

## Comment

# Should Attorneys Be Footsoldiers in the War on Corporate Fraud?

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A SLOW BUT steady march out of recession in the early 1990s set the stage for what would become one of the greatest explosions in growth of the capital markets. It was an unprecedented combination of excess venture capital, coupled with the new and seemingly limitless potential of developing computer technologies, particularly the internet, which created the now infamous “dot-com” boom that culminated in early 2000. From 1995 to the beginning of 2000, the Dow Jones Industrial Average<sup>1</sup> (“DJIA”) went from a value under 4000 to nearly 12,000,<sup>2</sup> representing an almost 300 percent increase.

By early 2000, the bubble had begun to burst, and companies began to collapse by the hundreds.<sup>3</sup> As stock prices tumbled, it became increasingly apparent that the downturn was not simply the product of a weak economy. “[I]rrational exuberance,” as Federal Reserve Chairman Alan Greenspan termed it,<sup>4</sup> had seemingly encouraged companies themselves to dabble in accounting sleight of

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\* Class of 2004. The author dedicates this Comment to his parents, whose support, love, and encouragement have been invaluable.

1. See BLACK'S LAW DICTIONARY 507 (7th ed. 1999) (“A stock-market-performance indicator that consists of the price movements in the stocks of 30 leading industrial companies in the United States.”).

2. See Michael Gonzalez, *Stock Prices Rebound and Ease Investors' Fears of Rising Rates*, WALL ST. J., Mar. 9, 1995, at C2 (noting that the Dow Jones Industrial Average (DJIA) was 3979.23 on Mar. 9, 1995); see also Robert O'Brien, *Chase, J.P. Morgan and Citigroup Slide, as Rate Fears Roil Stocks*, WALL ST. J., Jan. 4, 2000, at A1 (noting that the DJIA was 11357.51 on Jan. 4, 2000).

3. For a partial list of internet companies which disintegrated during this era, see HOOVER'S ONLINE, DEAD DOT-COM LIST, at [http://www.hoovers.com/news/detail/0,2417,11\\_3584,00.html](http://www.hoovers.com/news/detail/0,2417,11_3584,00.html) (last accessed March 22, 2003).

4. Chairman Greenspan first coined this famous phrase in a 1996 speech. See David Wessel, *Fed Chairman Pops the Big Question: Is Market Too High?*, WALL ST. J., Dec. 6, 1996, at A3.

hand, overstating earnings and painting an overly rosy picture of a financial garden that was tattered with weeds.<sup>5</sup>

The coup de grace was the collapse of the Enron Corporation, which filed for bankruptcy protection in December of 2001.<sup>6</sup> All the skeletons in its closet were released and the nightmare was revealed—earnings had been overstated by \$567 million, plus many of its thousands of hard working blue collar employees suffered the loss of over \$1 billion in pension plan savings.<sup>7</sup>

Even the passive, pro-business Bush administration could not ignore the political disaster that was destroying the lives of so many honest Americans. Washington was pressed to act in order to prevent a similar scandal from ever happening again. The proposed legislation, co-sponsored by Senator Paul Sarbanes and Representative Michael Oxley<sup>8</sup> and bearing their names, was the Bush administration's response to the charlatans of Wall Street.<sup>9</sup>

The bill's main goals were to increase oversight of the accounting industry,<sup>10</sup> and increase civil and criminal penalties for corporate malfeasance.<sup>11</sup> The bill also contained provisions detailing new rules of professional responsibility for attorneys who appear and practice before the Securities and Exchange Commission ("SEC").<sup>12</sup> These provisions, known as the Standards of Professional Conduct for Attorneys, place a greater burden on securities attorneys to police corporate malfeasance. They have generated a great debate about the new role attorneys will play in the securities bar—especially relating to the traditional requirement of attorney-client confidentiality.

This Comment will begin with an analysis of the economics following the Great Depression, as many of the issues that fueled the new legislation appeared years ago to encourage the creation of the SEC.

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5. See United States General Accounting Office, Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate 88, at <http://www.gao.gov/new.items/d03138.pdf> (last accessed Oct. 29, 2003) (stating that in 1997, 92 public companies filed earnings restatements, and by 2001 that number had increased to 244).

6. See Rebecca Smith, *Enron Files for Chapter 11 Bankruptcy, Sues Dynegy*, WALL ST. J., Dec. 3, 2001, at A3 (stating that Enron was, at the time, the largest bankruptcy filing in United States history). For a list of the largest United States filings, see Michael T. Burr, *Bankruptcy Gives United Second Chance at Taking Off*, 13 CORP. LEGAL TIMES 12 (Feb. 2003).

7. See John Emshwiller & Rebecca Smith, *Enron Jolt: Investments, Assets Generate Big Loss*, WALL ST. J., Oct. 17, 2001, at C1.

8. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

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

10. See Sarbanes-Oxley Act §§ 101–109.

11. See *id.* §§ 801–1107.

12. See *id.* § 307.

A brief discussion of the reporting requirements under the federal securities laws will follow, focusing on how the regulations are intended to help avoid investor fraud. Next, this Comment will review the role the corporate securities lawyer plays in the securities registration process and follow with a discussion of the corporate collapse that occurred during the late 1990s. Part II will introduce the new Sarbanes-Oxley legislation, giving an overview of the whole Act, then focusing on the specific requirements of the section 307 rules for attorneys. A discussion of the SEC comment and review process will precede an analysis of the final rules as issued by the SEC.

This Comment will then argue that the new rules for attorney conduct in section 307 are misguided, because corporate attorneys were not a source of the problem that led to the corporate meltdown. Unintended side effects of the new legislation will then be explored, focusing on potential loopholes in the new legislation that may prove fatal. A glimpse of the future follows, looking specifically at the proposed, but as yet unadopted noisy withdrawal and the ongoing changes to the ABA Model Rules, showing how the new laws will affect attorneys in unforeseen ways. This Comment will conclude by arguing that the reason companies like Enron were able to get away with such egregious fraud was because important safeguards for the market had been removed in the years leading up to the fiscal collapse. In addition, the passage of the Private Securities Litigation Reform Act ("PSLRA") in 1995 and the Supreme Court's decision to remove aiding and abetting liability for securities fraud worked to remove obscure but important market policing devices that hastened the downfall of the old order.

## **I. Background**

### **A. Overview of the Securities and Exchange Commission**

A look back at the creation of the Securities and Exchange Commission is instructive in light of the recent corporate meltdowns because it, too, was born from an era of unprecedented stock market fraud, resulting from a similar boom-to-bust decade.

During the 1920s, after the First World War ended, the United States entered a period of great economic gain, with economic growth averaging 5.9 percent per year.<sup>13</sup> American industries grew with considerably less competition because the European economies were in

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13. See THOMAS E. HALL & J. DAVID FERGUSON, *THE GREAT DEPRESSION* 44-61 (1998).

tatters following the horror of the First World War.<sup>14</sup> New technologies like the radio, the vacuum, and other household appliances were capturing the attention of the American consumer.<sup>15</sup> Companies like RCA, Ford, and AT&T dominated the era by producing fascinating new products with mass appeal.<sup>16</sup> Stock prices rose steadily throughout the decade, suffering only occasional and relatively minor drops in value in between.<sup>17</sup> The growth was fueled by speculation that the prices could only get higher.<sup>18</sup> One respected member of the Federal Reserve Board colorfully referred to 1929 as a "period of optimism gone wild and cupidity gone drunk."<sup>19</sup> Investors were buying stocks on margin, which is essentially a loan by a broker for the purpose of buying stock.<sup>20</sup> By the end of 1928, the interest rate a broker or bank could charge for loans on margin had risen to 12 percent.<sup>21</sup> This was an astonishing rate that encouraged an increasing influx of capital by institutions to support the speculation.<sup>22</sup>

The end of the boom market finally came in 1929.<sup>23</sup> Over the period of one week in late October, the New York Stock Exchange teetered on the edge of failure. Overvalued stocks purchased in margin accounts during a run-up of prices collapsed.<sup>24</sup> By the end of trading on black Tuesday, October 29th, the DJIA had lost almost half its value.<sup>25</sup> The rest of the story is history—a worldwide depression and

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14. *See id.* (noting the high unemployment rates and loss of population that Great Britain, Germany, and France suffered in the war).

15. *See* HALL & FERGUSON, *supra* note 13, at 17–18.

