hollow. Thus, when these lawyers argue for state disciplinary regulation, they are really arguing for no effective regulation at all.

Regulation by federal agencies of lawyers who practice before those agencies holds out at least some hope of effectively influencing large firm corporate lawyers. These agencies have better resources and greater expertise than state disciplinary authorities. Moreover, regulation by federal agencies provides another advantage over state regulation: uniformity. This advantage is particularly important when state rules diverge, as the state disciplinary rules on confidentiality do. In passing section 307, Congress recognized these advantages of regulating lawyers through federal agencies. But it is important to note, again because some lawyers seem to think otherwise, that securities lawyers are not the only lawyers who have been subject to federal regulation. Tax lawyers, patent lawyers, and others are also regulated by federal agencies. On the other hand, it is also important to note the limitations of regulation of lawyers by federal agencies.[5] These agencies often have numerous tasks they are required to perform besides regulating lawyers, and they are always battling budgetary restraints and personnel limitations. Moreover, in part because these agencies are staffed by lawyers who hope one day to enter, or return to, private practice, there is a good deal of sympathy for corporate lawyers.

A third form of lawyer regulation, and the one feared most by many corporate lawyers, is liability. Lawyers are subject not only to disciplinary rules, whether promulgated by states or federal agencies, but also to laws of general applicability. Most notably, state tort laws concerning fraud and federal laws establishing liability for securities fraud, apply to lawyers. Liability for both forms of fraud can be either civil (paying damages) or criminal (fines or prison sentences). Lawyers also face the possibility of malpractice actions by their corporate clients if

[4]See the remarks by Senator Michael Enzi during the Senate's consideration of § 307:

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

148 Cong. Rec. at S6555 (Jul. 10, 2002).

[5]Michael A. Perino, How Vigorously Will the SEC Enforce Attorney Up-the-Ladder Reporting Rules? An Institutional Analysis of Constraints, Norms, and Biases at the Commission, Vill. L. Rev. (2004) (forthcoming).

they do not sufficiently protect their clients from misbehaving managers, though in practice such suits are generally brought only in bankruptcy proceedings by the trustee. Section 307 does not address liability and the SEC rules specifically disclaim any attempt to create new causes of action against lawyers. But the liability question always lurks in the background of any debates over other forms of regulation because even though in theory they are independent, lawyers always fear that the content of disciplinary rules affects their liability. In particular, one of the main justifications lawyers offer for strong confidentiality rules is the belief that such rules will successfully stave off liability. This belief often turns out to be a false hope, but many lawyers seem to be misled nonetheless.

A significant change in the potential for liability to regulate corporate lawyers occurred in 1994, when the Supreme Court, in the *Central Bank* case,[6] declared that private damage suits for aiding and abetting could not be brought under the federal securities laws. These suits had been important vehicles for "disciplining" lawyers in past instances of corporate fraud, particularly the savings and loan crisis. Congress had a chance to overturn *Central Bank* when it passed the Private Securities Litigation Reform Act. But Congress declined to do so, because the bigger concern at that time was with perceived abuses by plaintiffs' lawyers in bringing class action suits for securities fraud than with deterring such fraud. Congress did reaffirm the right of the SEC to bring aiding and abetting suits against lawyers and other professionals, but it changed the "recklessness" standard that had been used by many courts to an "actual knowledge" standard, which is more difficult to prove.

3. Lawyer Regulation: Content

The debate over the content of the rules governing corporate lawyers, whether disciplinary, regulatory, or general law, has focused on one distinction and one tension. The distinction is between so-called "up-the-ladder reporting" or "reporting up," and so-called "reporting out," which involves questions of withdrawal and disclosure. The tension is between the lawyer's duty not to counsel or assist a client in committing a crime or fraud and the lawyer's duty of confidentiality to the client. The distinction and the tension are related: both reporting up rules and reporting out rules are designed to flesh out how the lawyer is to navigate between the avoidance of aiding and abetting and the protection of confidentiality.

a. Reporting Up

The SEC rules are directed primarily to reporting up, which was the one thing section 307 required the SEC to address. The purpose of reporting up is to implement the universally accepted "entity theory" of corporate representation, under which the corporate lawyer is supposed to represent the corporation as an entity rather than management when managers are breaching their fiduciary obligations to the corporation or leading the corporation to engage in wrongdoing. A lawyer who discovers a manager's misconduct, but continues to advise and assist the manager without stopping and redressing the misconduct, risks being deemed to have

[6]Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164, 191 (1994).

assisted in the misconduct. Of course, reporting up is easier said than done, especially when the lawyer has a close working relationship with management, and management generally has the authority to direct the lawyer's actions, as well as to fire the lawyer.

Thus, corporate lawyers have accepted the reporting up obligation in principle, but grudgingly and often with numerous qualifications. In particular, they have argued that managers will hesitate to consult and confide in them if they fear that the lawyers might go over their heads to the board. Although corporate lawyers owe no duty of confidentiality to managers, this argument is the same argument lawyers make in favor of strict confidentiality rules. Model Rule 1.13, as it existed up until last summer, reflected these concerns by limiting the lawyer's obligations in several ways. In particular, Model Rule 1.13 does not require a lawyer to do anything unless a lawyer "knows" that a corporate agent is engaged in wrongdoing. Moreover, Model Rule 1.13 includes reporting up as merely one possible option in responding to a rogue manager, rather than (at least under the interpretation given the provision by many lawyers) making it mandatory. The idea was to preserve maximum lawyer discretion.

The main substantive goal of section 307 and the SEC rules was to make reporting up mandatory and to trigger the obligation by "evidence of a material violation" rather than actual knowledge. Congress determined, correctly in my view, that there was sufficient evidence that too many lawyers were throwing in their lot with rogue managers rather than protecting the interests of their corporate clients. How well the SEC succeeded is a point I will address below.

b. Reporting Out

Reporting out has engendered much more discussion, and much more controversy than reporting up. But the question involved is essentially the same. If the corporation's board turns out to be corrupt and in cahoots with the rogue managers, can the lawyers continue to advise and assist the corporate client without becoming complicit in the wrongdoing? If not, what may or must the lawyer do to extricate himself from the situation?

Traditionally, the ethics codes and the other law regulating lawyer conduct have, for the most part, been consistent in their answers to these questions. If continued representation of a client constitutes illegal assistance, the lawyer must withdraw from the representation. A lawyer is permitted to disclose confidential information to prevent a client's prospective crime or fraud. And when the client in the course of the representation has used the lawyer's services to perpetrate a crime or fraud on a person or a tribunal, the lawyer is required to disclose confidential information to the extent necessary to rectify the consequences of the crime or fraud.

The reasons for these rules are straightforward. Neither the legal profession nor society as a whole should tolerate a regime in which lawyers may be used by clients as a means of carrying out a crime or fraud. The possibility of disclosure reinforces the lawyer's duty to provide only *lawful* assistance and advice to clients, and provides the lawyer with a last-resort weapon and increased leverage in dealing with a difficult client or one embarked on an unlawful or fraudulent course of conduct. Moreover, a lawyer's failure to take reasonable steps to prevent or rectify client fraud is likely to lead to civil liability of the lawyer. If insolvency and litigation occur as an aftermath of the fraud, a frequent occurrence, the client's confidentiality will inevitably disappear. A public company often desires to cooperate with likely to waive any privileges in an effort to recover assets for the insolvent entity; and, if these events do not take place, the crime-fraud exception of the privilege may be successfully investigators and waiving the privilege is often part of successful cooperation; a successor in interest, such as a bankruptcy trustee, is invoked; finally, if the lawyer is charged by defrauded persons, the lawyer will use the self-defense exception to confidentiality.

Despite the traditional answers to the reporting out question and the arguments in favor of these answers, the ABA in its ethics rules abandoned mandatory disclosure of transactional fraud in 1974 and permissive disclosure of such fraud in 1983. The source of the professional concerns that led to the ABA's retrenchment is relevant to today's concern that professional advisers have failed to perform their functions of preventing corporate wrongdoing. The ABA's actions in 1974 and 1983 were heavily influenced by the hostility of important segments of the legal community to the SEC's efforts during the 1970's to apply the ethics rules on disclosure to securities lawyers who remained silent when they knew or should have known that their client was engaged in a course of conduct that violated federal securities laws. Those propositions had not been viewed as problematic when they were not enforced by state disciplinary authorities. But when SEC enforcement came into play with the *National Student Marketing* case,[7] the two propositions were attacked and drastically narrowed by the ABA.

The states, however, for the most part did not go along, creating a hodgepodge of rules on the subject of permissive and mandatory disclosure of client fraud. The current landscape may be briefly summarized as follows. Forty-one states permit (and four of those require) a lawyer to disclose confidential information to prevent a client's criminal fraud. Forty-four states *require* (and three permit) a lawyer to disclose confidential information relating to a client's ongoing criminal or fraudulent act. And eighteen states permit a lawyer to disclose confidential information to rectify or mitigate a past client fraud in which the lawyer's services were used.

The SEC rules as they currently stand contain a permissive disclosure provision, under which a lawyer may reveal to the SEC information that the lawyer reasonably believes necessary to prevent the issuer from committing a material violation or to rectify the consequences of a material violation, though disclosure for rectification purposes requires that the lawyer's services have been used.

After the enactment of section 307 and the promulgation of the SEC rules, the ABA last summer changed its confidentiality rule, Model Rule 1.6, to permit disclosure of information either to prevent the client from committing a crime or fraud or to rectify a past or ongoing fraud in which the lawyer's services were used. The ABA also changed Model Rule 1.13 to include permissive disclosure outside the organization, even if the lawyer's services are not being used to perpetrate wrongdoing by an organization, though the matter must be related to the lawyer's representation. The primary motivation for these changes was to stave off further regulation by the SEC, and in particular the noisy withdrawal requirement. It is important to note that by permitting disclosure of ongoing fraud in Model Rule 1.6, the ABA has effectively required disclosure in cases of ongoing fraud in which the lawyer's services have been used. Model Rule

[7]SEC v. National Student Marketing Corp., 457 F.Supp. 682 (D.D.C. 1978).

4.1(b) says that a lawyer "shall not knowingly fail to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by rule 1.6."

One other point about reporting out is worth mentioning because there seems to be much misunderstanding about it. Sometimes press reports contain statements to the effect that lawyer disclosure of client confidences waives the client's attorney-client privilege. In fact, although some disclosures by lawyers may involve situations in which the crime-fraud exception to the privilege may apply, lawyer disclosure by itself, if not authorized by the client, does not generally waive the client's privilege, since the privilege belongs to the client.

4. Advocates versus Counselors

The SEC rules are largely addressed to lawyers acting in a counseling rather than an adversarial role. Their purpose is to enhance compliance with the law. Reporting evidence of misconduct and litigating are two very different legal events, even though they may involve the same conduct. Of course, the reporting of evidence of material violation may lead to litigation over whether a violation has occurred, but it need not.

The bar sometimes speaks as if every lawyer's job is to behave as lawyers in adversary adjudicatory proceedings are privileged to behave. But that is not so: lawyers who facilitate transactions or advise clients in private on complying with the law perform distinct functions in our democracy and operate in radically different environments from those inhabited by advocates engaged in adversary proceedings.

Advocates operate in an environment designed to guard against abuses of that broad license to manipulate fact and law. First, there is an adversary party equipped (in almost every case) with a lawyer both armed with information sufficient to challenge vigorously every theory, far-fetched or standard, that the opposing lawyer can make. Second, there is a judge who is acting as legal umpire (and sometimes as a neutral fact finder) and frequently a separate fact finder, the jury, in addition to the judge – actors obligated to decide with objectivity and neutrality between the contrasting visions of law and fact presented by the battling lawyers. None of those checks is present when, in the privacy of the office and the protections of lawyer confidentiality, a legal advisor counsels a client or corporate manager that it can act based on some unprecedented vision of what the law requires or some barely plausible interpretation of facts. In short, advocates have much more license to manipulate law and facts than advisors do.

And that is how it should be. Lawyers as advisors are a private sector solution to intrusive government alternatives to ensure that corporations, other entities and individuals operate within and not without the law. It is simply not true that the advisor's job is to stand by the client's position, no matter how implausible as a matter of fact or law, and not judge the client, as lawyers often assert. Advocates should not judge because there are others charged with that role in the environment in which they operate and they are present to guarantee the clash of positions that our adversary system depends upon. But advisors are relied upon to give advice made on prudent judgments. How else are they to tell anyone what the law requires and what it does not? And that is the role for which they are retained and paid to perform. The SEC rules do not change the traditional responsibility and role of lawyer-advisors; they just insist that lawyers properly fulfill that role and not act as advocates in situations where such behavior is not permitted or appropriate.

5. Problems with the SEC Rules as They Now Stand

In our comments to the SEC and in a forthcoming paper, Roger Cramton, Susan Koniak, and I offer a detailed critique of a number of the rules the SEC has adopted. For purposes of this testimony, I will discuss the three main problems we find with the SEC's rules.

a. The Triggering Standard for the Lawyer's Duty to Report

The heart of §307, and of the SEC rules, is the lawyer's duty to report. The key question under the duty to report is what circumstances trigger that duty. Section 307 obligated the SEC to adopt a rule requiring a lawyer "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)." The rule implementing this requirement, §205.3(b), states: "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 (of the equivalent thereof) or both the issuer's chief legal officer and its chief executive officer (or the equivalents thereof) forthwith." The SEC rules define "evidence of a material violation" in §205.2(e) as "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 occurring, or is about to occur."

In assessing how faithfully and well the SEC rules implement the Congressional mandate, it is important to keep in mind the goals of §307. In the wake of Enron and other corporate scandals, Congress was concerned that too many corporate lawyers were taking a "see no evil, report no evil" approach to their representations. Any lawyer worth his salt knows that assessing whether the law is actually being violated is no simple task. One extra fact, one nuance, one affirmative defense, one creative ambiguity, and a judgment of "illegality" is transformed into something more benign. Unfortunately, as lawyer behavior in the S & L scandal and countless other financial debacles demonstrates, the inevitable "grayness" or uncertainty of all law – a characteristic of all just legal regimes and not a flaw – has become an excuse for ignoring evidence of illegality, no matter how substantial the evidence or harm being wrought has been.

