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February 4, 2004

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

Re: Subcommittee Hearing on “the Role of Attorneys in Corporate Governance”
scheduled for February 4, 2004

Dear Mr. Chairman:

On behalf of the American Bar Association (“ABA”)¹, I write to express our views concerning the subject of today’s Subcommittee hearing, “the Role of Attorneys in Corporate Governance.” In addition, we would like to bring you up to date on the ABA’s recent efforts to reform the corporate governance system, and in particular, to enhance the role of corporate lawyers in that system. We ask that this letter and Attachments A, B, and C be included in the official record of today’s hearing.

The ABA has long recognized the crucial role that lawyers play in corporate governance. In the wake of Enron and the many other recent corporate scandals plaguing our nation, the ABA has taken an active role in proposing new corporate governance reforms, including new practices aimed at enhancing the role of lawyers in ensuring the legal compliance of the companies they represent. In addition, the ABA has actively sought to strengthen the ethical standards governing all attorneys, including those attorneys representing corporations.

The ABA’s Corporate Governance Reform Proposals

The collapse of Enron and other Enron-like cases in early 2002 convinced the ABA leadership of the need for a careful review of the role lawyers and other key parties play in corporate governance. As a result, in March 2002, well before Congress passed the Sarbanes-Oxley Act of 2002 (P.L. 107-204), the ABA announced the

¹ The American Bar Association, with over 400,000 members nationwide, is the largest lawyer association in the United States and includes lawyers of all major legal specialties. In addition, the ABA Section of Business Law, with over 65,000 members, is one of the largest organizations of corporate lawyers in the country.

formation of its Task Force on Corporate Responsibility to examine the current framework of laws, regulations, and ethical principles governing our corporate system in order to determine how the current system of checks and balances could be improved.

On July 16, 2002, the ABA Task Force submitted its Preliminary Report containing specific proposals for reforming the nation's system of corporate governance, with particular emphasis on ways to increase the effectiveness of attorneys in that system. After receiving extensive feedback from the public and from the legal community, the ABA Task Force issued its Final Report on March 31, 2003, and a copy of that report is available online at http://www.abanet.org/buslaw/corporateresponsibility/final_report.pdf.

The recommendations of the ABA Task Force on Corporate Responsibility were subsequently distilled into three specific resolutions and then adopted by the ABA House of Delegates as official ABA policy in August 2003. In particular, the ABA endorsed (1) a set of twelve proposed corporate governance practices, including regular executive meetings between the company's general counsel and its independent directors; (2) an amendment to ABA Model Rule of Professional Conduct 1.13 requiring corporate attorneys to report misconduct "up the corporate ladder" to the company's senior management and, if necessary, its board of directors; and (3) an amendment to ABA Model Rule 1.6 permitting lawyers to reveal confidential client information to third parties if necessary to prevent serious financial harm resulting from a client's crime or fraud. The three ABA policies are attached to this letter as Attachments A, B, and C, respectively.

The ABA's Twelve Proposed Corporate Governance Practices

In general, the twelve proposed corporate governance practices adopted by the American Bar Association involve structural and procedural reforms designed to enhance the independence and resources of outside directors of public corporations, increase the flow of material information and analysis to those directors, and enhance the ability of the lawyers representing public corporations to exercise and bring to bear independent professional judgment. If implemented, these practices would help promote corporate responsibility without undermining the constructive and collaborative relationship that must exist so that compliance with the law can be most effectively promoted. The full text of these twelve reforms is attached to this letter as Attachment A and is available online at <http://www.abanet.org/leadership/2003/journal/119c.pdf>.

The ABA believes that as corporate lawyers perform their essential role of promoting their clients' compliance with the law, one of the lawyers' key functions is to bring issues of legal compliance to the attention of the appropriate authorities within the organization. Of the twelve proposed corporate governance practices endorsed by the ABA, two are of particular importance in this regard. First, the board of directors should establish a practice of regular, executive session meetings between the general counsel and a committee of independent directors. Second, when retaining outside counsel, the corporation should establish two things at the outset of the engagement: (1) a direct line of communication between outside counsel and the corporation's general counsel; and (2) the understanding that outside counsel are obliged to

apprise the general counsel, through that direct line of communication, of material potential or ongoing violations of law by, and breaches of fiduciary duty to, the corporation.

Implementing these two corporate governance practices would greatly enhance the ability of the general counsel to closely monitor the activities of the corporation and help ensure that the organization and its senior executives comply with the law. These reforms alone would greatly reduce the possibility of another Enron-type scandal, thereby benefiting the corporation, its employees and suppliers, and the investing public.

The ABA's Amendments to Model Rules 1.13 and 1.6

In August 2003, the ABA also adopted two important changes to its Model Rules of Professional Conduct², including changes to Rule 1.13 (Organization as Client) and Rule 1.6 (Confidentiality of Information). Like the corporate governance practices described above, both of these changes to the ABA's attorney ethics rules will serve to strengthen the ability of corporate counsel to promote the company's compliance with the law. The resolutions outlining the two ABA rule changes are attached to this letter as Attachments B and C, respectively, and are also available online at <http://www.abanet.org/leadership/2003/journal/119b.pdf> and <http://www.abanet.org/leadership/2003/journal/119a.pdf>.