16. *See* HAROLD BIERMAN, JR., *THE CAUSES OF THE 1929 STOCK MARKET CRASH* 8 (1998). RCA was the high growth speculative stock of the day, reaching a pre-crash high of \$101 a share, sinking all the way to \$28 in early November 1929. *Id.*

17. *See id.* at 3 (noting that in 1922 the DJIA was valued at 91.0; by 1929 it had reached a value of 290.0).

18. *See id.* at 29.

19. *Id.* at 30.

20. *See* JOHN KENNETH GALBRAITH, *THE GREAT CRASH 1929* 20 (1979). If a stock continues to increase in value, then the margin loan can be repaid from the proceeds of the gain in price. However, when the price goes down, the investor must make up the difference when the margin loan comes due. Most loans by a broker are retrievable on demand, an event known as the margin call. When a margin call comes and stocks are falling, many investors can be quickly ruined by their margin obligations.

21. *Id.* at 22.

22. *Id.*

23. *See id.* at 88–89.

24. *See id.* at 88–107.

25. *See id.* at 111–113.

almost complete financial collapse of the American economy ensued.<sup>26</sup>

Ultimately, there were many factors which potentially led to the crash of 1929, such as overvaluation of stocks,<sup>27</sup> excessive purchasing in margin accounts,<sup>28</sup> and a tight monetary policy at the Federal Reserve.<sup>29</sup> However, a major element was outright fraud by companies listed on the stock exchange. At the time, there were no Federal laws governing the sales of securities to the public, and the various state laws in place were ineffective at policing the massive increase in stock transactions.<sup>30</sup>

In response, Congress passed the Securities Act of 1933<sup>31</sup> (" '33 Act") and the Securities and Exchange Act of 1934 (" '34 Act").<sup>32</sup> The main thrust of the '33 Act was to require that publicly traded companies disclose material information regarding their operations, so that an investor could weigh all of the risks and make a fully informed decision before purchasing stock.<sup>33</sup> A main element of this goal is an SEC registration requirement for any company that chooses to sell securities in interstate commerce to the public at large.<sup>34</sup> The goal of disclosure is not to pinpoint the risks and rewards of the individual security, but rather to provide all the necessary information that a rea-

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26. See generally HALL & FERGUSON, *supra* note 13 (taking a broad view of the international impact of the depression in which the U.S. stock market collapse was an event in a much larger chain).

27. See BIERMAN, *supra* note 16, at 1.

28. See *id.* at 71 (describing the huge volume of margin accounts in the late 1920s). In 1934, the Federal Reserve Board was given authority to set minimum requirements for margin purchases. See NORMAN G. FOSBACK, STOCK MARKET LOGIC 35 (1993).

29. See HALL & FERGUSON, *supra* note 13, at 29.

30. At the time, most states had various provisions forbidding fraud in the sale of securities. See DAVID L. RATNER & THOMAS LEE HAZEN, SECURITIES REGULATION 146 (5th ed. 1996).

31. 15 U.S.C. §§ 77a-77aa (1995).

32. *Id.* §§ 78a-78mm.

33. See Preamble to Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1995) ("An Act to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.").

34. See *id.* § 77e ("Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.").

sonable investor would require to make an informed purchase of the security.<sup>35</sup>

The requirements of the '34 Act augmented the registration process by requiring that an issuer who has filed under the '33 Act continue to report, at regular intervals, the financial condition of its company.<sup>36</sup> These reports are intended to keep investors apprised of any changes in the fortunes of their investment, and companies that file them are often referred to as "'34 Act reporting companies." Generally, there are two reports that a company must file with the SEC: an annual 10-K report, which is a detailed report of company finances and performance over the preceding fiscal year,<sup>37</sup> and a 10-Q, or quarterly report, which briefly summarizes company performance over the immediately preceding three month period.<sup>38</sup> When sudden or unanticipated events occur, such as the resignation of key management, sudden changes in earnings expectations, or other unforeseen events that might affect the value of a security, a company is required to file an 8-K report detailing the event and its potential effects.<sup>39</sup>

This extensive regulatory web is designed to keep current information flowing from the company to the investor so that they can constantly evaluate the merits of their investment. As long as the information provided is accurate, the goal of disclosure is met and in theory, fraud should be at a minimum. The goal and the reality do not always coincide so neatly.

## B. The Role of the Corporate Securities Attorney

Understanding the role of the securities attorney is critical to assessing his role in the corporate structure. This, in turn, is critical to a discussion of the scope of his ethical duty to the corporation, the directors and officers, and the shareholders. Although many professionals interact to produce the often voluminous SEC filings, the attorney

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35. See SECURITIES AND EXCHANGE COMMISSION, LAWS THAT GOVERN THE SECURITIES INDUSTRY, PURPOSE OF REGISTRATION, available at <http://www.sec.gov/about/laws.shtml#secact1933> (last accessed Mar. 23, 2003) ("A primary means of accomplishing these goals [of the '33 Act] is the disclosure of important financial information through the registration of securities. This information enables investors, not the government, to make informed judgments about whether to purchase a company's securities.").

36. See 15 U.S.C. § 781.

37. See 17 C.F.R. § 240.15d-1 (2003) ("Every registrant under the Securities Act of 1933 shall file an annual report . . . for the fiscal year in which the registration statement . . . became effective and for each fiscal year thereafter.").

38. See *id.* § 240.15d-13 (2003).

39. See *id.* § 240.15d-11 (2003).

occupies a position that involves him uniquely in critical financial transactions and decisions.

Securities attorneys come in two general varieties: those that represent the issuer of the securities and those that represent the underwriter, or investment bank.<sup>40</sup> Many companies also have in-house counsel who assist in the preparation of registration statements and reports,<sup>41</sup> but for large issuances of securities to the public, the issuer's counsel and underwriter's counsel square off in a battle over what information must ultimately be included in the registration statement.<sup>42</sup>

To avoid liability for any misstatements in a registration statement or any other '34 Act filings, the underwriter must exercise "due diligence" in reviewing the documents produced by the issuer,<sup>43</sup> a task typically relegated to the underwriter's counsel.<sup>44</sup> Underwriters, wishing to minimize their liability exposure for misstatements in registration statements, consequently demand great diligence on the part of their counsel.<sup>45</sup>

The standard for diligence for producing a registration statement is stated concisely in the '33 Act as "that of a prudent man in the management of his own property."<sup>46</sup> If this standard is met, the underwriter (and his counsel) will probably be found to have exercised "due diligence" and be exempt from liability if suit is brought by an investor who relied to his detriment on misleading information contained in a registration statement.<sup>47</sup>

However, under the due diligence defense offered under the '33 Act, an attorney can find safe harbor from liability for complicated financial information communicated in statements made by accountants.<sup>48</sup> When a so-called "expertised" portion of a statement is included in the filings, such as audited financial information from an

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40. See RATNER & HAZEN, *supra* note 30, at 16.

41. See *id.*

42. See MATTHEW BENDER & CO., SECURITIES LAW TECHNIQUES § 15.06 (2002).

43. See 15 U.S.C. § 77k(a)(5) (1995) (attaching civil liability for any materially misleading statements contained in a registration statement to "every underwriter with respect to such security."). For the companion '34 Act liability provision, see also 15 U.S.C. § 78r(a).

44. See BENDER & CO., *supra* note 42.

45. See *id.*

46. 15 U.S.C. § 77k(c).

47. See *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 692 (S.D.N.Y. 1968) (discussing in detail underwriters' counsel who failed to meet the due diligence threshold).