The purpose of §307 was to change this corporate legal culture and practice and encourage more reporting of dubious corporate activities. Thus, Congress abandoned the "subjective" approach of Model Rule 1.13(b), which imposes no obligations on a lawyer unless she "knows" that illegal activity is occurring or will occur. Instead, Congress mandated an objective trigger, while at the same time lowering the triggering standard from one of definitive violation to "evidence" of a violation. The hope was that an objective, probabilistic "evidence" trigger would be less subject to manipulation by lawyers inclined not to notice evidence of wrongdoing or to explain such evidence away. The question, then, is whether the SEC rules further this objective. The answer, unfortunately, is no.

In deciding whether to act – whether to report what Congress wanted to encourage lawyers to report up the corporate ladder – the lawyer confronting the definition of "evidence of a material violation" in §205.2(e) must ask herself whether it would be *unreasonable not to conclude* that the evidence before her demonstrates a reasonable likelihood of a material violation of law. This definition, which triggers the "up-the-ladder" reporting duty, is troublesome because its use of a double-negative formulation makes the standard difficult to understand, interpret or apply. Law is intended to guide action in the world. Yet it is barely possible to read the SEC's definition out loud without tripping (or, as I have discovered when presenting this definition in various fora, chuckling) over the words, let alone trying to remember the definition without reading it or trying to work out its "logic."

Moreover, the SEC's standard fails another critical test of sound rulemaking. It would be a nightmare to enforce. The Commission has asked its staff to assume the burden of proving not just one negative, but two. To enforce this rule, the Commission would have to show that it was *unreasonable* for a lawyer *not* to conclude that a violation was reasonably likely. I do not believe that this burden is a realistic one to ask the staff to meet.

The SEC's defense of this definition in the Adopting Release is that it "recognizes that there is a range of conduct in which an attorney may engage without being unreasonable." The idea is that if *any* "prudent and competent" lawyer *might* conclude that the evidence did not support the conclusion that a material violation has occurred, up-the-ladder reporting is not required. But this standard renders the reporting requirement of §307 nearly an empty shell. Any good lawyer will almost always be able to conclude that it is not 'unreasonable' to conclude that the evidence before her demonstrates legal conduct. Lawyers are trained to re-imagine evidence of illegality as evidence of legality. Not only will lawyers be able to reach this conclusion, they have strong motives to do so. The ethos of lawyers is not to report up the corporate ladder, and to find any possible way to avoid doing so.

The SEC could easily have adopted a rule that a lawyer must report when confronted with information that a prudent and competent lawyer, acting reasonably under the circumstances, would conclude was credible evidence of a material violation. In fact, that is precisely the triggering standard that Roger Cramton, Susan Koniak, and I proposed in our comments to the SEC, and which we still support. This clearer and more straightforward definition, incorporating a standard conception of reasonableness, would provide ample recognition of a "range of conduct" and the need for lawyer discretion. It would also be consistent with Congress's intent by providing an objective standard (a "prudent and competent lawyer, acting reasonably under the circumstances") with respect to both the factual question ("credible evidence") and the legal question ("material violation"). The fact that the SEC opted for a more convoluted double-negative standard, rather than the more straightforward standard, will be read by many lawyers as an invitation to inaction. The bar needs no such invitation and Congress surely did not intend the Commission to offer one.

The triggering standard is the gateway to the entire set of obligations created by the rules. If that standard is so weak that lawyers inclined to do so can easily circumvent it, if it is so ambiguous, convoluted, and weak that the SEC cannot effectively enforce it, the rules will not have effectuated the statutory objective. I find it disappointing, then, that so little attention has been paid to the triggering standard compared to other issues, most notably noisy withdrawal.

I find it even more disappointing that many lawyers who did pay attention to the trigger, and the SEC which sympathized with their objections, so strongly resisted a simple, objective standard, stated in affirmative terms, which would fully implement Congressional intent that lawyers report evidence of a material violation, while at the same time preserving an appropriate degree of lawyer discretion. The resistance is all the more troubling when one considers how little is really being demanded of the lawyer at the initial stage. The lawyer must simply report "evidence of a material violation" to the corporation's chief legal officer. The "report" is not a formal, detailed document, but can be a simple phone call, e-mail, or even casual water cooler comment. More important, the lawyer is not required to take any further steps without an additional, more demanding trigger, being satisfied.

b. Colorable Defense as an Appropriate Response

Aside from the initial duty to report evidence of a material violation to the chief legal officer or chief executive officer, the other key component of §307 is the obligation of the reporting lawyer to report the evidence up the corporate ladder to the board or relevant board committee if the chief legal officer or chief executive officer does not "appropriately respond" to the reporting lawyer. The SEC implemented this directive in §205.3(b)(3), which states that the reporting lawyer "shall report evidence of a material violation" to the board or relevant board committee, unless the lawyer "reasonably believes that the chief legal officer or chief executive officer . . . has provided an appropriate response within a reasonable time."[8]

The effectiveness of the SEC's rule implementing the reporting up obligation thus depends crucially on the definition and meaning of "appropriate response." Section 205.2(b) defines "appropriate response" to mean one of three things: there is no material violation; there is a material violation but it is being addressed with "appropriate remedial measures"; or another lawyer has been retained or directed to investigate the matter further. One would expect that the third option would simply default to one of the first two scenarios (no violation, violation being remedied) once the investigating lawyer completes the investigation. But the SEC rules offer a new possibility: the corporation makes an "appropriate response" if the "investigatory lawyer" advises the corporation that he or she "may, consistent with his or her professional obligations, assert a colorable defense on behalf of the issuer (or the issuer's officer, director, employee, or agent, as the case may be) in any investigation or judicial or administrative proceeding relating to the reported evidence of a material violation." Thus, the rule as adopted suggests that one alternative to stopping an ongoing fraud or abandoning plans to commit a new fraud is to get an opinion from a lawyer that should the issuer be investigated for the illegal conduct (there is no

[8] 17 C.F.R. §205.3(b)(3).

requirement in the definition that the investigation be underway, pending, or even likely to occur), a colorable defense would be available.

In my view, corporations will have a strong incentive to take advantage of this "colorable defense" option when faced with a report by a lawyer. And much like the confusing initial trigger, this option threatens to undermine Congress's intent in enacting §307. The colorable defense standard will result in too little reporting up of such evidence. The SEC should not be suggesting to anyone that the fact that a lawyer can (in good faith and/or reasonably) state that a "colorable" defense would be available, if the action is ever challenged, licenses an issuer to engage in activity that may more likely than not be illegal.

The problem with the colorable defense option is that it applies a standard appropriate to litigation to the quite different context of counseling and legal compliance, which is the primary concern of section 307 and the SEC rules. The existence of a colorable defense allows a lawyer when acting as an advocate, i.e., once conduct is challenged in a forum in which another party is arguing that the conduct is unlawful, the lawyer may argue that the conduct, even if very likely illegal, is legal. It has no other relevance.

It is of course true that there may be factual or legal uncertainty about the existence of a material violation, and this uncertainty may remain after an investigation of the initially reported evidence. But section 307 specifically requires that the reporting lawyer take "the evidence" to the board or relevant board committee if the chief legal officer or chief executive officer does not "appropriately respond." Thus, the statute itself mandates reporting up in at least some cases in which the violation is uncertain. This mandate makes sense because a concerned and prudent board would want to know about potential material violations of law.

The fact that a lawyer can advance arguments that would meet the minimum level of plausibility sufficient to avoid sanction in an adversary proceeding does not mean that the conduct is probably legal or somewhere near that middle ground. A public company subject to SEC regulation is guilty of a civil violation of the securities laws when the preponderance of evidence supports a finding of a violation. A lawyer acting as an adviser in transactions and filings subject to SEC disclosure requirements must advise the company on the basis of whether the available evidence indicates that a violation is more likely than not. The result of the SEC's rule is that both the firm and the lawyer potentially remain exposed to a significant risk of liability. The application of the "colorable defense" standard must be limited to the litigation context for which it is appropriate. The colorable defense standard certainly should not be used to permit lawyers to advise clients, particularly corporate clients with fiduciary obligations to their owner-shareholders, to proceed with conduct that is very likely illegal.

The better response to the problem of uncertain violation would be to adopt a graduated approach to reporting up, under which there would be a stricter standard for reporting evidence of a material violation to the board than for the initial duty to report, when the violation remained uncertain after investigation. Roger Cramton, Susan Koniak, and I supported such a graduated approach in our initial comments to the SEC. For example, the SEC could increase the quantum of evidence necessary by adopting a "substantial evidence" standard as triggering a duty to go to the board. The precise formulation could be debated.

My point is simply that the SEC could have adopted a graduated approach to the reporting up trigger without weakening the statutory mandate that "evidence of a material violation" be reported to the board. In particular, nothing in the statute required or even suggested that the SEC use a litigation standard – "colorable defense"– to handle the problem of uncertain violations. Requiring the reporting up of an uncertain violation in no way interferes with a subsequent decision by the board to litigate the issue, asserting all nonfrivolous defenses. Unfortunately, the colorable defense option falls far short of the statutory mandate. In short, the assertion of a colorable defense is not an appropriate response to a report of evidence of a material violation.

c. Law Firms

Section 307 refers to "standards of professional conduct for attorneys" without addressing the question whether firms in which attorneys practice are intended to be regulated. The SEC rules appear directed at individual attorneys. In my view, the rules should be revised to state explicitly that law firms, not just individual lawyers, "appear and practice" before the SEC. Similarly, the SEC should add a rule permitting the censure or reprimand of a law firm and the assessment of monetary fines when the firm has failed to conform to responsibilities required by the Commission. The SEC has sought to discipline law firms in the past in exercising its authority under Rule 2(e). It should renew these efforts under section 307.

The rationale for including law firms within the SEC rules is straightforward.[9] Corporate clients who hire outside counsel usually understand that they are represented by the law firm, not any one individual lawyer within the firm. And in matters of any size or complexity multiple lawyers in the firm, not just one partner and a few subordinates, are likely to be involved. Specialized corporate and securities practice involves the participation of a team of lawyers who bring differing skills and knowledge. Responsibility for decisions is often divided up or shared in ways that are uncertain or shifting. The diffusion of responsibility and knowledge leads to the argument that no one lawyer (or identified group of lawyers) can be held responsible for what was done.

The law of agency addresses these realities through rules of vicarious liability and imputed knowledge. If the SEC rules were to apply to law firms, the question would be whether a law firm might have "evidence of a material violation" as a result of information possessed by lawyers in the firm, even if those lawyers do not disclose the information to other lawyers in the firm who have authority to act for the firm. In particular, courts have adopted a doctrine of "composite knowledge," which attributes to an entity the collective knowledge of its individual agents even if no one agent had all the knowledge. The SEC has previously endorsed the composite knowledge idea in exercising its disciplinary authority against law firms under Rule 2(e).

[9]For a persuasive argument in favor of disciplining law firms, see Ted Schneyer, Professional Discipline for Law Firms?, 77 Cornell L.Rev. 1 (1991).

In my view, not only should the SEC rules apply to law firms, but the application to law firms should include the idea of composite knowledge. Absent such an imputation rule, law firms would have an incentive to decentralize legal work to minimize the number of lawyers with access to sufficient client information to bring them within the purview of these rules. As a result, the quality of legal work done in securities matters as well as compliance with the securities laws would decline, perhaps in dramatic ways. Moreover, I would not expect a composite knowledge rule to add significantly to legal costs. Firms often have good economic reasons for dividing up legal work (in particular, benefits from specialization), and so they already have a need to coordinate and monitor the work and information of various lawyers. A failure to coordinate is itself likely to result in duplication of legal work that itself would unnecessarily escalate fees, as well as an increased risk of malpractice. Finally, the increased risk on law firms as a result of the composite knowledge rule could be mitigated by adopting a system of reduced penalties for firms with effective compliance programs and procedures reasonably designed to prevent violations of the SEC rules.

6. The Noisy Withdrawal Proposal

Noisy withdrawal did not spring fully formed from the imagination of the SEC. It was a concept invented by the ABA to attempt to reconcile its (prior to last summer) absolute prohibition on disclosure of client fraud with its prohibition on aiding and abetting client wrongdoing. In a comment to Model Rule 1.6, the ABA stated that nothing in that rule would "prevent the lawyer from giving notice of the fact of withdrawal, and the lawyer may also withdraw or disaffirm any opinion, document, affirmation, or the like." The ABA then endorsed the noisy withdrawal comment in an ethics opinion in 1992. Using reasoning only lawyers can appreciate, the ABA claimed that the noisy withdrawal was an exception to the confidentiality rule because it was not a "disclosure."

Not only did the ABA create the concept of noisy withdrawal, but the ABA itself has suggested that in certain circumstances noisy withdrawal might be required. Comment [10] to Model Rule 1.2 in the Ethics 2000 revisions to the Model Rules states: "In 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." A similar statement occurs in Comment [3] to Model Rule 4.1, which adds: "In extreme cases, substantive law may require a lawyer to disclose information relating to the representation to avoid being deemed to have assisted the client's crime or fraud."

The SEC made the mistake of taking the ABA at its word. Initially, the SEC proposed section 205.3(d)(1), which would require an issuer's attorney, in the rare situation in which the attorney reasonably believes that (1) an issuer has not made an appropriate response to the attorney's prior report of evidence of a material violation, and (2) "the material violation is ongoing or is about to occur and is likely to result in substantial injury to the financial interest or property of the issuer or of the investors:"

to withdraw forthwith from representing the issuer, indicating that the withdrawal is based on professional considerations; . . . promptly disaffirm to the Commission any opinion, document, affirmation, representation, characterization, or the like in a document filed with the Commission, or incorporated into such a document, that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading.[10]

On January 29, 2003, when the Commission adopted its "reporting up" rule and permissive "reporting out," it also proposed an alternative to required "noisy withdrawal" which would require the issuer, rather than the reporting attorney, to notify the Commission of the reporting attorney's withdrawal and also report "the circumstances related thereto . . . ."[11]

The major argument against broadening exceptions to confidentiality is that clients will be deterred from confiding information to their lawyers. The lack of candor on the part of clients, it is said, will make it difficult for a lawyer to give informed advice. Moreover, the ability of the lawyer to disclose client information may diminish client trust and adversely affect the quality of the relationship and the single-mindedness with which the lawyer pursues the client's interests. If and when the lawyer informs the client that disclosure is desirable or contemplated, a serious conflict of interest arises between the lawyer and the client. The relationship ends in bitterness and a sense of betrayal.

The response to these arguments is several fold. First, some exceptions to both the professional duty and to the attorney-client privilege are longstanding and have not had the consequences that are feared. The people who might be engaged in wrongdoing (corporate managers who are violating fiduciary duties to the issuer or engaging in law violations that will harm the issuer as well as investors) have no privilege now and no legitimate claim of confidentiality. The privilege and the duty to keep confidences belong to the entity, not the managers or the directors. Either can be waived by future managers or trustees in bankruptcy.

Moreover, lawyers can disclose confidences in every state to defend themselves when necessary, even before the filing of actual charges or a complaint.[12] Lawyers can disclose confidences to collect a fee, when necessary. The crime-fraud exception to the privilege leaves unprivileged all communications of the client or its agents made in furtherance of illegality. And in most states, lawyers are already permitted, and in some cases required, to disclose client fraud. The self-defense and client-fraud exceptions involve situations that arise quite frequently and have limited lawyer secrecy from the very beginning.

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[10]An attorney employed by the issuer (an inside lawyer) would not be required to resign from employment but would have to stop working on the matter involved.

[11]SEC Release No. 33-8186, "Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys," Jan. 29, 2003.

[12]See Restatement of the Law Governing Lawyers §64, cmt. b (discussing the rationale for the "self-defense exception": disclosure of confidential information "to defend the lawyer . . . against a charge or threatened charge by any person that the lawyer . . . acted wrongfully in the course of representing a client."

With all these exceptions to confidentiality and the privilege extant, the idea that "noisy withdrawal" or the alternative's "circumstances" provision would suddenly result in clients not talking to their lawyers is untenable. Corporate clients (through their agents) confide in corporate lawyers (to the extent they do, which is now imperfect and always will be) because corporations need legal advice to carry on their business. Period. There is no evidence that those broad exceptions have had undesirable effects on the candor with which clients communicate to lawyers. There is no evidence whatsoever that corporate clients have avoided lawyers in those few states that now *require* disclosure of a client illegality (e.g., New Jersey) or those states that *permit* such disclosure (e.g., Pennsylvania), as distinct from the few that *prohibit* disclosure (e.g., District of Columbia). There is no evidence that lawyers in such states are told less than lawyers in other states. Corporate clients that function across state lines, as so many do, have a fairly wide choice of states from which they may secure outside lawyers. No evidence exists that lawyers in disclosure states have suffered at all or that the quality of representation or compliance with law in those states has been reduced. There is no reason to believe that a slight broadening of the exceptions in situations that arise less frequently will have any discernible effect.

Second, the available empirical evidence, albeit limited, suggests that most lawyers and clients expect that confidentiality will be breached when extremely important interests of third persons or courts would be impaired.[13] Nor is there any indication that clients are more candid with their lawyers in jurisdictions that have fewer exceptions to confidentiality than they are in jurisdictions with broader exceptions. Any objective observer must concede that there is insufficient solid empirical evidence to support firm conclusions in either direction. Do New Jersey lawyers, who are required to disclose to rectify a client's prior fraud on a third person, have an inferior relationship with their corporate clients than those in the District of Columbia, where such disclosure is prohibited? When severe harm is threatened that can be prevented by disclosure, the reality of that more certain interest should be preferred to dubious assumptions about effects on client candor.

Third, the confidentiality interests of public companies regulated by the SEC have a lesser moral claim for protection than those of private individuals who are suddenly confronted with a legal problem that requires a lawyer. Inexperienced individual clients, unfamiliar with legal matters and fearful of their predicament, have confidentiality interests that derive in part from constitutional provisions involving individual rights, especially the special protections given to criminal defendants. On the other hand, a public corporation "has neither a body that can be kicked or a soul that can be damned."

The public companies regulated by the SEC have many public obligations, operate in a goldfish bowl of scrutiny, and have large experience and sophistication concerning the hiring, supervision and firing of lawyers. They are sophisticated repeat-players who use law regularly in carrying on their business, entering into transactions, dealing with regulatory authorities, and participating in litigation. They are the major group of clients who are well informed about the details of the attorney-client privilege and the exceptions to it, the work-product immunity, and

[13]See Fred C. Zacharias, Rethinking Confidentiality, 74 Iowa L.Rev. 351, ??? (1989).

the professional duty of confidentiality. They are also clients whose managers may have a large economic incentive to use lawyer secrecy to delay compliance with regulations or to conceal ongoing violations of them. This group of clients has many advantages in litigation over those with less resources, experience and staying power. The social value of secrecy versus disclosure is less when one is dealing, not with individual citizens encountering law for the first time, but with large and informed repeat-player, profit-making organizations that have strong incentives to delay or conceal compliance with regulatory requirements that impose substantial costs.

Fourth, there is no evidence that exceptions to confidentiality have led or will lead to frequent whistle-blowing on the part of lawyers. Indeed, it is clear that the incidence of whistle-blowing by lawyers is astonishingly low given the fact that most or all states require disclosure when a crime or fraud has been perpetrated on a tribunal; thirty-seven states permit disclosure to prevent a client criminal fraud; and four populous states require disclosure in that situation. Disciplinary proceedings for failing to disclose information when required to do so are virtually non-existent and the same is true for failure to withdraw when withdrawal is required. On the other hand, law firms that learn that a client has used their services to defraud others and who have taken no action to prevent or stop the fraud have frequently settled malpractice and third-party liability claims for large and sometimes huge amounts. Available evidence indicates that lawyers who have discretion to disclose almost always decide not to do so, even when that course of action risks civil liability. The objection to rules permitting or requiring disclosure is not that they will lead to professional discipline, but the effect of the existence of such rules on the likelihood and success of the malpractice and third-party liability claims that are the real risk and, prior to the SEC's implementation of the Sarbanes-Oxley Act, the principal deterrent force.

Fifth, a lawyer's public disclosure of the fact of withdrawal and the general nature of the matter involved, does not waive the client's attorney-client privilege. The attorney-client privilege applies only to communications between lawyers and clients. It does not privilege the underlying facts. Thus the privilege allows a client (or its lawyer) to refuse to answer a question in this form: What did your lawyer tell you? Or, what did you tell your lawyer? The privilege does not allow a client to refuse to answer questions about a matter simply because the matter was discussed between lawyer and client.

In particular, a request that the circumstances of withdrawal be revealed, as the SEC's alternative proposal requires, is similar to a discovery request for certain underlying facts. The SEC is not asking issuers to hand over its lawyer's written reports or summarize the oral advice the lawyer gave. The SEC is not asking issuers to describe the back and forth between lawyer and client on the matter that was the subject of the report. What the Commission wants from issuers is two things: One, a statement that the lawyer has resigned, whenever a resignation is required by the SEC rules; and two, a statement that the lawyer's resignation was in connection with the following matter, including a brief description of the matter, with no requirement that the issuer repeat or disclose any of what the lawyer actually said about the matter.

Does this disclosure threaten the attorney-client privilege because it amounts to requiring the issuer to make this implicit statement: "My lawyer said that there is evidence that a material violation of law occurred (is occurring or will occur) in connection with this matter?" We think not. Courts do not treat the privilege so lightly as to find waiver based on "implicit" references to lawyer-client communications. The "circumstances" portion of the Commission's proposed alternative should not be changed in the absence of a convincing showing that the current law of attorney-client privilege adopts the proposition that "implicit" statements amount to waiver of the privilege. We know of no such authority and do not believe that any outlier authority that might exist for such a proposition would be followed by other courts. The Restatement (Third) of the Law Governing Lawyers §79, Comment *e*, states that "[k]nowledge by the nonprivileged person that the client consulted a lawyer does not result in waiver, nor does disclosure of nonprivileged portions of a communication *or its general subject matter*. Public disclosure of facts that were discussed in confidence with a lawyer does not waive the privilege if the disclosure does not also reveal that they were communicated to the lawyer." (Emphasis added.)

Finally, securities laws now require issuers to disclose a contingent liability when that liability is likely to be significant enough to be of concern to investors. Any such disclosure involves as much of an implicit statement about what a lawyer told the issuer as the "circumstances" provision of the alternative proposal of a report by the issuer to the SEC would require. In sum, eliminating the "circumstances" provision would render the alternative less protective than the original proposal. It should not be eliminated. If it is, the original proposal requiring the reporting lawyer to notify the Commission should be adopted. Whatever version of the rule is adopted should include the requirement that the lawyer disaffirm any opinions or representations that the lawyer reasonably believes are or may be materially false or misleading. That additional step is required to ensure that these "minimum" standards are not lower than the fraud provisions of the securities laws or the ethics rules of most states.

6. Recommendations

My recommendations for Congress and the SEC are the following:

a. <u>Fix the flaws and omissions in the SEC's current rules on reporting up.</u> In particular, the initial trigger should eliminate the double negative formulation; the "colorable defense" option should be eliminated from the list of "appropriate responses"; and the rules should make clear that they are applicable to law firms.

b. <u>Adopt the SEC's noisy withdrawal proposal.</u> I have no strong views about which version should be adopted. If the issuer reporting standard is adopted, however, it should include the requirement that the issuer report the "circumstances" of the withdrawal. It should also add a requirement that the reporting lawyer inform the SEC if the issuer does not.

c. <u>Restore private suits for aiding and abetting.</u> The threat of liability is in many ways the most effective regulator of lawyer behavior. I would gladly trade the SEC rules for the overturning of *Central Bank*. Although securities class actions have many problems, those problems should be addressed directly, not by eliminating causes of action that may have the best chance of deterring corporate fraud. In addition, Congress should restore the recklessness standard of knowledge that was eliminated in the Private Securities Litigation Reform Act.

d. <u>Consider adopting rules similar to the SEC's rules for other agencies.</u> The problem of corporate wrongdoing is of course not limited to securities fraud. The approach taken by the

SEC could easily be applied to lawyers who practice before other federal agencies. That would not only help deter more corporate wrongdoing, it would further the goal of providing more uniform standards of conduct for lawyers.

Testimony Concerning the Role of Attorneys in Corporate Governance:
SEC Rules of Professional Conduct

by Stanley Keller, Esq.,
Palmer & Dodge LLP, Boston, Massachusetts

Before the House Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

February 4, 2004

I am pleased to have the opportunity to testify before the House Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises on the role of attorneys in corporate governance, with a focus on the SEC's adopted and proposed rules governing the professional conduct of attorneys representing public companies. These rules are designed to implement Section 307 of the Sarbanes-Oxley Act of 2002.

I personally have devoted a great deal of attention to this subject both in my professional capacity and with responsibility within my law firm for implementation. Until recently, I served as chair of the American Bar Association's Committee on Federal Regulation of Securities, completing my four-year term in August 2003. Thanks in part to Congress, it was, to say the least, an interesting period. I also served as a special advisor to the ABA's Task Force on Corporate Responsibility (known as the Cheek Commission) and as a liaison to the ABA's Task Force on Section 307 of the Sarbanes-Oxley Act of 2002, having a primary role in commenting on the SEC's proposals, which activity continues to this day. However, I do not appear here as a representative of the ABA, but rather in my individual capacity.

With the Sarbanes-Oxley Act, Congress took bold action to restore investor confidence in our economic system and financial markets in the face of unparalleled corporate scandals. This boldness included mandating that the SEC adopt minimum standards of professional conduct for attorneys for public companies, including a so-called "reporting up" within the organization rule. The SEC acted with equal boldness in adopting its Part 205 rules, which include not only reporting up provisions but also permission for attorneys to report out to the SEC when necessary notwithstanding inconsistent state rules. There were some, including myself, who would have preferred that standards of lawyer conduct not become the subject of federal legal requirements but rather be left primarily to ethics rules. However, that was last year's battle, and the rules that were adopted were sufficiently in line with prevailing state ethics rules and the ABA Model Rules of Professional Conduct that they have gained widespread (even if begrudging) acceptance. Beyond that, the rules have had a clear beneficial impact by refocusing lawyers on their professional responsibilities and on their role in corporate governance, including enhancing client legal compliance.

I would like to address two related subjects: the significant changes that have taken place since (and as a result of) the Sarbanes-Oxley Act and the issues surrounding the SEC's proposals to mandate lawyer withdrawal in certain circumstances and require disclosure of that withdrawal (whether by the company or the lawyer) – so-called "noisy withdrawal." The two subjects are related because the attorney professional conduct rules are best understood and considered in the context of the corporate governance enhancements that have taken place and the need for additional SEC action at this time along the lines of the noisy withdrawal proposals should be evaluated in light of these enhancements.

There have been significant steps taken over the past year and a half to address good corporate governance and ensure legal compliance. These include:

- The rules of the stock exchanges requiring a majority of independent directors and effective committees of independent directors, including the audit committee.

- The recommendations for improved corporate governance from various groups, including the ABA's Task Force on Corporate Responsibility.
- The ABA's approval this past summer of revisions to the Model Rules of Professional Conduct to enhance the lawyer's role in ensuring legal compliance.
- The SEC's reporting up rules, which focus the lawyer's responsibility on the corporation as the client and, as I noted, have found widespread acceptance because they mesh well with prevailing ethics rules.
- The SEC's effort to override inconsistent state rules so as to permit lawyers to report out when appropriate, again substantially consistent with the ethics rules of most states and with the ABA Model Rules (notwithstanding the few dissents which I find unfortunate and shortsighted).
- The significant efforts of law firms and corporate law departments to develop policies and procedures to implement the SEC's rules.
- The commitment of the ABA and other professional groups to educate the legal community on the new rules.

These steps have already had a dramatic impact on the recognition by lawyers of their responsibilities to the corporation as the client acting through its board of directors and on the attitudes of directors, particularly independent directors, regarding their responsibilities to address the corporation's legal compliance, both as a structural matter and as to particular issues. As a result, we have achieved a system in which we can have confidence – lawyers who are vigilant and aware of their responsibility to report up within the organization, to the board if necessary, and independent directors in a position to receive and act on those reports. We should allow this system, newly put in place, to operate before adopting additional rules, such as the SEC's proposed noisy withdrawal rules, with potentially serious adverse consequences.