48. See 15 U.S.C. § 77k(b)(3).

accountant, the attorney need only have reasonable grounds to believe that it is true.<sup>49</sup>

Generally, therefore, an attorney working for an issuer is not responsible for checking the validity of the actual numbers contained in a financial statement. He is generally responsible for assuring that the statement contains no materially misleading statements, or as the Supreme Court has stated it, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available" to the investor.<sup>50</sup> A securities attorney is not an accountant, and therefore he is not liable for mistakes in the numbers that an accountant produces.<sup>51</sup>

The '34 Act, as noted previously, governs the ongoing reporting requirements once an issuer has filed a registration statement with the SEC.<sup>52</sup> There is no due diligence defense under the '34 Act for an attorney who is helping prepare the annual and quarterly reports. To attach liability to an attorney, an aggrieved investor must establish that the attorney was somehow engaging in fraud.<sup>53</sup> This is known as Rule 10b-5 liability, and was seen as a very powerful tool that investors could use to police fraud practiced by "any person" who "employ[ed] any device, scheme, or artifice to defraud."<sup>54</sup>

It was generally felt that all parties involved in the fraud could be liable under Rule 10b-5, but the Supreme Court ruled in 1994 that such liability could not extend to those who only aided and abetted the securities fraud.<sup>55</sup> Congress, in response to the limitations placed on Rule 10b-5 by the Court, passed legislation the following year to restore the ability of the SEC to go after aiders and abettors,<sup>56</sup> but did not extend the cause of action to private plaintiffs. Because of these developments, attorneys are largely shielded from liability under the

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49. *Id.* See also *BarChris*, 283 F. Supp. at 682 (detailing the due diligence defense as applied to all the actors generally involved in preparing registration statements for the SEC).

50. *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

51. See 15 U.S.C. § 77k(b)(3).

52. See *id.* § 78l.

53. See 17 C.F.R. § 240.10b-5 (2003).

54. *Id.*

55. See *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

56. 15 U.S.C. § 78t(e) (2001) ("any person that knowingly provides substantial assistance to another person in violation of a provision of this chapter, or of any rule or regulation issued under this chapter, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.").

'34 Act, unless they can be shown to be primary violators.<sup>57</sup> Successfully establishing that an attorney was a primary violator is nearly impossible, because they act as a link in the chain, and are not involved in assessing the validity of the financial statements, but instead assure that the required documents are filed with the SEC.

### C. The Corporate Collapse

It is essential to have a general understanding of the scope and nature of corporate greed as well as the regulatory atmosphere that led to the demise of corporate giants like Enron. To understand sweeping legislation such as this, one must also understand the source of the momentum that brought forth such rapid change.

This time around, no great crash woke the masses and shook them out of their irrational stock buying spree. Fundamentally, the stock market was on steadier ground than in 1929, and safeguards existed to prevent another total collapse.<sup>58</sup> The crisis that spurred the recent change came mostly from large corporations that abused the reporting requirements, engaged in creative accounting practices, and sculpted corporate arrangements to make complicated corporate transactions look and feel legitimate. No single company demonstrated this attitude more than Enron, and arguably no single company had more to do with the resulting flurry of legislative change.<sup>59</sup>

The fall of Enron alone would have been significant because of its size and the scope of its fraud,<sup>60</sup> but the scandals were illustrative of fraud endemic to corporations everywhere.<sup>61</sup> Trusted companies like Xerox were indulging in misleading accounting practices and eroding the trust of investors.<sup>62</sup> What was it that they did?

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57. See *Central Bank of Denver*, 511 U.S. at 177-78 ("The proscription does not include giving aid to a person who commits a manipulative or deceptive act. We cannot amend the statute to create liability for acts that are not themselves manipulative or deceptive within the meaning of the statute.").

58. See HALL & FERGUSON, *supra* note 13, at 165 (stating that the Federal Reserve is now keen in the face of sudden crisis to flood the financial system with money and lower interest rates quickly to maintain liquidity in the markets).

59. U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, *THE ROLE OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE*, S. REP. NO. 107-70, at 2-4 (2002).

60. See *id.* (noting that at the time of its bankruptcy filing, Enron was the seventh largest publicly traded corporation in America).

61. See Jesse Drucker & Henny Sender, *Sorry, Wrong Number: Strategy Behind Accounting Scheme*, WALL ST. J., June 27, 2002, at A9.

62. See James Bandler & John Hechinger, *Leading the News: SEC Says Xerox Misled Investors by Manipulating Its Earnings*, WALL ST. J., Apr. 12, 2002, at A3 (noting that Xerox "agreed to pay a record \$10 million civil penalty and restate its earnings covering four years to settle the SEC charges detailed in the complaint").

Enron was at the head of the class when it came to innovative accounting practices. In theory, the best way to boost the value of a company is to hide its losses while showcasing its gains. This allows a corporation to appear as if they are growing without limit, and without downside risk. Enron essentially created that scenario. It formed finance entities, called "Raptors," which were used to hedge against declines in volatile energy stocks.<sup>63</sup> The Raptors were subsidiaries Enron claimed were independently owned but were in fact financed almost entirely by Enron itself. Enron wanted to keep the assets and debts of these entities off its own financial statements, but to do so under the existing accounting rules, outside investors would have to put up at least three percent of the working capital for each one.<sup>64</sup> This made it possible to treat the Raptors as subsidiaries, and the gains and losses they suffered would not be reflected on Enron's balance sheets. However, the three percent investment came from a company called LJM2 Co-Investment LP, which was actually a partnership established by Enron's CFO, Andrew Fastow. He provided the Raptors with \$30 million in cash, the three percent required, which they promptly repaid plus a handsome \$10 million in profit.<sup>65</sup> The repayments meant that Enron itself was exposed to the liability entirely and was required to report the huge losses—almost \$500 million in six months—the Raptors suffered in its own financial statements. Enron was fully exposed to the liability that the Raptors were incurring, but investors had no idea because the information was not disclosed. The value of Enron's stock was ostensibly based on what it reported in quarterly and annual reports. These reports hid almost \$500 million in losses and investors were caught completely off guard.

In another coup, Enron's CEO Jeff Skilling convinced regulators in 1992 to allow the company to use market-to-market accounting methods, which allowed the energy giant to book earnings based on transactions that had occurred during each day.<sup>66</sup> This accounting method is similar to what brokerages use to record sales at the end of the day.<sup>67</sup> This change allowed Enron to book earnings from long term contracts as current income, even though it had received no payments and might never see them.<sup>68</sup>

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63. Kathryn Kranhold, et. al., *Following the Trail: As Enron Inquiry Intensifies, Midlevel Players Face Spotlight*, WALL ST. J., Apr. 30, 2002, at A1.

64. *See id.*

65. *See id.*

66. *See id.*

67. *See id.*

68. *See id.*

The dual process of shielding debt in off-balance-sheet entities, plus the inflated booking of income allowed Enron to appear as if it were taking over the world. The stock soared as investors piled on the bus, while the company continued to meet and exceed every one of its earnings forecasts. Eventually, the lies could no longer be kept, and as the stock price began to fall, the whole venture collapsed, leaving thousands unemployed, and their retirement funds in ruins.

## II. The Sarbanes-Oxley Amendments

By the summer of 2002, Congress had decided to take action and get tough on corporate malfeasance. In July 2002 a bill was passed which would curb the abuses and reinforce existing regulations.<sup>69</sup> The bill, co-sponsored by Senator Paul Sarbanes and Representative Michael Oxley,<sup>70</sup> was Congress's response to the declining confidence of investors in the capital markets.<sup>71</sup> The Act was signed into law by the President amid great fanfare on July 30, 2002.<sup>72</sup>

### A. Overview of the Entire Act

The Sarbanes-Oxley Act's ("the Act") main goals were to increase oversight of the accounting industry<sup>73</sup> and increase civil and criminal penalties for corporate malfeasance.<sup>74</sup> The majority of the damage done to corporate confidence during the meltdown came from actions by accountants<sup>75</sup> and heads of corporations.<sup>76</sup> Many accounting firms were offering clients consulting services, such as tax advice on certain dealings, or ways to shift assets to lower debt and avoid paying

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69. See Shailagh Murray, *Bill Overhauling Audit Regulation Passes in Senate*, WALL ST. J., Jul. 16, 2002, at A3.

70. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

71. See President George W. Bush, Remarks at Signing of Bill to Combat Corporate Fraud (Jul. 30, 2002) (transcript available at 2002 WL 1752435).

72. See Elisabeth Bumiller, BUSH SIGNS BILL AIMED AT FRAUD IN CORPORATIONS, N.Y. TIMES, Jul. 31, 2002, at A1.

73. See Sarbanes-Oxley Act §§ 101-109.

74. See *id.* §§ 801-1107.

75. See 148 CONG. REC. S6561-01 (daily ed. Jul. 10, 2002) (statement of Rep. Levin) ("One key factor [for the corporate misconduct] is the terrible performance of too many in the accounting profession.").

76. See *id.* (noting that the Rigas family, controlling members of the publicly traded Adelphia Communications, were accused of borrowing over \$2 billion from the company and failing to pay it back, driving the company into bankruptcy).

taxes.<sup>77</sup> At the same time, they were acting as the auditor for the financial statements of the company.<sup>78</sup>

This dual role created some difficult conflicts of interest because the accounting firms were motivated by the need to retain the lucrative consulting business to increase their earnings.<sup>79</sup> To meet this end, they had to avoid chaffing a CEO who was pushing to meet the market earnings expectations that Wall Street demanded.<sup>80</sup> The result was that accounting firms became softer in their review of financial statements by a corporation, often accepting and categorizing income and expenses in creative ways.<sup>81</sup>

The CEOs themselves were also seen as charlatans, and rightfully so, based on the actions of many in their ranks, like Kenneth Lay at Enron, Bernard Ebbers at WorldCom, and Dennis Kozlowski at Tyco.<sup>82</sup> These CEOs misused the trust of their shareholders by engaging in various forms of fraud to mislead investors.

The Sarbanes-Oxley Act of 2002 sought to address the entire potpourri of grievances against corporate America. Title I established a new Public Accounting Oversight Board,<sup>83</sup> probably the largest and most significant change in the law. This board will act as a regulatory body to supervise accountants,<sup>84</sup> set industry standards,<sup>85</sup> and imple-

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77. *See id.* The most notorious example was the relationship between Enron and Arthur Andersen, LLP. "By 1999, Andersen was earning more for its non-audit services than for its audit services at Enron." *Id.*

78. *See id.* ("[I]n many cases the same Andersen employee served as both consultant and auditor, essentially auditing his or her own work.")

79. *See id.* ("By 1999, 50% of firm revenues at the big five accounting firms came from consulting, while only 34% came from auditing. A few years later, the data indicates that almost 75 percent of the fees earned by the big five accounting firms came from non-audit services. Specific company proxy statements show that many publicly traded companies now pay millions more for consulting than they do for auditing.")

80. *See id.* ("Common sense tells us that as Andersen's joint efforts with Enron management increased, it became tougher and tougher for Andersen auditors to challenge Enron transactions—after all, these transactions had been set up with Andersen's assistance at the cost of millions of dollars.")

81. *Id.*

82. *See Pia Sarkar, Ex-CEO Bernie Ebbers Flew High, Fell Hard and Took the Telecom Giant with Him*, S.F. CHRON., Dec. 27, 2002, at B1.

83. *See Sarbanes-Oxley Act of 2002*, Pub. L. No. 107-204, §§ 101–109, 116 Stat. 750–769 (2002).

84. *Id.* § 104(a) ("The Board shall conduct a continuing program of inspections to assess the degree of compliance of each registered public accounting firm and associated persons of that firm with this Act.")

85. *Id.* § 103(a)(1) ("The board shall, by rule, establish . . . through adoption of standards . . . such auditing and related attestation standards, such quality control standards, and such ethical standards to be used by registered public accounting firms.")

ment punishment for breaking the rules.<sup>86</sup> It will, in many ways, serve the same function for the accounting industry that the SEC has for the securities industry.

Title II addressed the problem of auditor independence.<sup>87</sup> As noted above, the dual role played by many of the large accounting firms—offering consulting services while having to perform audits for the same company—created a conflict of interest that needed attention. This section of the Act clearly defines actions that are outside the scope of an auditor's services,<sup>88</sup> and even contemplates that the major accounting firms be required to rotate after a certain number of years in service of one company, to avoid sweetheart deals and laxity from long term business relationships.<sup>89</sup>

Title III was directed at the heads of corporations, particularly the malfeasant CEOs.<sup>90</sup> This section forces CEOs, who sign an accounting statement, to forfeit any performance bonuses received if that statement is fraudulent.<sup>91</sup> Further, it requires CEOs nationwide to certify that their statements are accurate and true, attaching personal liability if these statements are in fact untrue.<sup>92</sup>

The remaining Titles of the Act, IV through XI, focus on miscellaneous issues that arose from the scandals, including enhanced sentencing for white collar crime,<sup>93</sup> penalties for tampering,<sup>94</sup> and retaliation against informants of malfeasance.<sup>95</sup>

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86. *Id.* § 105(a) ("The Board shall establish, by rule . . . fair procedures for the investigation and disciplining of registered public accounting firms and associated persons of such firms.").

87. *See id.* §§ 201–209.

88. *See id.* § 201. This is a toughly worded section which prohibits an accounting firm engaged in providing auditing services to also provide, inter alia, "(3) appraisal or valuation services . . . (7) broker or dealer, investment advisor, or investment banking services . . . (8) legal services and expert services unrelated to the audit . . . (9) any other service that the Board determines, by regulation, is impermissible." *Id.*

89. *See id.* § 207. Although not likely to occur, this section does require that the "Comptroller General of the United States shall conduct a study and review of the potential effects of requiring the mandatory rotation of registered public accounting firms." *Id.*

90. *See id.* §§ 301–307.

91. *See id.* § 304(a)(1).

92. *See id.* § 302(a).

93. *See id.* §§ 801–807.

94. *Id.* § 1102.

95. *See id.* § 1107.

## B. Section 307—New Rules for Attorneys

Section 307 was bundled into Title III of the Act, which carries the title “Corporate Responsibility.”<sup>96</sup> It increases responsibilities for attorneys who represent public companies by requiring them to disclose evidence of possible fraud “up the ladder,” starting with the chief legal counsel of the corporation.

The term “up the ladder” comes from analogizing the corporate structure to a ladder, with the full board of directors at the top, and the attorney somewhere further down on a lower rung. Each interval above the attorney is occupied by a management level employee of the corporation, beginning with the chief legal officer of the company.<sup>97</sup> Next is the CEO, then the audit committee of the board of directors, then, if available, a committee of the company consisting of directors not employed by the company.<sup>98</sup> The idea is that the attorney, upon coming into contact with evidence of a possible securities violation, will report to each of these persons or groups in turn, going up the ladder until he reaches the top. The structure is based on the assumption that the company’s board of directors, as shareholder representatives, would not sanction securities violations committed by the CEO or others in employ of the company. Thus, the attorney serves as an internal whistleblower, alerting management higher and higher on the ladder until the fraud is smoked out.

Section 307 requires that the SEC “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.”<sup>99</sup> Congress then directs the SEC, through the language of the statute, to implement a rule which models the “up the ladder” disclosure detailed in subsections (1) and (2).<sup>100</sup> Congress, however, allowed the SEC to retain its rule-making authority by including the words “including a rule” in the statute before the description of the “up the ladder” model.<sup>101</sup> The use of this wording indicates that Congress wants the SEC to implement the “up the ladder” reporting requirement, but also wants the SEC to implement other rules as the agency deems necessary.

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96. *See id.* §§ 301–308.

97. *See* 17 C.F.R. § 205.3(b)(2) (2002).

98. *See id.* § 205.3(b)(3).

99. Sarbanes-Oxley Act § 307.

100. *Id.*

101. *Id.*

In subsection (1) the law requires an attorney “to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company.”<sup>102</sup> This is the first rung of the ladder for disclosure.

If the chief executive officer or chief legal counsel fails to “appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation),”<sup>103</sup> the attorney then has a duty to “report the evidence to the audit committee of the board of directors . . . or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.”<sup>104</sup>

By the time the attorney reaches the board of directors, ideally the potential fraud will be exposed and then remedied. The SEC also proposed going beyond this and requiring a “noisy withdrawal,” which would require an attorney who has gone to the top of the ladder with no remedy in sight to withdraw from representing the issuer and notify the SEC.<sup>105</sup> This proposal, however, has not been accepted and will be discussed in detail later in this Comment.

### C. The SEC Review and Comment Process—The Making of the Final Rules

When Congress passes legislation affecting the SEC, it generally does so by setting broad goals in a statute without specifying the minutia of how the new rules should affect day to day operation, as it generally did under section 307 of Sarbanes-Oxley. The task of developing and implementing the final regulations is left to the SEC. When legislation is of a magnitude that will have a significant impact on the functions of the securities industry, comment from the public is required before implementing final rules of any kind.<sup>106</sup>

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102. *Id.* § 307(1).

103. *Id.* § 307(2).

104. *Id.*

105. See SECURITIES AND EXCHANGE COMMISSION, FINAL RULE: IMPLEMENTATION OF STANDARDS OF PROFESSIONAL CONDUCT FOR ATTORNEYS 2, at <http://www.sec.gov/rules/final/33-8185.htm> (last accessed Oct. 28, 2003).