Let me identify some of these adverse consequences, but first let me be clear: the concern over the SEC's proposed noisy withdrawal rule is not primarily about protecting lawyers. Rather, it is about clients and their right to effective, independent legal representation, about preserving the core values of our legal system, and about avoiding interfering with the integrity of corporate governance.

Specifically, an SEC rule mandating lawyer withdrawal and the reporting out of that withdrawal has the potential to pit lawyer against the client, thus eroding the client's trust and confidence in its lawyer and interfering with the client's access to effective legal counsel on complex issues when it is needed most. A mandatory rule is different in kind from the permissive reporting out rule that the SEC has adopted because it eliminates the professional judgment allowed by a permissive rule and puts lawyers in the position of having to consider their own interest rather than solely the client's.

Next, the lawyer's misjudgments based on incomplete information or concern over the lawyer's own legal exposure can critically injure the client and its investors. A noisy withdrawal rule is likely to encourage lawyers to prematurely withdraw rather than continue to counsel legal compliance regarding difficult issues. Even worse, because of the serious consequences that would flow from identifying a possible material violation, such a rule might prompt some lawyers to avoid asking the hard questions that enable them to counsel legal compliance.

As importantly, a noisy withdrawal rule would shift decision-making on critical business issues from the directors, who are charged with responsibility to make those decisions in the interest of the company and its shareholders, to the lawyers, who are not usually in the best position to make those decisions.

In my judgment, there are real risks that we will end up with lawyers who do not want to know and clients who are reluctant to tell, with the result that overall legal compliance will be reduced rather than promoted, and that complex business judgments that should be made by boards will be shifted to lawyers unsuited to make those judgments.

Before taking the risks of these and other adverse consequences, we should be certain that these dramatic changes in client – lawyer relationship and decision-making authority clearly are needed, and we should give the improvements in corporate governance and lawyer professional responsibility rules that have taken place a chance to operate.

In conclusion, I believe that the SEC has taken the proper actions to implement Congress' intent[1], and that these actions, which have been taken seriously by the corporate and legal communities, should be permitted to operate before the Commission decides whether its noisy withdrawal proposals, with their potentially serious adverse consequences, are necessary.

[1] I note the colloquy on the floor of the Senate regarding Section 307 in which Senator Edwards, responding to Senator Sarbanes' question whether it was correct that a lawyer doesn't go outside the corporate structure, stated: "Mr. President, my response to the question is the only obligation that this amendment creates is the obligation to report to the client, which begins with the chief legal officer, and, if that is unsuccessful, then to the board of the corporation. There is no obligation to report anything outside the client – the corporation." *See* 148 Cong. Rec. §6557 (July 10, 2002). Similarly, Senator Enzi commented: "The [Edwards] amendment. . .would not require the attorneys to report violations to the SEC only to corporate legal counsel or the CEO and ultimately to the board of directors." *See* 148 Cong. Rec. §6555 (July 10, 2002).

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The Role of In-House Counsel in Ensuring Corporate Governance Under the Provisions of the Sarbanes-Oxley Act

STATEMENT OF THE ASSOCIATION OF CORPORATE COUNSEL (ACC)

(formerly the American Corporate Counsel Association)

HOUSE FINANCIAL SERVICES SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED SERVICES

Testimony presented by Linda Madrid[1]

Managing Director, General Counsel & Corporate Secretary, CarrAmerica Realty;
Member, Board of Directors of the Association of Corporate Counsel

February 4, 2004

On behalf of the Association of Corporate Counsel, we are honored to present comments to this Subcommittee on the impact of the Sarbanes-Oxley Act of 2002 on legal compliance efforts within corporations: in specific, you have requested our impressions on the impact of Section 307's attorney conduct rules[2] on the roles and responsibilities of in-house attorneys and their relationship with their clients.

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1 Please note that the comments presented today are those of ACC, and may not reflect the opinions or positions of Ms. Madrid's employer, CarrAmerica Realty.

2 As promulgated by the Securities and Exchange Commission, the rules can be found at 17 C.F.R. Part 205 (Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer). ACC's executive summary of the rules is available at http://www.acca.com/legres/corpresponsibility/307/summary.pdf.

ACC is the in-house bar association, serving the professional needs of attorneys who practice in law departments of corporations and other private sector organizations worldwide. The association promotes the common interests of its members, contributes to their continuing education, seeks to improve understanding of the role of in-house attorneys, and encourages advancements in standards of corporate legal practice. Since its founding in 1982, the association has grown to almost 16,000 members, representing over 7,000 organizations; the association has 43 chapters and 12 committees serving the membership. ACC has members in 47 countries, representing a wide range of substantive interests and a diverse base of clients: public and privately held, large and small, in every industry. ACC members are represented in 47 of the Fortune 50 companies and 97 of the Fortune 100 companies. Internationally, its members are represented in 42 of the Global 50 and 75 of the Global 100 companies.

As the bar association for in-house counsel - lawyers from outside practice are not eligible for membership - everything we do - programs, publications, web resources, networking, advocacy - is strictly "by and for corporate counsel." Accordingly, we can say with confidence that we truly have our finger on the pulse of in-house issues in a way that no other organization can.

ACC has a long-standing interest in the Sarbanes-Oxley Act (SOX) and its provisions affecting our members and their representation of their clients. ACC submitted two sets of comments to the Securities and Exchange Commission (the SEC or Commission) regarding their proposed promulgation of the rules under Section 307, and our Corporate & Securities Law Committee filed several additional comment letters on a variety of Sarbanes-Oxley-related subjects. Today, we will focus primarily on the impact of Section 307, but we will also provide some insight into related, but broader issues of the lawyer's role in ensuring good corporate governance. Due to space and time constraints, we will not address in specific, however, other SOX provisions and their impact on our members' practices (e.g., certification and accountability rules).

Our comments reflect information gleaned from our membership through research, surveys and other feedback. We have developed significant practice resources to assist our members to comply with SOX. A bibliography of related ACC material on Section 307 compliance issues is available online and the web address and listing of those resources is provided as an attachment at the end of this document.

General Comments and Key Points

The passage of the Sarbanes-Oxley Act reflects an understandable response to recent and devastating corporate scandals. The underlying premise of the Act is an attempt to restore shareholder and investor confidence. Corporate counsel have an important contribution to make in achieving that goal. Chief Legal Officers (CLOs) and their in-house legal teams can and should play a key role in helping management and the Board enact governance reforms that ensure that the company's ethical culture is supported by a framework of sound systems of compliance. Corporate counsel embrace their professional and fiduciary responsibilities as managers of the legal compliance function, which include reporting allegations "up the ladder" of responsible management to the highest authority necessary to insure that the *client* can and does remedy legal problems caused by rogue employees or executives. Indeed, lawyers who represent corporations owe their duties to the institution, not to any individual within it; this is a basic tenet of all professional ethics rules, not just the SEC's attorney conduct standards promulgated under SOX 307.

If there is one complaint that is regularly heard, it is that the Act has the unfortunate effect of burdening highly compliant companies with procedural reforms aimed at preventing the misconduct of the few. Hence, the response of many companies to SOX in general is one of frustration. Many of our members question whether any of these procedural reforms would have prevented the financial failures of the companies whose names are now household synonyms for corporate misconduct. It goes without saying that procedural requirements and new structural mechanisms will not necessarily translate into better decision-making, nor can they guarantee moral behavior amongst those who are already prone to unethical or illegal behavior. Even the best governance systems are no substitute for sound decision-making by corporate leaders.

That said, in-house counsel are working hard within their companies to implement SOX requirements and to help their clients institutionalize the ethical behavior SOX is intended to encourage. And they are doing so within the framework established under Section 307.

Our concerns regarding the 307 rules are not about the reporting up procedures; they are about the rule's continuing ambiguities and some of the unintended consequences the rules have wrought, such as a marked increase in the number of threatened lawyer whistleblower actions in response to a negative performance review or a disagreement with the CLO's more informed judgment about the merits of an allegation brought forward by a junior attorney.

Additionally, our members are very concerned about the exposure they face in terms of increasing liability in light of constantly shifting rules and unclear standards of behavior as the SEC, the state bars, and even other federal and state agencies enter the fray to fight over the right to "own" the regulation of the professional behavior of lawyers representing corporations.

So long as Section 307 reforms help - rather than hinder - in-house lawyers in their efforts to team closely with the managers to instill compliance values and guarantee legal outcomes, they are fully supported by our members. However, we strongly oppose mandatory reporting out requirements, because we believe that they will damage the underlying relationship between in-house lawyers and their clients to the detriment of corporate compliance initiatives and the protection of shareholder interests and the public's confidence.

Section 307 /The SEC Attorney Conduct Rules

The SEC's attorney conduct rules implementing Section 307 led many corporate law departments to adopt new or re-examine existing internal reporting practices and professional conduct policies. The 307 rules - now known as Part 205 rules (referring to the Federal Register section at which they are codified) became effective on August 5, 2003, and set minimum standards of professional conduct for attorneys "appearing and practicing before the Commission in the representation of an issuer." The rules require, among other things, that affected attorneys report up-the-ladder within the company certain matters upon discovery of "credible evidence of a material violation ."

Our comments will now address how companies and law departments - in general - are ensuring compliance with the 307 rules.

Many companies have developed written policies, standards, or memoranda describing their "up-the-ladder" reporting expectations.

While reporting up the ladder within an organization is not a new concept for in-house lawyers since it is written into each state's professional licensing code as a basic tenet of organizational client representation, as a result of Section 307, many law departments updated their conduct manuals or formalized up-the-ladder conduct rules for the first time in written policies, orientation and evaluation manuals, and mandatory-attendance educational programming. Although law department responses to the 307 rules may vary in form and substance, many include commonly shared key resource features to help attorneys understand expectations pertaining to circumstances that require reporting, the types of information that must be reported, and the appropriate methods for complying with reporting requirements.

It is probably fair to state that even now, CLOs responsible for such policies and conduct compliance are carefully watching what everyone else is doing; even departments with policies in place concede that their policies are not set in stone because regulation under the new rules is so new and untested, and adverse and unintended consequences are now starting to pop up, as detailed below. They are also carefully watching whether the SEC will adopt a threatened amendment to the rule, which would change the standard from "permissive" reporting to an outside authority (in the event of client intransigence to remedying a problem) to a mandatory outside reporting requirement, which ACC and the vast majority of our members strongly oppose.

Reporting expectations are communicated and applicable to all attorneys within company; reportable allegations covered by department policies are generally broader in scope and application than the SEC rules may require.

Although the SEC rules regulate individual attorney conduct, most activity is focused at the organizational level, and thus made applicable to all attorneys working for the company at every location, including in non-US locations. The reasoning is: 1) the rules are unclear as to exactly which attorneys are subject to the rules and companies would rather be safe than sorry; 2) law department leaders dislike the idea that there are two sets of standards applicable to attorney conduct at the company (one for Section 307 lawyers and one for everyone else); and 3) if the idea behind better conduct rules is to codify and generally raise the bar on law department processes for reporting problems, then such better practices should be the rule for everyone.

Additionally, while the SEC rules offer a bit of wiggle room for reporting attorneys in beginning their progress of reporting up the ladder "forthwith," most company policies don't want inside lawyers mulling over whether they should or should not report something amiss to the CLO or other senior designated counsel: they want allegations of wrongdoing reported up within the law department immediately (even if the matter will receive more considered attention and investigation, and even possibly remedial action before any report to other corporate leaders outside the legal department is made).

Thus, many company policies generally go beyond the SEC's definition of covered attorneys and apply to all company attorneys and any significant allegations brought to the lawyer's attention.

Up-the-ladder reporting procedures adopted may vary between companies, but most include the creation of internal "guidance resources" and extensive training.

Written up-the-ladder reporting expectations vary in length, style, and content. Some take the form of short memoranda or electronic communications summarizing key requirements and identifying contacts for consultation or reporting. Others are more formal and detailed written policies, standards, or guideline documents. Some companies have not developed formal written policies, but have more casually reinforced continuing expectations that all lawyers are invited to communicate problems up-the-ladder, or otherwise focused lawyers' attention on the desirability of broadly sharing information that could trigger an attorney's reporting responsibilities under the SEC rules.

Some of these variances in communication are directly connected to the size of the legal department: in larger or more geographically dispersed departments where attorneys may be faced with complex or heavily populated reporting up channels, one is more likely to see longer, more detailed policies, and find online or in-person ethics training resources and advisory or reporting committees in place. Many of these departments have designated an internal advisory counsel or committee to help attorneys who are confused or who have a difficult situation to navigate and need advice.

In smaller departments, where all the attorneys communicate openly on a daily basis, a formal written guideline may exist, but it is more likely that the CLO will simply reinforce the duties implied by the rule in a summary "all staff" email or a regularly scheduled department meeting; this is often accompanied by permission to attend an outside-sponsored ethics training event, and a suggestion that anyone with a concern about something they run across should simply tell the CLO immediately.

Even with SEC regulatory and corporate policy guidance to direct them, in-house counsel – from the CLO to the junior-most attorney – are concerned about how procedural and remedial responses will be judged by others with 20/20 hindsight.

Whatever form these communications or policy prescriptions take, they are unlikely to fully answer questions about how attorneys should proceed when caught between employer policies, the SEC's rules, their client's "best interests" (which each attorney is presumably left to define individually), public and shareholder expectations in this highly charged prosecutorial environment, and the professional conduct rules of their state licensing entities, all of which may suggest a different manner of responding, or even different responses to the same matter.

Most internal 307 policies, therefore, are mindful of separating the purpose of these rules (which is to set a floor for attorneys' proper professional conduct) from the client service and risk management/liability concerns of the law department (to mandate acceptable department policies that ensure reports are made and a remedy to allegations is pursued). Many CLOs are concerned that these rules and policies, delivered alone, may generate an atmosphere in which lawyers are more concerned about their compliance with the technicalities of proper reporting up than with the remedy of the underlying client problem they may have discovered. This would obviously be a perverse result of this rule's application, but feedback from our members suggests that it is an emerging problem, especially for more junior attorneys.

SOX 307 rules are impacting lawyers who work in private and non-profit companies.

The SEC's rules regulate only public companies and thus, public company lawyers, but the "best practice" standards they are setting, and the momentum at the state legislatures, in the state bars, and certainly amongst stakeholders of all kinds is that all companies and all lawyers, representing any entity (public, private, for or not for profit) should take steps to encourage their lawyers live up to these requirements and procedures.

The rules are nonetheless untried, often undefined or ambiguous, and even in conflict with other rules that lawyers are required to professionally follow.

The interplay between the SEC rules and changing state bar rules regulating lawyers under each state's version of the Model Rules of Professional Conduct (regarding client confidentiality standards and proper representation of an organizational client when allegations of wrongdoing surface) adds yet another layer of necessary analysis and angst to the issue. While the SEC has openly stated that they believe that their rules "trump" state bar rules which do not regulate lawyers to the SEC's more aggressive standard or are in direct contradiction to state bar professional rules of practice (under the theory of pre-emption), some state bars are already taking issue, claiming that the regulation of lawyers is a practice reserved to the states, and advising state bar members that they will be disciplined for any and all breaches of the state bars' rules, even if the lawyer was attempting good faith compliance with the requirements of the SEC's rules. In other words, lawyers are getting caught in a regulatory turf war.

QLCCs may create more problems than they are intended to resolve.

The SEC's response to many of these concerns raised during the rule-making process was a proposal to allow companies worried about placing their lawyers in the middle of a professional standards wrestling match to establish a QLCC or Qualified Legal Compliance Committee. This board level committee was to be composed in a manner to include independent directors, and was to be a vehicle to which lawyers who uncovered an allegation could report concerns and be discharged of virtually all other reporting obligations under the rule. The concept sounds appealing (in theory), yet only a few companies have adopted such a committee.

The vast majority of companies and CLOs find the creation of a QLCC to be a practical disaster. ACC has published a paper listing the reasons why so many companies that adopted every other board-level SOX reform option made available chose to forego creating a QLCC: this paper is available through our resource listing attached. In a nutshell, most in-house counsel disparage the idea that they would ask their board to assume the additional burden of establishing yet another "audit" type committee so that lawyers who are paid well by the company could be removed from responsibility for handling legal matters: the message to the board would be that the company's in-house counsel is not interested in, should not be trusted, or is not equipped to handle the most sensitive issues of legal compliance the company faces. Other practical concerns were raised, as well, and are detailed in our paper.

> *Essentially, our members tell us that the bottom line is that Section 307's conduct rules – when properly working -- build and support procedural mechanisms through which the legal department can formally participate in improved corporate governance initiatives; the rules help to insure that lawyers are responsible and empowered to individually contribute to a stronger ethical culture in the company. When improperly applied or misused, however, aberrant results will flow, and should be addressed.*

Once over the initial shock of finding themselves accountable to the SEC for professional standards of conduct, most ACC members would agree that there is little in the rules that is theoretically objectionable, and that there is much to be done in order to address the crisis of accountability and the devastation that recent corporate failures have brought to the marketplace and the public's trust in corporate responsibility.

In-house lawyers accept the reporting up responsibilities of the 307 rules, since to do so is highly consistent with their professional obligations to represent the client entity's interests and not any one malfeasant executive's motives. In addition, while the SEC codification of the reporting up principle is more detailed than the states' comparable rule version of the "organization as client" rules, the underlying principles are already well-established, accepted and understood. The main issues outstanding involve the definition or the appropriate threshold that triggers a reporting up requirement, as well the triggers for *permissive* "reporting out" in the rare circumstance that the intransigent client refuses to remedying an illegal action which the lawyer believes he must breach the client's confidence and report to an outside authority. But the concept of authorizing the lawyer to use her judgment to exercise a permissive report outside the company is not controverted, especially since history and practice shows us that it is used only rarely and most judiciously because of its dire consequences.

What is not accepted is the SEC's continuing flirtation with the imposition of an additional rule that would require *mandatory* reporting out by lawyers. Mandatory reporting out will inhibit (rather than support) legal compliance efforts by discouraging clients from welcoming lawyers into every aspect of the company's most sensitive business; in-house lawyers are only effective if they are integrated and trusted members of corporate executive, strategic, and compliance management teams. If clients view mandatory reporting lawyers as in-house policemen whose fiduciary duties flow to regulators and not to the client's need for confidential counsel, then the attorney-client relationship has been undermined in a manner which is both counterproductive to the purpose and intent of this legislation, and a disservice to the effective protection of the public and the client.

Concerns Beyond the 307 Rules:
Full Employment for Attorneys and Consultants

SOX has spawned a cottage industry for "experts" to "assist" companies in compliance with regulatory obligations. This industry often preys upon the unease of board members and senior executives by playing up their potential personal liability for corporate malfeasance, and feeding their belief that they need outside and independent counseling in order to make sound decisions. While there is a place and a need for independent counsel in certain well-defined situations, what is often sold as independent counsel would be more appropriately called "lack of any institutional knowledge or practical experience in solving your problems!"

As the fiduciaries within the company who are responsible for the management of legal costs, our members are very concerned about the unnecessary retention of leagues of outside legal advisors at high cost to the company, as well as over the possible turmoil their disparate advice can cause. While many in-house counsel do consult with outside firms in areas in which the in-house team lacks experience or the staff to execute compliance requirements, CLOs are concerned that lawyers hired by board members and executives in an effort to by-pass the legal department are seeking independent counsel on the company's dime for legal advice that is already being provided in-house.

Conclusion

ACC thanks the Committee and Subcommittee for this opportunity to present our views. If we can be of any assistance, or if there are additional subjects that you would like addressed from our perspective, we are happy to help.

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Comments of the Association of Corporate Counsel
February 4, 2004

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Additional ACC Resources and References of Interest:

The following documents are accessible at the following URL:
http://www.acca.com/testimony/

ACC Member Briefing: Executive Summary of the 307 Rule and its Application

99 Questions and Answers about Complying with the 307 Rules

ACC Member Briefing: *"ABA Adopts New Model Rules Affecting In-House Practice"*

ACC Member Briefing: *"Five Practical Steps" (for In-House Counsel Concerned About Lawyer Regulation Pursuant to Sarbanes-Oxley Section 307)"*
ACC Article: *"It's Private Companies' Turn to Dance the Sarbox Shuffle"*

ACC Member Briefing: "Why haven't more companies adopted a QLCC?"

ACC / NACD Comparative Survey on CLO and Director Impressions of Governance Issues Post Sarbanes-Oxley

ACC's Leading Practice Profile: Indemnification and Insurance Coverage for In-House Lawyers: What companies are doing.

United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Hearing on The Role of Attorneys in Corporate Governance
February 4, 2004

Testimony of Professor Thomas D. Morgan[1]

Mr. Chairman and Members of the Subcommittee:

I begin with a proposition that should not be controversial: No attorney has any right knowingly to assist a client to commit a crime or fraud. There are a number of serious questions about exactly how an attorney should act in particular concrete situations, but the basic limitation should be clear. The boundary of zealous representation ends where knowingly assisting crime or fraud begins.

My testimony this morning makes four points. First, a comprehensive body of state regulation of attorneys already exists and renders doubtful the need for additional federal legislation or regulation. Second, the role of corporate attorneys in formulating corporate policy tends to be small and their responsibility for corporate wrongdoing is not likely great. Third, federally-mandated noisy withdrawal in the face of possible wrongdoing would potentially create problems rather than solve them. Fourth, if Congress and the S.E.C. do decide to regulate the conduct of securities attorneys, they have the constitutional authority to do so.

Taking these one at a time: First, some critics of attorney conduct seem to assume that there was virtually no effective regulation of corporate attorneys prior to the federal Sarbanes-Oxley legislation. That is simply not true. The sources of professional regulation of corporate

[1]I am the Oppenheim Professor of Antitrust and Trade Regulation Law at George Washington University Law School. I have taught and written in the field of lawyer professional responsibility for over 25 years. I am co-author of "Problems and Materials on Professional Responsibility" (8th Edition 2003), and I served as one of two Associate Reporters for both the American Law Institute's Restatement of the Law (Third): The Law Governing Lawyers and the American Bar Association's Ethics 2000 Commission that proposed changes to the A.B.A. Model Rules of Professional Conduct. I am appearing at the invitation of the Subcommittee and not as the representative of any client or interest.

attorneys prior to the Sarbanes-Oxley Act and the SEC regulations that implement it were primarily found in the rules of the state supreme courts that license attorneys. Most of the state rules, in turn, are based in large part on the American Bar Association (A.B.A.) Model Rules of Professional Conduct. At least seven such rules, taken individually and together, define what state law has understood to be a corporate attorney's duties in dealing with possible corporate crime or fraud.

First, A.B.A. Model Rule 1.2(d) says simply: "A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent * * *." That was the proposition with which I began this testimony. There was no dispute before Sarbanes-Oxley – and no more clarity today – about the fact that an attorney's knowing involvement in, or giving advice that assists, a client's crime or fraud is no part of any attorney's legitimate role.

Second, turning specifically to corporate attorneys, A.B.A. Model Rule 1.13(a) makes clear: "A lawyer employed or retained by an organization represents the organization * * *." It would be hard to say more concisely or unmistakably that an attorney represents the corporation itself, not its officers, directors or prominent shareholders.

Third, Model Rule 1.4(b) establishes a duty to take information about the matter on which any attorney is working to duly authorized constituents of the client "to the extent reasonably necessary to permit the client to make informed decisions regarding the representation." That is also unambiguous. It is important to understand that, even before Sarbanes-Oxley, corporate attorneys had no right to keep information about corporate crime or fraud to themselves.

Fourth, if Model Rule 1.4(b) leaves any ambiguity about the attorney's duty to keep the client informed, Model Rule 1.13(b) makes it unambiguous that an attorney has a duty to take steps to protect a corporate client, saying:

> (b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall

proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances, to the highest authority that can act on behalf of the organization as determined by applicable law.

(c) Except as provided in paragraph (d), if

(1) despite the lawyer's efforts in accordance with paragraph (b), the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action or a refusal to act, that is clearly a violation of law, and

(2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization,

then the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.

(d) Paragraph (c) shall not apply with respect to information relating to a lawyer's representation of an organization to investigate an alleged violation of law, or to defend the organization or an officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law.

(e) A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to paragraphs (b) or (c), or who withdraws under circumstances that require or permit the lawyer to take action under either of those paragraphs, shall proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal.

There is simply no question that an attorney is required to take action ("shall proceed") if the attorney knows of serious crime or fraud committed by – or against – the corporate client. The action taken is to be whatever is necessary given the nature and seriousness of the offense, but the action may include referring the matter to the client's board of directors for action. Indeed, the duty to act must include that step if the conduct is serious enough and if lower-level corporate management refuses to deal with the problem the attorney has identified.

Fifth, Model Rule 1.16(a)(1) requires a corporate attorney to withdraw from any case in which the "representation will result in violation of the rules of professional conduct or other law." Thus, while the attorney need not withdraw from representing the client if the attorney's own work would not involve counseling or assisting criminal or fraudulent conduct – for example, because the improprieties involve the work of some other attorney or law firm – when the attorney's own services are involved, withdrawal is mandatory now and long has been so.

Sixth, and sometimes seen as a problematic exception from the above rules, Model Rule 1.6(a) provides that "a lawyer shall not reveal information relating to the representation of a client * * * ." Thus, while an attorney may or must report misconduct to persons within the corporation who can do something to correct it, the attorney seems to be expressly forbidden to reveal the information to persons outside the corporation.

Model Rule 1.6(b) does have exceptions to the confidentiality requirement, including one permitting attorney disclosure to prevent "death or substantial bodily harm" that the client or someone else is "reasonably certain" to cause. However, at the time Sarbanes-Oxley and the SEC regulations implementing it were adopted, there was no corresponding provision permitting disclosure of criminal financial fraud.

On the other hand, state laws actually governing the conduct of corporate attorneys tended not to follow the A.B.A. on this issue. The A.B.A. Model Code of Professional Responsibility that had preceded the Model Rules, and that all states but California had incorporated into state law, permitted disclosure of otherwise confidential information about "the intention of [the lawyer's] client to commit a crime and the information necessary to prevent the crime." When the time came to consider Model Rule 1.6, over 40 states retained the Model Code exception, or something close to it, instead of the narrower version in the Model Rules.[2]

Thus, while one would not know it from reading only the A.B.A. Model Rules, in the

[2]The Attorneys' Liability Assurance Society, Inc., has kept abreast of these state rules for many years and reports them in a table reprinted in annual editions of Thomas D. Morgan & Ronald D. Rotunda, Selected Standards on Professional Responsibility, Appendix A [to the Model Rules]. See,e.g, the 2004 Selected Standards at 144.

vast majority of American jurisdictions even prior to Sarbanes-Oxley, attorneys were authorized to disclose the intention of their corporate client to commit a criminal financial fraud and the information necessary to prevent it. Summarizing the current state of U.S. law on the issue, the American Law Institute said in its Restatement Third, The Law Governing Lawyers § 67:

> "(1) A lawyer may use or disclose confidential client information when the lawyer reasonably believes that its use or disclosure is necessary to prevent a crime or fraud, and:
>
> "(a) the crime or fraud threatens substantial financial loss;
>
> "(b) the loss has not yet occurred;
>
> "(c) the lawyer's client intends to commit the crime or fraud either personally or through a third person; and
>
> "(d) the client has employed or is employing the lawyer's services in the matter in which the crime or fraud is committed."
>
> "(2) If a crime or fraud described in Subsection (1) has already occurred, a lawyer may use or disclose confidential client information when the lawyer reasonably believes its use or disclosure is necessary to prevent, rectify, or mitigate the loss.

Now, after reconsideration of its Model Rule 1.6(b) in August 2003, the A.B.A. has caught up with the states and has adopted largely the same rule as that described in the Restatement.