106. 17 C.F.R. § 202.6(a) (1999) (“[I]n the adoption of substantive rules materially affecting an industry or a segment of the public, such as accounting rules, every feasible effort is made in advance of adoption to receive the views of persons to be affected.”).

The SEC does this by developing a proposed rule amendment based on the language of the statute.<sup>107</sup> The proposed rule is then published in both the Code of Federal Regulations and on the SEC website for commentary and feedback by the public within a specified time period after release.<sup>108</sup> After the commentary period, the SEC will examine all of the comments it has received and may review the proposed rule.<sup>109</sup> The rule will frequently be revised, clarified, or changed, depending on the nature and content of the responses.<sup>110</sup> Typically, the SEC will release the final rule, but in circumstances where a proposal generates substantial commentary, a revised proposed rule may be issued and the process will begin anew.<sup>111</sup>

The comments received on a proposed rule are extremely valuable because they reflect the collective attitudes of practitioners, academics, and commentators regarding rule changes.<sup>112</sup> They incorporate a wide range of viewpoints, helping to clarify the meaning of terms, the intent of the rules, and reveal new angles on the arguments already put forth to sculpt a final release that is more formed than un-molded clay. The SEC thus ensures that it does not enact rules by fiat, but through a collaborative enterprise which allows all interested parties to express a point of view.<sup>113</sup>

#### D. New Standards of Professional Conduct

On November 21, 2002, the SEC released its proposed rules for attorney conduct based on its interpretation of the Sarbanes-Oxley Act.<sup>114</sup> The debate over the proposal was robust, and ultimately

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107. See 15 U.S.C. § 77s(a) (1999) ("The Commission shall have authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this subchapter . . .").

108. 17 C.F.R. § 202.6(b).

109. *Id.* § 202.6(c) ("Following analysis of comments received, the rule may be adopted in the form published or in a revised form in the light of such comments.").

110. *Id.*

111. *Id.*

112. The SEC encourages and receives input from any person or company. See, e.g., SEC. AND EXCHG. COMM'N, SEC PROPOSED RULES, at <http://www.sec.gov/rules/proposed.shtml> (last accessed Oct. 28, 2003).

113. 17 C.F.R. § 202.6(a) ("[E]very feasible effort is made in advance of adoption to receive the views of persons to be affected.").

114. SECURITIES AND EXCHANGE COMMISSION, PROPOSED RULE: IMPLEMENTATION OF STANDARDS OF PROFESSIONAL CONDUCT FOR ATTORNEYS 1, at <http://www.sec.gov/rules/final/33-8150.htm> (last accessed Oct. 28, 2003).

prompted 167 “timely comment letters” to the SEC.<sup>115</sup> The comment period exposed a rift between academics who support greater regulation of the securities bar by the SEC and practitioners in the field who do not.<sup>116</sup>

The academics were led by Susan P. Koniak of Boston University in a comment letter signed by approximately fifty leading professors at law schools around the nation.<sup>117</sup> This comment letter lucidly supported the proposed rules (with some clarifications and adjustments), and offered support for the “noisy withdrawal” rule, which would require an attorney who had gone all the way up the ladder to withdraw from representing an issuer.

On the other side of the debate were many notable securities firms, including Latham and Watkins,<sup>118</sup> Palmer & Dodge,<sup>119</sup> plus a letter signed by “77 law firms” firmly opposing the noisy withdrawal proposal, but also arguing against ambitious rule changes to existing law.<sup>120</sup> The law firms reasoned that such a drastic change would require careful balancing of the various state ethics laws and establishing a noisy withdrawal would have a damaging effect on a client’s ability to confide in his attorney.<sup>121</sup> They argued it was best for the state courts, not the SEC, to make such a profound change in the law.<sup>122</sup>

Ultimately, the SEC issued a final rule, but suspended implementation of the noisy withdrawal rule to allow for an additional comment

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115. SECURITIES AND EXCHANGE COMMISSION, FINAL RULE: IMPLEMENTATION OF STANDARDS OF PROFESSIONAL CONDUCT FOR ATTORNEYS 2, at <http://www.sec.gov/rules/final/33-8185.htm> (last accessed Oct. 28, 2003).

116. Gary Young, *Law Professors Question Attack on SEC*, 229 N.Y.L.J., Jan. 9, 2003, at 5. The full range of all responses to the rule proposal can be viewed at <http://www.sec.gov/rules/proposed/s74502.shtml> (last accessed Feb. 14, 2003).

117. See Comment letter from Susan P. Koniak, Roger C. Cramton and George M. Cohen (with Attached List of Supporting Academics), to the SEC (April 7, 2003), at <http://www.sec.gov/rules/proposed/s74502/skoniak1.htm> (last accessed Oct. 28, 2003).

118. See Comment letter from Latham & Watkins, to the SEC (Dec. 18, 2002), at <http://www.sec.gov/rules/proposed/s74502/latham1.htm> (last accessed Oct. 28, 2003).

119. See Comment letter from Palmer & Dodge, to the SEC (Dec. 24, 2002), at <http://www.sec.gov/rules/proposed/s74502/palmerdodge1.htm> (last accessed Oct. 28, 2003).

120. See Comment letter from 77 Law Firms, to the SEC (Dec. 18, 2002), available at <http://www.sec.gov/rules/proposed/s74502/77lawfirms1.htm> (last accessed Oct. 28, 2003).

121. See *id.*

122. See *id.*

period.<sup>123</sup> The final rule tracks closely the requirements set forth by Congress in the Sarbanes-Oxley Act.<sup>124</sup>

#### IV. Argument

##### A. The Attorneys Were Never the True Source of the Problem

Much ire has been directed at Enron's chief outside counsel, Vinson & Elkins, especially in the congressional hearings that followed the energy company's demise.<sup>125</sup> It is this anger, the feeling that the attorneys did nothing while the company self-destructed, or that Vinson & Elkins actually had a hand in deceiving investors that drove Congress to ultimately examine the role that attorneys play. Sherron Watkins, a vice president at Enron who is now known as the Enron whistle-blower, resisted having Vinson & Elkins investigate her claims of wrongdoing because she harbored doubts about their integrity, believing their role in the scandal was deep.<sup>126</sup>

Vinson & Elkins's role in the corporate meltdown is mixed, and the details are still emerging.<sup>127</sup> What is clear is that Vinson & Elkins should have "brought a stronger, more objective and more critical voice to the disclosure process."<sup>128</sup> While there are investor lawsuits still pending against Vinson & Elkins and the ultimate status of their liability is undetermined, it is generally agreed that they were more part of the problem than the solution at Enron.

What has been lost in the intense focus on Enron is that it was clearly an example of how bad things can become when the right elements are present, but it is not an example of how the securities industry functions as a whole. Enron and Vinson & Elkins were

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123. SECURITIES AND EXCHANGE COMMISSION, FINAL RULE: IMPLEMENTATION OF STANDARDS OF PROFESSIONAL CONDUCT FOR ATTORNEYS 2, at <http://www.sec.gov/rules/final/33-8185.htm> (last accessed Oct. 28, 2003).

124. See *id.*; see also 17 C.F.R. § 205 (1999).

125. See Richard A. Oppel, Jr., *Lawmakers Contend Lawyers for Enron Should Have Raised Concerns*, N.Y. TIMES, Mar. 15, 2002, at C1.

126. *Id.* (noting it was Watkins who was championed by Congress for her vigilant actions in trying to alert then C.E.O. Kenneth L. Lay, warning that "Enron could 'implode in a wave of accounting scandals.'"). See also Thomas S. Mulligan, *Calls for Faster, Fuller Disclosure by Insiders Regulations: Reformers Say Official Reports of Stock Sales by Enron's Lay Came Too Late to do Investors Any Good*, L.A. TIMES, Mar. 3, 2002, at C1.

127. See Ellen Joan Pollock, *Limited Partners: Lawyers for Enron Faulted Its Deals, Didn't Force Issue*, WALL ST. J., May 22, 2002, at A1.

128. WILLIAM C. POWERS, REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMM. OF THE BOARD OF DIRECTORS OF ENRON CORP. 25-26 (2002), at <http://news.findlaw.com/wp/docs/enron/specinv020102rpt1.pdf> (last accessed Feb. 14, 2003) [hereinafter *Powers Report*].

anomalies. They were certainly not the norm. There are two clear truths that support the isolated nature of the misbehavior.

First, it is widely noted that Enron fostered a culture of risk taking in business ventures. Jeffery Skilling, Enron's CEO from February 2001, was the driving force behind this attitude.<sup>129</sup> Skilling's approach to management tended to foreclose dissent from his ranks because of his aggressive, all-knowing attitude. One colleague noted that Skilling could "out-argue God,"<sup>130</sup> and another, when queried on the attitudes at Enron noted, "[w]e were creating a very arrogant management team . . . . We were trying to project a figure of a Super Human."<sup>131</sup>

At WorldCom the same pattern emerges. There it was Bernard Ebbers who drove his company into near-total collapse when he took a \$408 million loan from the company to pay off a personal debt.<sup>132</sup> Ebbers' personal wealth was tied closely to the price of the stock, creating incentives for him to encourage and even direct unscrupulous accounting methods.<sup>133</sup> Ebbers now faces criminal charges for his actions in Oklahoma state court.<sup>134</sup>

The evidence points greatly in the direction of the CEOs as the perpetrators of the fraud. Their dominating personalities, together with their "do-no-wrong" attitudes drove their fortunes into insolvency.

The second element present in all of the corporate misconduct was a laxity within the accounting industry. The major thrust of the Sarbanes-Oxley Act was directed at creating a Public Company Accounting Oversight Board ("PCAOB") to supervise the conduct of the major accounting firms.<sup>135</sup> The accounting industry, prior to the Act, followed generally accepted accounting principles ("GAAP")<sup>136</sup> when performing audits and preparing financial statements. Those princi-

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129. See April Witt & Peter Behr, *Dream Job Turns into a Nightmare; Skilling's Success Came at High Price*, WASH. POST, Jul. 29, 2002, at A1.

130. *Id.*

131. *Id.*

132. See Sakar, *supra* note 82, at B1.

133. See Barnaby J. Feder, *Management Practice Enabled Huge Fraud, 2 Investigations Find*, N.Y. TIMES, June 10, 2003, at C1.

134. See Barnaby J. Feder & Kurt Eichenwald, *A State Pursues WorldCom; Effects Seen on U.S. Case*, N.Y. TIMES, Aug. 28, 2003, at C1.

135. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, §§ 101-109, 116 Stat. 750-769 (2002); see also Shailagh Murray, *Leading the News: Bill Overhauling Audit Regulation Passes in Senate*, WALL ST. J., Jul. 16, 2002, at A3.

136. See BLACK'S LAW DICTIONARY 692 (7th ed. 1999) ("The conventions, rules and procedures that define approved accounting practices at a particular time . . . . The principles include not only broad guidelines of general application but also detailed practices and procedures.").

ples are established by the Financial Accounting Standards Board (FASB), which is comprised of an independent body of accounting professionals.<sup>137</sup> The FASB was unregulated, and exerted great pressure on Congress to avoid any constraints on its ability to police its own ranks.

With the establishment of the PCAOB, it is hoped that government regulators will establish the standards, independent of what the accounting industry would like to see.

The thrust of all of this is that attorneys were not the major sources of the corporate scandals—the CEOs and accountants were. It makes sense that the majority of the legislation was directed at them, not at the lawyers who served them. This is another reason why the standards for attorney conduct are largely irrelevant, because they address a perceived problem that never really existed in the first place.

The new rules for attorney disclosure mark a dangerous step forward by Congress and the SEC. The new laws are essentially an overreaction to public outcry at corporate wrongdoing. As with all quickly executed, sweeping legislative changes, the full effects of the new law will take years to percolate through court decisions, altering many things that were never intended to be touched. Attorney conduct will also be shifted, as lawyers struggle to understand the full impact of the Sarbanes-Oxley Act and how it will affect their everyday practice of law.

## **B. Unintended Side Effects**

### **1. Loopholes Under the New Disclosure Rules Will Make Silence the New Standard**

The concept for the ladder up reporting was based partly on a report by William Powers<sup>138</sup> released after an investigation of the scope of wrongdoing at Enron.<sup>139</sup> The report found that, in at least one instance, a junior attorney working in-house for Enron questioned, in a memo to senior attorneys, the legitimacy of some of the company's financial transactions.<sup>140</sup> The attorney, a relative neophyte

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137. See *id.* at 644.

138. See Richard A. Oppel, Jr., *Enron Official Says Many Knew About Shaky Company Finances*, N.Y. TIMES, Feb. 15, 2002, at A1 (noting “Mr. Powers, the dean of the University of Texas School of Law, was appointed to the board in October [2001] to lead an investigation into the company’s partnership deals.” He resigned his position when the report was completed in February 2002.).

139. *Powers Report*, *supra* note 126, at 36.

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

to the Enron family, commented that “transactions posed grave risks and ‘might lead one to believe that the financial books at Enron are being manipulated.’”<sup>141</sup> The response he received was a reprimand from his supervising attorney, who chided him for using language that was “critical and inflammatory” in the memo.<sup>142</sup> However, as was later revealed, that attorney was entirely correct—Enron had cooked the books and relied on dubious accounting methods to convince the unfortunate skeptics who dared to ask what they were doing.

Under the newly adopted rules by the SEC, the junior attorney has a duty to report “evidence of a material violation”<sup>143</sup> to “his or her supervising attorney.”<sup>144</sup> The duty would then fall on the senior attorney to report the evidence to the company’s chief legal officer as the first step in the whole ladder-up process.<sup>145</sup> As an additional safeguard, the SEC rule provides that the junior attorney can go over his superior’s head, straight to the chief legal officer (“CLO”) or CEO if he/she “reasonably believes that a supervisory attorney to whom he or she has reported evidence of a material violation . . . has failed to comply with [the ladder-up reporting requirements].”<sup>146</sup>

So, in theory, this situation should never occur again. The junior Enron attorney who spotted wrongdoing, after being rebuffed by his seniors, would now be able to march straight into the office of the CLO or the CEO and divulge his dossier of evidence of wrongdoing and expose the fraud to fresh air. However, there are two things that will make this scenario almost certain never to occur.

First, the rule provides that the junior attorney “may” take the initiative to go over the head of his senior attorney, not that he is required to do so.<sup>147</sup> So, even after this rule is adopted, junior level attorneys will have the option to report the perceived violation to their superiors, wait for a response, and if it is negative or critical, simply let the matter go, choosing not to take the matter any further.

Second, the reality of corporate culture and pressures of pleasing superiors to gain promotion make it highly unlikely that an attorney at a junior level will buck the trend and blow the whistle. In many instances, an attorney with relatively minimal experience may doubt his own understanding of financial matters such as those at Enron. He

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141. *Id.*

142. *Id.*

143. 17 C.F.R. § 205.3(b) (2002).

144. *Id.* § 205.5(c).

145. *See Id.* § 205.3(b).

146. *Id.* § 205.5(d).

147. *Id.* § 202.6(c).

may be hesitant to bring the matter to his seniors, let alone attract the ire and potential of career suicide by going beyond those he works under to the top.

In many ways junior staff are in the best position to detect fraud because they are more likely to bring youthful enthusiasm to their efforts and use a sharp eye to catch things that superiors may have missed. However, the dual nature of this rule—allowing the junior attorney to go over his senior's head but with no requirement that he do so—coupled with the realities of corporate life, make it unlikely that the ladder-up provisions will have any significant impact.

The same concerns will affect the judgment of senior attorneys in a corporation. Will they seek to draw the negative attention of the CLO or CEO if they sense that something might be amiss? For the in-house attorney this might mean risking his career at the company. For the outside counsel, it might mean losing the client to another firm in a competitive marketplace.

The new rules issued by the SEC have a loophole to potentially avoid the duty to speak. An attorney has a duty under the new rules to report evidence of a material violation.<sup>148</sup> Material violation is defined in another section as meaning “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.”<sup>149</sup>

This definitional text sets a preponderance of the evidence standard to judge reasonableness.<sup>150</sup> In theory, if an attorney found some piece of evidence that indicated the issuer was engaged in wrongdoing, he may not have any reasonable grounds to conclude at that time there is anything amiss. Under the new rules, to avoid trouble, his wisest course would be to ignore that information, rather than to investigate further. If the attorney was questioned later, he could contend that although he saw some potentially troubling evidence, he was only thirty percent certain that any violation was possible. John Coffee of Columbia Law School has noted that although such a circumstance seems farfetched, it is exactly the kind of rationalizing that an attorney engages in every day.<sup>151</sup>

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148. *Id.* § 205.3(b).