Seventh and finally, Model Rule 4.1(b) makes clear that sometimes an attorney not only may – but must – disclose seemingly confidential information. Rule 4.1(b) requires an attorney not to "knowingly fail to disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6." At the time Sarbanes-Oxley was adopted, looking only at the four corners of the Model Rules themselves, the reference to Rule 1.6 swallowed up the rest of Rule 4.1(b). However, given the actual state law versions of Rule 1.6, that limitation was not applicable in a majority of jurisdictions, and given the A.B.A.'s new Rule 1.6(b)(2) & (3), it is clearly not true. Thus, corporate attorneys are now – or soon will be – *required* by Model Rule 4.1(b) to disclose outside the corporation any "material fact * * * necessary to avoid assisting a criminal or fraudulent act by a client." It would be hard to make the point much more clearly.

My point in discussing these seven rules is to make clear that any need for additional regulation – particularly federal regulation – is far less clear than critics of the conduct of the conduct of particular attorneys might suggest. Most informed critics of pre-Sarbanes-Oxley regulation have known about those rules, of course, so they have had to center their principal concern on the rules' alleged under-enforcement.

It is true that few if any attorneys for major corporations have been disbarred or otherwise disciplined for violations of state professional standards. However, that is not because corporate attorneys have been granted special immunity from compliance. One unfortunate reality about the legal profession has been the general breakdown of the attorney disciplinary process nationwide. Even according to the A.B.A., a traditional defender of state regulation, a charge filed with a state attorney disciplinary agency has a 70% chance of being dismissed without serious investigation. Of the remaining 30% of complaints, 5 out of 6 will be investigated but not tried. Thus, only 5% of the original total will be brought to trial, and of those, only 2% will produce significant professional discipline.[3] Many complaints are frivolous, of course, but not all of them. The cases that result in discipline tend to be ones in which the offense is clear and the facts unambiguous, features not common in most cases involving corporate attorneys.

But while a corporate attorney is not likely to receive professional discipline for a failure to prevent or disclose a client's crime or fraud, statistics about professional discipline alone ignore the fact that civil liability has long replaced professional discipline as the principal means of enforcement of professional standards in the corporate context. And in the liability arena, judgments and settlements have been substantial enough to throw fear into the heart of the least risk-averse corporate attorney.

[3] A.B.A. Center for Professional Responsibility, Standing Committee on Professional Discipline, 1995 Survey on Lawyer Discipline Systems (1997).

During the savings and loan scandals of the 1990s, for example, in FDIC v. Mmahat, 907 F.2d 546 (5th Cir. 1990), cert. denied 499 U.S. 936 (1991), the damage award was $35 million. In re American Continental Corporation/Lincoln Savings and Loan Securities Litigation, 794 F.Supp. 1424 (D.Ariz. 1992), led to a reported $51 million settlement, and earlier, another firm representing Charles Keating's family of companies reportedly settled for $41 million.

Those concerned that ordinary malpractice liability – even at damage levels such as those just cited – is not enough to deter misconduct correctly note that the availability of suits for attorney liability under the securities laws was put in doubt by Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994). The bank had not itself committed fraud, but its failure to act had arguably "aided and abetted" the fraud of the borrower. The Supreme Court held that § 10(b) of the Securities Exchange Act of 1934 imposed private civil liability for an actual manipulative or deceptive act (a "primary"violation), but not for aiding and abetting such an act (a "secondary" violation). Most attorneys saw their own role as, at worst, likely to involve "aiding and abetting" and thus not subject to securities law liability.

Newby v. Enron Corporation, 235 F.Supp.2d 549 (S.D.Tex. 2002), however, has cast doubt on even that assumption by saying that attorneys can be found to have committed a primary violation of the securities laws if they have affirmatively participated in preparation of disclosure documents on which investors had arguably relied. The *Newby* litigation has a long way to go before its understanding of what is required to impose primary liability is universally accepted, but the case casts doubt on any easy assumption that attorneys cannot be liable under the securities laws for work done on behalf of their clients

My purpose in making the above points has been to be sure the Subcommittee's record is clear that any legislation is considered in a context of existing regulation that is comprehensive in scope and intended to achieve the same results that you undoubtedly hope to achieve. The fact that existing regulation in any area of life fails to prevent a catastrophic event – including the Enron meltdown and similar corporate scandals – does not mean that the regulation was nonexistent or insufficient. There will always be some people who will violate any law: witness the inability of even the death penalty to eliminate murder.

Or, it may turn our that particular corporate calamities have had causes unrelated to the conduct of the company's attorneys. Only pending litigation will determine whether that was true in cases such as those involving Enron, for example. It is to that possibility that I next turn.

The title of this hearing is "The Role of Attorneys in Corporate Governance." One author has put the case for new regulation of attorneys most urgently: "No major corporate transaction goes forward without an lawyer's okay," the author says; "no securities documents get filed without an lawyer's review * * *."[4] Thus, if a corporation gets into serious financial or legal difficulty, the argument goes, it must be because the company's attorney was inattentive, incompetent, dishonest or cowed into silence. No one can disagree with the first step in that argument, but in my view, the second step does not follow.

Indeed, data from the SEC itself tends to confirm the relatively minor role attorneys have played in significant instances of corporate failure and professional misconduct over recent years. The Commission was required by Section 703 of Sarbanes-Oxley to report on cases in which it had brought enforcement actions against securities professionals between the years 1998 and 2001. The SEC identified 1713 cases in which securities professionals were found guilty of a primary violation of the securities laws or of aiding and abetting such conduct. Of the 1713, only 48 (2.8%) of the violators were attorneys.[5] That is 48 too many, but the data tends to confirm that in the overall picture of securities fraud and corporate wrongdoing, the role of attorneys is largely peripheral.

In part, I think the difference between the critics' perception and observed reality is that corporate attorneys are victims of an attractive mythology. The myth is that in an idyllic past,

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[4]Susan P. Koniak, Corporate Fraud: See Lawyers, 26 Harv. J.L. & Pub. Pol'y 195, 227 (2003).

[5]The report can be found at http://www.sec.gov/news/studies/sox703report.pdf. One might argue that the low number is because the SEC relies on state authorities to discipline attorneys. The context of the study, however, was not discipline cases which the SEC has eschewed, but actions directly to enforce the securities laws.

attorneys were all knowledgeable, trusted advisers to corporate titans. They sat at the right arm of corporate chief executives, helping think through corporate strategy and details of corporate conduct. For most corporate attorneys, however – if they even think there was such a day – that day is long gone. A few inside general counsel might have such a corporate role, but not many. Even fewer outside counsel do.

The problem is one of incomplete information. At today's rates of compensation, it is expensive for a client to "educate" an attorney about more than the attorney needs to know to address a problem. Most often, attorneys both inside a corporation and in private firms do assigned tasks following at least general guidelines. An attorney may be directed to negotiate and close corporate real estate transactions, for example. She will know what price the company will not exceed, by what date the property is needed, and other requirements the client wants met in the purchase. She will not necessarily know, however – or think relevant to the assigned task – what overall strategic objective the company hopes to serve with a particular acquisition.

Similarly, an attorney may be directed to write a patent application or defend the patent in subsequent litigation. Another attorney may counsel the company on its hiring or other human resources practices. Each may know enough to do his or her assigned job effectively, but neither is likely to know whether the patented product is being illegally tied to an unpatented product, for example, or whether the employees being hired will be used in a project that violates the securities laws. Divided responsibilities and partial information are characteristic of modern practice, no matter how much attorneys might like to think of ourselves as wise and all-knowing.

Hindsight may accurately show that an attorney's work at some stage of the process played a part in allowing a fraudulent scheme to be perpetrated. The attorney may have closed a commercial sale that turns out to have been part of a money laundering scheme, for example. The reality is, however, that the attorney may have been a victim of the dishonesty, not one of its perpetrators. In a world of incomplete information, the observation that dishonest people had attorneys does not amount to a legitimate condemnation of those attorneys. It thus would be a mistake for Congress to think that further regulation of attorneys would be an effective way to better regulate their corporate clients.

Third, attorneys should not be required to make a "noisy withdrawal" from representation of a corporate client even if the client does not adequately respond to the attorney's concerns about corporate wrongdoing. No one can predict who will first become aware of corporate misconduct, and it may seem hypertechnical to excuse an attorney with possibly valuable information about the client from the duty to make that information available to the public.

As I have reported above, existing A.B.A. standards already impose the obligation to report concerns to corporate management and possibly even to the board of directors, at least in matters relating to the attorney's own work for the client. The S.E.C., in 17 CFR § 205.3(b) has now extended that obligation to information obtained from any source, even with respect to issues as to which the attorney has had no personal responsibility or prior knowledge.

The S.E.C. view of the appropriate standard for requiring up-the-ladder internal reporting seems to assume that the costs of such reporting are low and that the more formal reporting that occurs, the better. I believe those assumptions are seriously flawed. In fact, even the internal investigations contemplated by the S.E.C. Final Rule are likely to involve significant costs.

A formal investigation as contemplated by the Final Rule is, at the very least, likely to involve an issuer's soliciting an outside opinion or investigation that will often be expensive. More important, the need for the investigators' detailed access to company records, their need to interview employees who may themselves feel they must hire counsel, and the risk of otherwise creating excessively adversarial relations with corporate officials are all costs that should be taken seriously in determining the desirable frequency of such investigations.

Surely, it is obvious that the risk of uninformed reports will increase significantly when attorneys report matters outside the field of their practice or experience. Imagine, for example, that Attorney provides tax advice to the issuer. She prepares tax opinions that she knows will be filed with the Commission in connection with a required disclosure obligation. She, in short, "appears and practices before the Commission" and she does her tax work honestly and well.

Now suppose Attorney hears from a friend in the company that the company's newly issued patent is subject to challenge based on prior art in the field that was not disclosed to the Patent Office. That information, if true, would be material to investors because both corporate officers and financial analysts have based predictions of the company's future success on the strength of that patent. If the friend had told Attorney about facts relating to a possible tax position, Attorney could relatively easily make the § 205.2(e) evaluation about whether the information was "credible" and whether a similarly situated reasonable attorney would "conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur." But how will Attorney make that judgment about an issue of patent law she does not understand? In particular, how can she do so when the issue requires a judgment about prior scientific literature that Attorney would likely be unable even to comprehend even if she were to read it?

The likely answer is that, as a matter of self-protection, Attorney will simply make a formal report and shift the problem to the company's Chief Legal Officer (CLO) as long as the Final Rule continues to require reports that do not relate to the attorney's representation of the issuer. If one thought that such reports were costless, that would be fine. As discussed above, however, reports will often involve real costs to the issuer and to the attorney-client relationship with that issuer. Clearly, investigation is essential where the risk of wrongdoing is real and the facts or law are unclear. My point is simply that formal reporting should not be seen as inherently desirable; the goal should be optimal reporting, not maximum reporting.

The problem described here is only likely to get worse as the process required by the S.E.C. Final Rule continues. When the CLO gets back to Attorney with a response that the charge is baseless, Attorney will have little more basis upon which to evaluate the "adequacy" of that answer. She may know that a new attorney has concluded that all is well, but her own evaluation of the "adequacy" of the conclusion will add little or nothing to its reliability.

Now add a system of mandatory "noisy withdrawal" to the mix. Presumably in the above illustration, under the Proposed Rule now pending before the SEC, Attorney plausibly might think she would have to resign. What message would withdrawal by a tax attorney send to the

Commission and to investors? I suggest that it would be a message about non-existent tax problems rather than problems with the important patent.

Noisy withdrawal, in short, is the professional equivalent of "charades," the parlor game in which participants seek to read substantive content into otherwise ambiguous gestures. The problems of restoring investor confidence – and the role of good legal advice in that process – are too serious to be transformed into such a game.

First, an attorney's withdrawal is costly for any client. Clients may fire their attorneys, of course, but when an attorney walks away in the middle of a representation, it is the client who gets hurt. Thus, attorney professional rules such as A.B.A. Model Rule 1.16 properly place significant limits on an attorney's right to withdraw without client consent.

As discussed above, attorney withdrawal is already required by Model Rule 1.16(a)(1) when a failure to withdraw would involve the attorney in knowingly assisting a client's crime or fraud. In adopting a federal standard going that far, Congress or the Commission would be building upon an established principle. I thus encourage adoption of the triggering standard now proposed for § 205.3(d)(1) – the "attorney reasonably believes that a material violation is ongoing or is about to occur and is likely to result in substantial injury to the financial interest or property of the issuer or of investors." That is a step beyond the "knowing" standard in the Model Rules, but it requires that the attorney in fact believe the facts to be true and requires that the belief be reasonable. That comes quite close to the view of "knowing" now used in the A.B.A.'s Model Rule 1.13(b), and it seems a fair articulation of the kind of circumstance that should require attorney withdrawal.

However, such a withdrawal standard requires an important qualification. In my earlier hypothetical, Attorney, the tax attorney, would have no right or obligation under Model Rule 1.16 to stop giving tax advice because she thought the client might have a doubtful right to a patent. Surely, that is the right result. At least, the federal standard should make clear that any requirement of attorney withdrawal should be limited to withdrawal from the representation that involves a "material violation" as defined in § 205.2(i). The S.E.C.'s Proposed Rule, for example, should not require that the attorney sever all ties with the allegedly offending client.

Second, the harder question becomes disclosure of the fact of, or reasons for, the withdrawal. I begin with the observation that disclosure of information to securities markets is not an unvarnished good. Accurate, easily-understood information makes markets work better. However, confusing, ambiguous information can make markets work less well. If investors are led to believe they know facts but later find they are untrue or less significant than they appeared, real dollars of real Americans will be lost unnecessarily. Charades may be funny in the family room, but securities markets process clear and accurate information best.

Furthermore, in § 205.3(c)(2) of its already-adopted Final Rule, the Commission has adopted a provision for explicit permissive disclosure of the problem creating a perceived "material violation." An attorney may "reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary" to prevent or rectify a "material violation" causing "substantial injury to the financial interest or property of the issuer or investors." In short, the Commission already has approved a method of disclosure to provide the kind of accurate, helpful information that "noisy withdrawal" never will.

To be sure, under the Final Rule, disclosure is permissive rather than mandatory. I have heard it said that permissive disclosure would result in too little disclosure to the Commission, but I believe that view is mistaken. Mandatory versus permissive disclosure was extensively examined in preparation of Restatement Third, The Law Governing Lawyers § 67, which found permissive disclosure to be the prevailing rule and the right result. Comment *k* explained that any such disclosure "would inevitably conflict to a significant degree with the attorney's customary role of protecting client interests. Critical facts may be unclear, emotions may be high, and little time may be available in which the attorney must decide on an appropriate course of action." Making disclosure mandatory in such circumstances "would be unwarranted."