149. *Id.* § 205.2(e).

150. See John C. Coffee Jr., *Myth and Reality: SEC's Proposed Attorney Standards*, 229 N.Y.L.J., Jan. 16, 2003, at 5.

151. See *id.*

Thus, one effect of the rule is to chill the communication between the attorney and the client. The attorney's instincts will steer him away from actually investigating the matter, thus choosing a course that directs him away from any disturbing signals. And if the potential violation appears severe enough to warrant further action, what is a senior attorney likely to do?

According to the new rules, his first action should be to contact the CLO of the issuer, to alert him to a potentially material violation. In reality, his first action is likely to get a second opinion on the reasonableness of his suspicion, to determine if he should go forward or not. One former SEC general counsel sees things progressing this way under the new rules. "There will be more lawyers hired . . . [e]veryone will want someone else's opinion as to whether their opinion is reasonable as they go up the ladder."<sup>152</sup>

Attorneys will never be sure if they are reasonable in going to the CLO in the first place, and they will never be sure whether the response they receive from the CLO is reasonable enough to avoid going forward to the next step on the ladder.<sup>153</sup> To avoid guessing and the potential liability that might arise, the best option would be to have another counsel view the evidence and give an opinion on the reasonableness of the actions.

This scenario is more than likely to occur. However, this can hardly be something desired by the originators of the legislation. The attorneys will place their focus on their actions vis-à-vis the material violations, not whether there were violations or not. The issue will center on the attorney's conduct, not the conduct of the issuer. Even if there is a violation in progress, and the attorney alerts the CLO, who responds in reasonable time to make the reporting attorney reasonably sure that something is being done, the inquiry will end. If the reporting attorney gets a second opinion to bolster his position, everyone will feel good that something has been done. However, the material violation may live on after all this process is complete.

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152. Kathleen Day, *Lawyers as Stool Pigeons?; SEC May Force Attorneys to Blow Whistle on Corporate Clients*, WASH. POST, Jan. 9, 2003, at E01.

153. See 17 C.F.R. § 205.2(1) ("Reasonable or reasonably denotes, with respect to the actions of an attorney, conduct that would not be unreasonable for a prudent and competent attorney.").

## 2. A Glimpse of the Future: The Changes Sarbanes-Oxley May Continue to Bring

### a. The Noisy Withdrawal Proposal

At the time the final rules for section 307 were adopted, the SEC deferred on implementing its most controversial rule proposal—the noisy withdrawal. Although packaged with the original rule release,<sup>154</sup> it engendered such heated response from the securities bar that it was tabled for an additional comment period.<sup>155</sup> The SEC respectfully noted that the “compressed time period resulting from the 180-day implementation deadline” was insufficient to render a thoughtful rule of such a sweeping change in securities law.<sup>156</sup>

The noisy withdrawal requirement would have added an additional rung to the top of the ladder imposed by section 307. Instead of stopping at the issuer’s board of directors,<sup>157</sup> the attorney would be required to “withdraw forthwith from representing the issuer, indicating that the withdrawal is based on professional considerations.”<sup>158</sup> The withdrawal is called “noisy” because it would alert the SEC to potential violations of the securities laws and allow them to focus their resources on investigating the implicated company.

This robust proposal was criticized because many felt that it exceeded the mandate that Congress had established for the SEC under section 307.<sup>159</sup> Many are concerned that such a proposal would unreasonably alter the attorney-client relationship by requiring the issuer’s counsel to essentially breach the trust by alerting the SEC of withdrawal.<sup>160</sup> The review and comment process regarding the noisy withdrawal is ongoing. The rule may become a reality, especially if more corporate fraud appears in the months ahead.

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154. SECURITIES AND EXCHANGE COMMISSION, PROPOSED RULE: IMPLEMENTATION OF STANDARDS OF PROFESSIONAL CONDUCT FOR ATTORNEYS 1, at <http://www.sec.gov/rules/final/33-8150.htm> (last accessed Oct. 28, 2003).

155. SECURITIES AND EXCHANGE COMMISSION, FINAL RULE: IMPLEMENTATION OF STANDARDS OF PROFESSIONAL CONDUCT FOR ATTORNEYS 2, at <http://www.sec.gov/rules/final/33-8185.htm> (last accessed Oct. 28, 2003).

156. *Id.*

157. 17 C.F.R. § 205.3(b)(3)(iii).

158. SECURITIES AND EXCHANGE COMMISSION, PROPOSED RULE: IMPLEMENTATION OF STANDARDS OF PROFESSIONAL CONDUCT FOR ATTORNEYS 7, at <http://www.sec.gov/rules/proposed/33-8186.htm> (last accessed Oct. 31, 2003).

159. See Michael Schroeder, *SEC Modifies New Attorney Rules*, WALL ST. J., Jan. 24, 2003, at C11.

160. See Mitchell Pacelle & Michael Schroeder, *Proposed SEC Rules Could Turn Lawyers into Whistle-Blowers*, WALL ST. J., Jan. 9, 2003, at A1.

## b. Revisions to the ABA Model Rules

Finally, the changes are prompting revisions to attorney ethics standards, whittling away attorney-client confidentiality. The American Bar Association has proposed adding language to Model Rule 1.6(b) that would allow an attorney to disclose confidential information to stop a client from committing a crime that would bring financial loss to others.<sup>161</sup> The impact of this proposed change has two notable consequences.

First, the canons of professional conduct have stated frequently that disclosure of confidential information should only occur in the most extreme circumstances—when the attorney's client is reasonably certain to kill or substantially injure another human being.<sup>162</sup> California's requirement is more extreme, stating that an attorney must "maintain inviolate the confidence, and at every peril to himself or herself to preserve the secrets, of his or her client."<sup>163</sup> The lesson has always been that an attorney should blow the whistle only in the most extraordinary circumstances; that client confidences have a hallowed sanctity. The bar will be lowered considerably if financial injury serves as adequate ground for breach of the duty of confidentiality. The spectrum of crimes ranging from murder to securities fraud includes thousands of other bad acts that a client might contemplate. If exceptions are made for securities fraud, practitioners and the public will clamor to have exceptions carved out for many other misdeeds.

The second troubling aspect of the proposed changes to the ethics rules is that thousands of attorneys who have little familiarity with the SEC, securities regulation, or the requirements under the '33 and '34 Acts will suddenly be required to watch out for clients who are possibly engaging in garden-variety financial fraud. If the proposed changes to Rule 1.6 are adopted, these attorneys will now face the decision of whether or not to break the confidence of their client and alert shareholders or even the police. While exposing fraud is a lauda-

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161. See ABA MODEL RULES OF PROF'L CONDUCT R. 1.6(b)(2) (proposed rule change from Task Force on Implementation of Section 307 of the Sarbanes-Oxley Act of 2002, 2003).

A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary: to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services.

*Id.*

162. See *id.* 1.6(b)(1).

163. CAL. BUS. & PROF. CODE § 6068(e) (West 2002).

ble goal, it should not be the attorney's role to police it. Rather than expose a client and breach his trust, the attorney should maintain the confidence of the client and encourage him to correct the error and comply with the law. This is the traditional and proper role of counsel—as advocate against lawbreaking, not as constable of the bar.

A full treatment of the ethical rule changes is not possible here and is the proper subject of a larger analytical thesis. However, these examples show how far reaching the impact of the section 307 changes has been and will continue to be in the coming years.

### **C. The Path Not Followed—Safeguards Removed Before the Frenzy Started**

When the lights went out on the stock market party, most investors realized their wallets were empty and wondered, where were all the corporate police? Before, it seemed, there were too few. Now, it seems, there are too many, as the SEC has essentially deputized every corporate attorney who works in any capacity with a publicly held company, forcing them to be on the lookout for fraud.

In the years before Enron exploded there were important safeguards in place. Slowly they were whittled away until a dangerous situation was created. This Comment will now examine two subtle market policing devices that disappeared in the years leading up to the end of the bubble, but could be revived again as alternatives to imposing the heightened ethics standards on attorneys.