Further, attorneys will have significant incentives to make permissive reports where they are justified in doing so. An attorney would need several lifetimes to overcome the damage to his or her reputation caused by failing to disclose something that later causes serious public harm. Thoughtful professionals will not let clients put them in that position.

Make no mistake, furthermore, pressures on the attorney-client relationship will be equally great whether it is the lawyer or the company that is required to disclose. The possibility that information about attorney withdrawal will create more market "noise" than understanding makes the S.E.C.'s proposed requirement that the issuer immediately issue a Form 8-K a more precipitous step than necessary.

I would favor what I understand may be an alternative proposal whereby an issuer would be required to describe to the Commission the controversy leading to the attorney's withdrawal in a confidential manner that would go to the securities markets only if the Commission believed it would be appropriate to release it. Honest reporting is critically important; ambiguous or even misinformation present a genuine problem. Caution in dealing with information an issuer discloses is essential.

Fourth and finally, I do not believe there is any serious doubt that Congress – or the SEC acting consistent with clear Congressional authority – may impose requirements of disclosure on attorneys for publicly-traded companies. I will not spend much time on this point. The effect on interstate commerce of the attorney conduct is clear, and federal requirements can be clearly tailored to address an important federal concern. As indicated above, I believe that imposing such requirements will often be a bad idea, but while I recognize the Subcommittee will be hearing from others whose views on this question differ from my own, the authority to impose federal rules that preempt state attorney regulation on questions relating to compliance with the federal securities laws seems to me clear.

U.S. House of Representatives Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Hearing on "The Role of Attorneys in Corporate Governance"
10 a.m., Wednesday, February 4, 2004
Room 2128 Rayburn House Office Building
Written Testimony of Professor Richard W. Painter
University of Illinois College of Law

Mr. Chairman and Members of the Committee:

I believe that it is preferable, where possible, to leave regulation to the states rather than to the federal government.[1] There are, however, exceptions, and Section 307 of the Sarbanes-Oxley Act is one of them. I pointed out in the early 1990's my frustration that, out of dozens of lawyers accused by federal banking regulators of aiding and abetting savings and loan fraud costing taxpayers billions of dollars, not one lawyer was disciplined by a state bar association. This was so even though many lawyers settled cases brought by federal regulators for twenty, thirty and even over forty million dollars.[2] Fact is that state bar discipline is virtually meaningless for policing the practice of securities and banking law.

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[1] See my Testimony and Prepared Statement Before the United States Senate Committee on Banking, Housing and Urban Affairs Subcommittee on Securities, reprinted in Hearing on S. 1260, The Securities Litigation Uniform Standards Act of 1998 (February 23, 1998) (stating reasons why federal preemption of state securities class actions was premature); and my Testimony and Prepared Statement Before the House of Representatives Committee on Commerce Subcommittee on Finance and Hazardous Materials, reprinted in Hearings on H.R. 1689, The Securities Litigation Uniform Standards Act of 1998 (No. 105-85) at 73-84 (May 19, 1998) (same).

[2] See Roger C. Cramton, Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues, 58 The Business Lawyer 143 (2002) (discussing how state bar discipline committees have failed to act against securities lawyers, including the savings and loan lawyers in the early 1990's); Richard W. Painter, The Moral Interdependence of Corporate Lawyers and their Clients, 67 S. Cal. L. Rev. 507, 572 (1994) (discussing large settlements paid by lawyers in the savings and loan crisis and the bar's failure to respond).

It is for this reason that I proposed in a 1996 law review article that Congress enact a statute requiring securities lawyers to report known illegal acts of corporate clients up-the-ladder to the client's full board of directors.[3] It is for this reason that I also appealed to the ABA in 1998 to amend its Model Rules of Professional Conduct to require such up-the-ladder reporting,[4] only to have my proposal rejected in favor of the then prevailing opinion that such matters lie with the discretion of the lawyer. Finally, it is for this reason that, in March of 2002, I and forty other law professors wrote SEC Chairman Harvey Pitt asking that the SEC promulgate rules requiring up-the-ladder reporting by securities lawyers.[5] The SEC in its reply letter deferred action on this proposal and cited my 1996 article for the proposition that Congress ought to be the body to enact such a rule.[6] That summer, Congress took up this invitation and, in a bipartisan amendment that became Section 307 required the SEC to promulgate an up-the-ladder reporting rule, along with whatever other rules for securities lawyers the SEC believes are necessary for the protection of investors.

Section 307 and the SEC rules thereunder appear to be working. Just last month the new York Times reported that because of Section 307 outside lawyers for TV Azteca, Mexico's second largest broadcaster, told its board that the company violated United States securities laws.[7] For the most part, I support the SEC's final rules under Section 307 and would be happy to go into further detail in my testimony if you would like.[8]

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[3] See Richard W. Painter and Jennifer E. Duggan, Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation, 1996 SMU Law Review 225, 263 (1996).
[4] See Proposal to Amend Model Rule 1.13 (Organization as Client), presented in testimony before the ABA Ethics 2000 Commission, May 1998, and reprinted in The Professional Lawyer, Spring 1998 at 10 (ABA).
[5] See Letter dated March 7, 2002 from Richard W. Painter et. al, to Harvey Pitt, Chairman of the Securities and Exchange Commission (proposing a mandatory up-the-ladder reporting rule).
[6] See Letter dated March 28, 2002, from David Becker, General Counsel for the Securities and Exchange Commission, to Richard W. Painter ("As you noted in the 1996 SMU Law Review article which you enclosed, there may be reasons to prefer having one uniform nation-wide rule governing lawyers who participate in nation-wide securities practices; but there are also good reasons why consideration of such a significant change in established practice should be undertaken in the context of Congressional legislation, as opposed to agency rulemaking, As I understand it, your 1996 article concludes that any such changes to the rules governing lawyers should be the result of Congressional changes to the securities laws, analogous to Section 10A's rules for accountants.").
[7] See Patrick McGeehan, Lawyers Take Suspicions on TV Azteca to its Board, New York Times, December 24, 2003 at Page C1 (reporting that "In one of the first applications of a new provision of the Sarbanes-Oxley Act, outside lawyers [at Akin Gump Strauss Hauer & Feld in New York] for Mexico's second-largest broadcaster have told its board -- and, possibly, federal regulators -- that they think that the company violated United States securities laws.")
[8] My comments on the proposed rules are in my letter dated December 12, 2002 to Jonathan Katz, Secretary of the SEC. See http://www.sec.gov/rules/proposed.

With respect to the SEC's proposed rules which have not yet become final, the most controversial would require "noisy withdrawal" if up-the-ladder reporting is unsuccessful.[9] Withdrawal from a securities representation is necessary if the client insists on violating the securities laws. Indeed, a law firm that wants to limit its liability exposure almost certainly would withdraw. While I do not strongly oppose the SEC's proposal, I am not convinced that mandating the "noise" is necessary. Even a quiet withdrawal should convey the message to vigilant regulators, underwriters and others that something is wrong. Furthermore, few lawyers, once they withdraw, will allow a former client to perpetrate a fraud for which the lawyers themselves could be sued. In sum, the SEC should require prompt withdrawal from securities law representation of a client that refuses to obey the securities laws, but should probably leave the amount of noise accompanying the withdrawal up to the lawyer.

There are also other issues that the SEC should address that are more important than the debate over noisy withdrawal. One is the fact that up-the-ladder reporting is triggered by a knowledge requirement in the final SEC rules that is too stringent and arguably does not comply with the broader language of the statute which requires lawyers to report "evidence" (not just "knowledge") of a violation. Section 307 thus requires the SEC to

> "issue rules, in the public interest and for the protection of investors . . . requiring an attorney to report *evidence* of a material violation of securities law or breach of fiduciary duty or similar violation by the company . . . " (emphasis added).[10]

Section 307 thus clearly states, without limitation or other qualifying language, that evidence of a violation should be reported by the attorney. The SEC's final rules under Section 307, however, define "evidence" so narrowly as to eviscerate this reporting obligation. "Evidence of a material violation" is defined in the final rules to mean

> "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."[11]

With this double negative, the definition appears to say that all reasonable attorneys would have to agree that a violation is likely for a report to be required. In circumstances where a reasonable attorney could fail to conclude that a violation is likely, up-the-ladder reporting apparently is not required under this definition, even if the vast majority of reasonable attorneys would disagree and believe that a violation is likely. If Congress's objective in Section 307 was to require lawyers to report evidence of violations that

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[9] See Release No. 33-8186; 34-47282; IC-25920 (proposing 17 C.F.R. Parts 205, 240 and 249). See http://www.sec.gov/rules/proposed.shtml

[10] Sarbanes-Oxley Act Section 307, codified at 15 U.S.C.A. Section 7245 (Supp. 1 2003).

[11] 17 C.F.R. Part 205.2(e) (definition of "Evidence of a material violation"), adopted in Release No. 33-8185; 34-47276; IC-25919. See http://www.sec.gov/rules/final.shtml.

senior officers and directors should be aware of because the circumstances pose substantial risk to the corporation and its investors, this threshold definition fails to do the trick.

Second, the SEC needs to consider how easy or difficult it is for issuers to use the alternative provided for in the rules, which is reporting to a Qualified Legal Compliance Committee (QLCC) instead of to the client's full board. I urged in earlier law review articles[12] and commentary letters to the SEC that such opt-out mechanisms are useful because they allow client directors flexibility in deciding how future violations will be dealt with. If, however, the composition and responsibilities of the QLCC are such that few clients plan to use them, the opt-out mechanism is meaningless. Of particular concern is whether qualified individuals are willing to serve on such committees or decline to do so because of liability concerns. The SEC should continue to solicit commentary on how this aspect of its rules is working in practice.

Third, the SEC should be cognizant of the extraterritorial application of its rules under Section 307. Lawyers perform different tasks for clients in different countries, and boards of directors are structured differently. For example, the SEC's rule requiring a QLCC to consist solely of independent directors is probably unworkable for issuers incorporated in Germany and other jurisdictions that require employees to sit on corporate supervisory boards. The SEC should thus consider permitting non-U.S. issuers to include an employee on the QLCC.[13] Perhaps most important, the proposed noisy withdrawal rule conflicts with attorney regulations in many countries. These include Japan,[14] a country with far fewer lawyers that the U.S. and whose lawyers rarely advise clients on U.S. securities laws.[15] Given the limited role that foreign attorneys have in

[12] See Painter and Duggan, *Lawyer Disclosure of Corporate Fraud*, supra, at 266-270 (1996) (describing advantages of using such default and opt-out rules for reporting of corporate fraud); Richard W. Painter, Rules Lawyers Play By, 76 NYU Law Review 665, 719 (2001) (suggesting that a client should be allowed to direct up-the-ladder reporting to a compliance committee instead of to a client's full board of directors).

[13] See Letter dated April 7, 2003 from Sullivan & Cromwell to Jonathan G. Katz, Secretary of the SEC (suggesting such an exemption). Similar issues are also discussed in various comment letters by foreign lawyers and bar associations to the SEC, available at http://www.sec.gov/rules/proposed/s74502.shtml.

[14] See letters dated December 14, 2002 and March 31. 2003 from The Japan Federation of Bar Associations (Nihon Bengoshi Rengokai) to Jonathan G. Katz, Secretary of the SEC (stating that the noisy withdrawal proposal directly conflicts with the duty of confidentiality under Article 23 of Chapter IV of the Practicing Attorney Law of Japan, and that the SEC's alternative proposal of requiring issuer disclosure of the attorney's withdrawal, while not directly conflicting with Japanese law, would undermine the purpose of that law, which is to facilitate open attorney-client communication).

[15] See letter dated December 14, 2002 from The Japan Federation of Bar Associations to Jonathan G. Katz, supra (stating that "In practice, Japan Attorneys usually play only a supporting role in assisting U.S. attorneys in the submission of registration statements

advising their clients on U.S. securities laws, the SEC should be reticent about applying its Section 307 rules to attorneys outside our borders.

In this respect, the SEC's final rules are a significant improvement over its proposed rules.[16] It is possible that exemptions for foreign lawyers will drive legal business overseas, but such fears are exaggerated because U.S. securities lawyers are usually best positioned to represent clients in connection with U.S. securities laws. Furthermore, lawyer reporting rules are unlikely to be a deciding factor in selection of counsel because an issuer, by setting up a QLCC, can also avoid a required report to its full board, and avoid the proposed noisy withdrawal provision. Issuer selection of foreign counsel in order to avoid the SEC rules is thus both unnecessary and unlikely.

Finally, Congress in Section 307 gave the SEC a broad mandate to promulgate those rules of professional responsibility for securities lawyers that the SEC believes necessary for the protection of investors, a mandate not limited to up-the-ladder reporting.[17] The SEC should give serious thought to other ways it can promote high standards of professionalism among lawyers who represent issuers before it.

On one clearly relevant topic, I have asked the SEC to consider whether it is appropriate for lawyers to charge contingent fees in securities transactions.[18] I pointed out that in the Time-Warner/AOL merger, one of the most disastrous mergers in corporate history, Time-Warner's counsel was reported in the press to have received a $35 million fee that was contingent on the deal closing (the fee would have been closer to $5 million if the deal had not closed).[19] While I do not believe that Time-Warner received anything other

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and other securities filings with the Commission. . . . [and] are necessary to assist in the filing process in the role of local counsel to Japanese issuers").

[16] See 17 C.F.R. Part 205.2(j) (definition of "Non-appearing foreign attorney"), adopted in Release No. 33-8185; 34-47276; IC-25919. This definition was absent from the proposed rules, which would have covered a broad range of foreign attorneys involved in securities filings.

[17] See Sarbanes-Oxley Act Section 307, codified at 15 U.S.C.A. Section 7245 (Supp. 1 2003) (stating 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* . . . [the up-the-ladder reporting rule set forth in subsections (1) and (2) of the statute]." (emphasis added) The plain text of the statute – its use of the plural for "rules" and "standards" and the word "including" – clearly demonstrates that up-the-ladder reporting was not the only subject matter that Congress expected to be covered by the SEC's rules for attorneys.