#### **1. The PSLRA Ended Many Frivolous Lawsuits but Helped Bar Legitimate Ones as Well**

With great fanfare in 1994, the Republican party swept into control of Congress after 40 years as the minority party of the House and the Senate.<sup>164</sup> As part of their collective campaign to retake the House, they touted the Contract with America, a list of promises to enact legislation if elected, focusing on tax cuts, welfare reform, and a Presidential line-item veto.<sup>165</sup> As a part of the contract, Republicans delivered to the American voters the Private Securities Litigation Reform Act (“PSLRA”).<sup>166</sup>

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164. See Adam Clymer, *The 1994 Elections: Congress, G.O.P. Celebrates its Sweep to Power; Clinton Vows to Find Common Ground*, N.Y. TIMES, Nov. 10, 1994 (Late Edition), at A1.

165. See David E. Rosenbaum, *Republicans Offer Voters a Deal for Takeover of the House*, N.Y. TIMES, Sept. 28, 1994 (Late Edition), at A16.

166. Private Securities Litigation Reform Act, H.R. 1058, 104th Cong. (1995).

Prior to the PSLRA, companies were subjected to what many considered harassing litigation.<sup>167</sup> When the stock price in a particular company declined, often by only small percentages, a class-action lawsuit would be filed by the aggrieved shareholders.<sup>168</sup> The complaint would typically present a prima facie case and discovery would commence. Since the cost of going forward to defend such suits was relatively high, many were settled despite the possibly meritless nature of the actions.<sup>169</sup>

The PSLRA was designed in part to elevate the pleading requirements and discourage the filing of lawsuits that could not state with some specificity corporate acts that reduced shareholder value.<sup>170</sup> Thus, a complaint filed to recover money damages for securities fraud must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."<sup>171</sup> The Ninth Circuit later interpreted this to require a plaintiff plead "deliberate recklessness" on the part of a defendant to survive a summary judgment motion.<sup>172</sup> Deliberate recklessness is so close to fraudulent intent that a difference can hardly be discerned.

Additionally, the PSLRA included automatic stays on discovery while a motion to dismiss is pending,<sup>173</sup> a safe harbor for potentially misleading forward looking statements made by executives and under-

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167. See H.R. CONF. REP. NO. 104-369, at 31-32 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 730-31 (1995).

The House and Senate Committees heard evidence that abusive practices committed in private securities litigation include: (1) the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer, and with only faint hope that the discovery process might lead eventually to some plausible cause of action; (2) the targeting of deep pocket defendants, including accountants, underwriters, and individuals who may be covered by insurance, without regard to their actual culpability; (3) the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle; and (4) the manipulation by class action lawyers of the clients whom they purportedly represent.

*Id.*

168. See William S. Lerach, *Securities Class Action Litigation Under the Private Securities Litigation Reform Act's Brave New World*, 76 WASH. U. L.Q. 597, 598 (1998) (noting that many suits were filed "based merely upon the fact that a stock price had dropped ten percent or more").

169. See Eugene P. Caiola, Comment, *Retroactive Legislative History: Scienier Under the Uniform Security Litigation Standards Act of 1998*, 64 ALB. L. REV. 309, 315-16 (2000).

170. See H.R. 1058, 104th Cong. (1995).

171. See 15 U.S.C. § 78u-4(b)(2) (1998).

172. See *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 976 (9th Cir. 1999).

173. 15 U.S.C. § 78u-5(f).

writers,<sup>174</sup> and elimination of joint and several liability.<sup>175</sup> The PSLRA changes were met with resistance, including one individual who noted that the PSLRA was "trying to eliminate frivolous lawsuits, and one way to do it is to make sure there are no lawsuits at all. But we don't think that's a good approach."<sup>176</sup>

The filing of frivolous lawsuits that primarily enriched class action plaintiff's attorneys was and is a real problem. Even former SEC chairman Arthur Leavitt noted in 1995 that "current litigation practices can be made fairer for both investors and corporations, especially in the area of class-action litigation."<sup>177</sup> But the fact remains that those lawsuits acted as a form of policing the market, if for no other reason than to remind public companies that someone was watching them closely and had the power and resolve to challenge them. The settlement of a claim occurs when the plaintiff has a legitimate chance of winning on the merits, and the settlement tends to be proportionate to the value of the claim.<sup>178</sup> If the PSLRA had limited only the plaintiff's attorney's fees and nothing more, it would have discouraged all but the most intrepid from filing class action claims. By setting such high standards for pleading, it penalized plaintiffs themselves and ended a unique form of internal policing of the market.

## 2. The Disappearance of Aiding and Abetting Liability Destroyed a Major Tool To Address Fraud by Those Who Assisted in Securities Fraud

As noted earlier, the Supreme Court eliminated the possibility of pursuing aiders and abettors of securities fraud in the *Central Bank* decision.<sup>179</sup> Congress was surprised by this development because aiding and abetting liability had long been an implied cause of action under Rule 10b-5.<sup>180</sup> In partial response, Congress included legislation within the PSLRA that restored to the SEC enforcement power to act against aiders and abettors.<sup>181</sup> However, private litigants are still

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174. *Id.* § 78u-5(a).

175. *Id.* § 78u-5(c).

176. Diana B. Henriques, *SEC Chief Assails Bill Restricting Litigation*, N.Y. Times, Jan. 26, 1995, at D2.

177. *Id.*

178. See Leonard B. Simon & William S. Dato, *Legislating on a False Foundation: The Erroneous Academic Underpinnings of the Private Securities Litigation Reform Act of 1995*, 33 SAN DIEGO L. REV. 959, 962-63 (1996).

179. *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).

180. See Nicole Miller, Note, *The Judicial Rejection of Aiding and Abetting Civil Liability Under Section 10(b)*, 1995 UTAH L. REV. 913 (1995).

181. See 15 U.S.C. §§ 77z-1, 77z-2, 78j-1, 78u-4, 78u-5 (1999).

foreclosed from seeking damages against aiders and abettors, including an issuer's attorney unless the attorney can be shown to be a primary violator.<sup>182</sup>

The dissent in *Central Bank* was shocked by the majority opinion. Justice Stevens noted that “[i]n *hundreds* of judicial and administrative proceedings in every Circuit in the federal system, the courts and the SEC have concluded that aiders and abettors are subject to liability under § 10(b) and Rule 10b-5” and that “all 11 Courts of Appeals to have considered the question have recognized a private cause of action against aiders and abettors under § 10(b) and Rule 10b-5.”<sup>183</sup> In fact, the parties in *Central Bank* were directed by the Supreme Court to address the issue of aiding and abetting liability—it was not at issue and thought by both petitioner and respondent to be settled law.<sup>184</sup> The strength of Rule 10b-5 is that it applies to “any person, directly or indirectly” who employs “any device, scheme, or artifice to defraud” an investor.<sup>185</sup>

An alternative to the sweeping changes of the section 307 requirements would be for Congress to overrule the *Central Bank* decision and re-instate aiding and abetting liability, specifically targeted towards attorneys who assist in corporate fraud. There exists no better way to encourage compliance with the securities laws than to impose potential liability on law firms. This action could even encourage self-initiated noisy withdrawals, as respectable firms learn of client malfeasance and withdraw to save themselves.

## Conclusion

The new rules of professional conduct set forth in the Sarbanes-Oxley Act are a dangerous overreach in the face of immediate crisis. First, they were developed to address a perceived problem that never really existed in a widespread way. Second, the actual rules adopted by the SEC deny the reality of corporate life and have been set up to allow enough loopholes to make them basically unenforceable. Finally, they have spawned and will continue to generate revisions to the practice of law that were never intended to occur.

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182. See *Central Bank of Denver*, 511 U.S. at 191 (“Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5.”).

183. *Id.* at 192 (Stevens, J., dissenting).

184. *Id.* at 194–95 (Stevens, J., dissenting).

185. 17 C.F.R. § 240.10b-5 (2001).

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This is not to say that the entire Act was without merit. Certainly the sections that have addressed greater oversight of the accounting industry, as well as increasing the penalties for executive fraud, will hopefully have a lasting impact on the future of the securities industry. Attorneys have a role in this industry as well, but section 307 has improperly placed the burden of policing on the everyday corporate lawyer. Policing mechanisms were removed that could have helped avoid the trouble, and some of those mechanisms could be replaced. Section 307 will rest largely as a warning to those firms like Vinson & Elkins who breach the public trust, and to the rest, only an arcane sideshow of a horrible time in the history of American corporate life.