[18] See my Letter dated September 10, 2002 to Mike Eisenberg, SEC Deputy General Counsel (setting forth suggestions for SEC rules under Section 307, and asking that the SEC consider whether contingent fees are appropriate in securities transactions).

[19] Id. Before it became clear in 2003 that the Time-Warner/AOL merger was a debacle and questions arose about the integrity of AOL's prior financial reporting, press reports praised both the merger and Time-Warner's contingent fee arrangement with its lawyers

than the most competent and loyal advice from counsel, this is not the type of transaction for which a contingent fee is appropriate.[20] Counsel should be paid to ferret out problems with a transaction as well as to promote its virtues, and legal fees that depend so much on whether a deal closes undermine this objective.[21] The SEC should, under its Section 307 mandate, say something about fee structures that create perverse incentives for lawyers in situations where a transaction may be ill advised, or worse yet where closing a transaction would violate federal securities laws.[22]

In conclusion, while the noisy withdrawal debate has received much attention, I urge the SEC to consider requiring withdrawal without requiring noise, and then to move on to other more pressing issues in carrying out its Congressional mandate.

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at Cravath, Swaine and Moore. See e.g. Karen Hall and Kristin Eliasberg, Cravath's Contingency, The American Lawyer, February, 2001 (describing the fee arrangement as a "win-win" deal for Time-Warner and Cravath) ("each side deserves credit for structuring it so that the other was satisfied at the end. . . "). Accounting considerations may in part motivate such contingent fee arrangements. If a deal does not close, the company normally must account for legal fees spent on the transaction as an operating loss. If the deal closes, however, legal fees can be accounted for "below the line" as a capital expenditure. This meant that "Time Warner essentially hedged its earnings downside in the event the deal bombed." Id. Once again, the fact that the deal eventually would "bomb" a little over a year after its "successful" closing was apparently not known at the time.

[20] My knowledge of the fee agreement is from news reports rather than first hand, and I am not aware of any evidence that Time Warner's lawyers did less than exemplary work on the Time-Warner/AOL merger. My concern here is to point out that such fee arrangements may in other contexts discourage lawyers from putting a stop to transactions that are not in the interests of clients or investors. A lawyer's job is sometimes to say "no" to a deal, and a contingent fee arrangement makes it very hard to say anything but "yes."

[21] Although fee agreements that give lawyers stock in a client pose conflict problems of their own, they are superior to contingent fees for corporate transactions because at least the lawyers have an incentive to look out for the long term interests of the client, which may or may not be in closing a particular deal.

[22] See Hall and Eliasberg, supra ("'If the goal was to get Cravath highly focused, it worked,' says a lawyer close to the deal. 'The whole firm focused on getting this transaction done.'"). Although the legal work consisted in large part of wrangling with the FTC over antitrust issues connected with the merger, it appears that collapse of the deal for any reason – including if Time-Warner had uncovered problems in AOL's financial reporting – would have jeopardized Cravath's fee.

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February 3, 2004

The Honorable Michael G. Oxley
Chairman
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Richard Baker
Chairman
Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
Washington, D.C. 20515

Attention: Ms. Sapna Delacourt (sapna.delacourt@mail.house.gov)

Re: Subcommittee Hearing on "The Role of Attorneys in Corporate Governance"
Scheduled for February 4, 2004

Dear Messrs. Chairmen:

Because I am unable to appear at the Hearing, I submit these comments relating to the role of lawyers in corporate governance and request they be made part of the record. I speak for myself alone. Because of my extensive involvement with the American Bar Association (ABA), however, I will refer to some ABA measures intended to provide a greater role for lawyers in corporate governance, as well as to my personal experiences regarding Section 307 of the Sarbanes-Oxley Act of 2002 (the Act) and related SEC rules. My biography is Attachment 1 to this letter.

The ABA's response to the notorious lapses in corporate governance responsibility included the appointment in March 2002 of a Task Force on Corporate Responsibility charged to develop how the current system of corporate governance might be improved. The Task Force was chaired by James S. Cheek, Esquire, of the Nashville, Tennessee Bar, an experienced securities lawyer.

On July 16, 2002, the ABA Task Force submitted a Preliminary Report proposing measures to improve corporate governance, with particular emphasis on ways to increase the effectiveness of lawyers who represent public companies. The Task Force's final Report, issued on March 31, 2003, is available at http://www.abanet.org/buslaw/corporateresponsibility/home.html.

The recommendations of the ABA Task Force were contained in three resolutions adopted by the ABA House of Delegates in August 2003, also available at the above address. These included (1) practices to enhance the role of lawyers in corporate governance; (2) amendments to ABA Model Rule of Professional Conduct 1.13 to emphasize that corporate lawyers represent the organization rather than management as individuals; and (3) amendments to ABA Model Rule 1.6 specifically providing that lawyers may reveal client information to prevent or rectify serious financial losses in certain circumstances.

Included in the corporate governance improved practices (Item 1) among other recommendations are the following:

- The board of directors should establish a pattern of holding regular, executive session meetings among the company's general counsel and its independent directors.

- Outside counsel should establish at the outset of the engagement a direct line of communication between outside counsel and the company's general counsel, as well as an understanding that outside counsel are obliged to apprise the general counsel of material violations or potential violations.

The ABA's Amendments to Model Rules 1.13 and 1.6 (Items 2 and 3) also are intended to strengthen the ability of legal counsel to assure the company's compliance with the law. ABA Model Rule 1.13 (Organization as Client) emphasizes that the lawyer for an organization represents the organization rather than managers individually. The Rule requires corporate lawyers to report misconduct "up the corporate ladder" to the company's senior management or, if necessary, to its board or independent directors, unless the lawyer reasonably believes that it is not in the best interest of the company to do so. This rule change closely parallels the standard adopted by the SEC in its Part 205 Rules under Section 307 of the Act. See § 205.3(b).

Similarly, the ABA's Model Rule 1.6 would now permit attorneys to divulge client information to the extent reasonably necessary to prevent or rectify reasonably certain substantial financial injury to third parties arising from the client's crimes or fraud in which the lawyer's services are used. These provisions are consistent with the existing lawyer disciplinary rules of about forty-two states and are substantially similar to provisions of the SEC's Part 205 Rules. See §§ 205.4, 205.5.

The ABA in November 2002 appointed a Task Force on Section 307 of the Sarbanes-Oxley Act of 2002 that I chair. The Task Force helped to prepare recommendations sent by the ABA to the SEC concerning its proposed Part 205 Rules. The ABA expressed general support for the

SEC's final "up the ladder" rule in its April 2, 2003 Comment Letter, but noted serious concerns regarding the Commission's two "noisy withdrawal" proposals. ABA comment letters are available at http://www.sec.gov/rules/proposal/S74502/aba040203.htm (filed 4/2/03) and http://www.sec.gov/rules/proposed/S74502/apcarlton.htm (filed 12/18/02).

Despite some criticism and continuing concern over their breadth and interpretive uncertainty expressed by the ABA and others, the up-the-ladder rules have found general acceptance among lawyers and their company clients. This is because the rules do not depart significantly from most state ethics standards and are recognized as having established some clear benefits in enhancing the lawyer's role in helping to improve corporate governance.

Thus, the SEC has addressed reporting out by <u>permitting</u> lawyers to report evidence of serious client crimes to the SEC, notwithstanding any inconsistent state rules. As noted above, the SEC's permissive reporting rule resembles exceptions in the ABA Model Rules and lawyer conduct rules that apply in all but 8 states. The rules the Commission continues to consider would, however, increase the obligations of lawyers well beyond reporting up the ladder and permissive reporting outside the company by forcing lawyers to resign from representing companies with the resignations reported to the SEC.

The "noisy withdrawal" rule under consideration would require a lawyer, if (1) having reported evidence of a material violation up the ladder the lawyer fails to receive an "appropriate response" within a reasonable time, and (2) the lawyer reasonably believes that a material violation is ongoing or about to occur that is likely to result in substantial injury to the financial interest of the company or investors, to withdraw forthwith from representing the issuer based on "professional considerations," so notify the company and, within one business day, also notify the Commission and promptly disaffirm to the Commission any materially false or misleading document or representation. See Part 205 Rules, proposed § 205(d)(1).

The alternative rule that the Commission also is considering would require the lawyer to withdraw in circumstances similar to those just described. But the company (rather than the reporting lawyer) would then have to report publicly the lawyer's withdrawal from representing the company for "professional considerations." See Part 205 Rules, proposed § 205.3(e).

This alternative would not, however, eliminate the fundamental policy concerns regarding harm to the client-lawyer relationship and interference with effective corporate governance that many of us believe would result from mandatory noisy withdrawal. Mandating lawyer withdrawal at all would deny lawyers the flexibility they need to counsel clients effectively on compliance with complex securities laws. It might, for example, encourage lawyers to withdraw prematurely rather than continue to counsel legal compliance regarding difficult issues – when companies most need the lawyer's advice. If the lawyer withdraws prematurely, the damage to the company and its stockholders could have serious adverse consequences. Even worse, because of the serious consequences that would flow from identifying a possible material violation, a mandatory withdrawal requirement might prompt some lawyers to avoid asking the hard questions that enable them to effectively counsel legal compliance.

Requiring that the lawyer withdraw followed by immediate mandatory reporting by the lawyer or the company could, in addition, severely damage companies and their investors through public disclosure of a withdrawal that might have been unwarranted. The company's board might feel forced to disclose damaging information despite justifiably believing that no material violation has occurred solely to avoid the lawyer's withdrawal, the resulting company reporting and its consequences – likely a full scale SEC investigation and private class action suit. While an SEC mandatory noisy withdrawal and reporting requirement might make a difference in the rare situation in which it would be invoked, the mere existence of such a requirement would be likely to make clients reluctant to confide in their lawyers. For these and other reasons, it seems clear to many that either of the SEC's pending proposals would be more likely to harm than protect companies and their investors. In this respect, the pending mandatory withdrawal standards for lawyer conduct do not appear to be "in the public interest and for the protection of investors," as Section 307 requires.

Of course, when a lawyer knows her services are being or will be used to assist the client in a crime or fraud, she must terminate assistance and if necessary withdraw from representing the client. When it becomes clear, for example, that a client is using its lawyer's services to help accomplish material violations of securities law, the lawyer who continues to assist the client would not only violate disciplinary rules but also engage in illegal and possibly criminal conduct already subject to severe sanctions.

The SEC's Part 205 Rules that provide for permissive reporting out, allow lawyers sufficient flexibility to dissuade clients from criminal or fraudulent activities where the lawyer is likely to be implicated and, if that fails, to protect innocent third parties against substantial financial injury as well as avoid personal liability themselves. Moreover, as the SEC has indicated in *Carter & Johnson* [1981 WL 36552 (SEC 1981)], the best way to assure compliance is to encourage lawyers to continue counseling clients to comply with law, rather than to provide incentives for withdrawing prematurely because of concern for their own liability. It recognized that, short of assisting fraud, a lawyer's continuing to counsel compliance with the law serves both the public interest and the interests of the company and its investors.

In these circumstances it seems to me unwise to adopt either of the mandatory withdrawal and reporting out rules still under consideration, or to legislate further on lawyers' professional conduct before the SEC. Ample sanctions already exist. Moreover, voluntary compliance so necessary to the effective operation of the securities law is well under way. For example, Lawyers for TV Azteca, Mexico's second largest broadcaster, reportedly applied the SEC's Part 205 Rules to persuade Azteca's independent directors to investigate the adequacy of disclosure of its executive officer's dealings in Azteca's debt instruments. Steven H. Scheinman of Akin Gump's New York office is reported to have written the directors that the Firm had withdrawn from representing Azteca because, in their opinion, certain transactions that the chief executive officer and the general counsel decided not to disclose were required to be disclosed pursuant to U.S. Securities law. Citing Section 307 of the Act, Mr. Scheinman also reserved the right to inform the SEC of the Firm's withdrawal from the representation. (*New York Times*, 12/24/03, page C1, col. 6)

It is clear to those of us involved in the work of the ABA Section of Business Law that securities lawyers all over the country have adopted § 307 guidelines within their law firms. Many firms have conducted § 307 compliance programs that are mandatory for all lawyers, not just securities law specialists. More significantly, greater vigilance by independent directors and in-house corporate counsel is evident in public companies, and requiring more timely and precise financial disclosures will surely have an enormous impact in assuring that public companies comply with securities law.

We hope that these and many other measures already in place will be given a chance to work, as we believe they will.

Thank you for the opportunity to present my views.

Respectfully yours,

M Peter Moser

M. Peter Moser

MPM:mwc
Attachments

Piper Rudnick

M. Peter Moser, is of counsel to Piper Rudnick LLP and serves on its Ethics Committee. Mr. Moser is Chair of the American Bar Association (ABA) Task Force on Section 307 of the Sarbanes-Oxley Act of 2002. His practice emphasizes corporations, tax and estate planning, and counseling attorneys in legal ethics, malpractice and disciplinary matters, and has also included trial and appellate advocacy. Mr. Moser has written extensively in the areas of judicial conduct and lawyer professional responsibility and has taught these subjects at the University of Baltimore and University of Maryland Law Schools. He has served on various governmental commissions, including the Maryland State Ethics Commission as Chair, the Maryland Attorney Grievance Commission as Chair, and the Maryland Constitutional Convention as Local Government Committee Chair. He currently serves as a consultant to the Maryland Court of Appeals Rules Committee regarding the revised MD Code of Judicial Conduct and amendments to the MD Rules of Professional Conduct for Lawyers, and as a member of the Court of Appeals MD Rules of Professional Conduct Revision Committee. Mr. Moser was an Adviser to the ALI American Law Institute Law Governing Lawyers Restatement project. He was a member of the American Bar Association House of Delegates for 24 years, served on the ABA Ethics Committee and as its Chair, was ABA Treasurer and a member of the ABA Board of Governors. He currently is President of the American Bar Foundation. He also has been President of the Maryland State and Baltimore City Bar Associations. Mr. Moser received his B.A. from The Citadel and his LLB. from Harvard Law School.

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Attachment 1

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