ABA Model Rule 1.13 (Organization as Client) describes the ethical duties of a lawyer representing an organization—such as a corporate counsel—when the lawyer learns that an officer, employee, or other person associated with the organization is engaged or plans to engage in improper conduct that is likely to harm the organization. As adopted by the ABA, the revised version of Rule 1.13 strengthens the rule by requiring corporate attorneys to report misconduct “up the corporate ladder” to the company's senior management and, if necessary, its board of directors, unless the lawyer reasonably believes that it is not necessary to do so in the best interest of the company. This rule change closely parallels the new legal standard adopted by the Securities and Exchange Commission (“SEC”) under Section 307 of the Sarbanes-Oxley Act of 2002 (which is discussed more fully below) and would require all organization lawyers—including but not limited to corporate lawyers—to adopt a more pro-active role in ensuring legal compliance by the entities that they represent.

Similarly, the newly-adopted changes to ABA Model Rule 1.6 (Confidentiality of Information) also allows attorneys to take a more active role in preventing misconduct on the part of their clients by expanding the circumstances under which the lawyer may reveal confidential information to third parties, including the authorities. For hundreds of years, the attorney-client relationship has been one of trust and confidence, and attorneys have been prohibited from disclosing confidential client information to third parties except with the client's informed consent. Maintaining this confidential relationship is necessary in order to encourage open and

² The ABA Model Rules of Professional Conduct, adopted by the ABA House of Delegates in 1983 and then revised and updated on numerous occasions since then, are a comprehensive and uniform set of ethical standards for lawyers. While most state supreme courts have chosen to base their binding lawyer ethics rules, in whole or in part, on the ABA Model Rules, the final decision is entirely that of the state supreme courts.

frank communication between the client and advocate. More importantly from the investing public's standpoint, preserving a strong confidential relationship between the lawyer and the corporate client ensures that the lawyer's advice will be sought on complex or questionable legal matters, thereby giving the lawyer the opportunity to counsel legal compliance.

Because the confidential attorney-client relationship is so vitally important, ABA Model Rule 1.6 only permitted the attorney to reveal confidential client information under a very narrow set of circumstances, including to the extent reasonably necessary (1) to prevent reasonably certain death or substantial bodily harm; (2) to secure legal advice about the lawyer's compliance with the rules; (3) to allow the lawyer to defend him or herself against certain civil or criminal claims or in a controversy with the client; and (4) to comply with other law or a court order.³ While these exceptions are necessary and appropriate, the ABA concluded—following the recent rash of corporate scandals—that they did not sufficiently protect the investing public and other innocent third parties. Accordingly, in August 2003, the ABA adopted an amendment to Model Rule 1.6 that permits attorneys to divulge confidential client information to the extent reasonably necessary to prevent the client from committing a crime or fraud that will cause substantial financial injury to third parties when the lawyer's services have been used in furtherance of the client's misconduct. The ABA believes that this reform, which is consistent with the existing lawyer disciplinary rules of forty-two states, is necessary and appropriate to promote corporate responsibility and to protect innocent third parties.

The ABA and Section 307 of the Sarbanes-Oxley Act

On July 30, 2002, the President signed the Sarbanes-Oxley Act of 2002 into law. While the new law focused on regulating the conduct of accountants and corporate officers, the law also contained a provision aimed at strengthening the duty of attorneys to combat fraud within their corporate clients. Section 307 of the Act instructed the SEC to adopt a new federal rule by January 26, 2003 requiring all attorneys appearing and practicing before the agency to report evidence of material violations of the federal securities laws and other misconduct “up the ladder” to the company's senior management, and if necessary, to its board of directors. Section 307 also contains language generally authorizing the SEC to adopt other “minimum standards of professional conduct” for attorneys appearing and practicing before the agency.

In November 2002, the ABA announced the creation of its Task Force on Implementation of Section 307 of the Sarbanes-Oxley Act of 2002 (the “ABA Section 307 Task Force”) for the purpose of preparing written comments to the proposed SEC rules. The ABA Section 307 Task Force is comprised of a distinguished group of attorneys and judges with expertise in the fields of legal ethics and securities law.

³ In addition to Model Rule 1.6, several other ABA Model Rules require lawyers to divulge confidential client information in certain other narrow circumstances, including, for example, to correct false material evidence given by the client to a court or other tribunal (Model Rule 3.3), or when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client (Model Rule 4.1).

On November 21, 2002, the SEC released its initial proposed rule as required by Section 307. In addition to requiring American and foreign corporate attorneys to report misconduct “up the ladder” within the company, the original proposed rule also contained “noisy withdrawal” provisions stating that if the corporate client fails to take appropriate remedial steps after being informed by the attorney of illegal activity, the attorney would be required to withdraw from representation, notify the SEC of the withdrawal, and disaffirm any tainted documents. The original proposed rule also would permit attorneys to reveal confidential client information to the SEC under certain circumstances. After releasing its original proposed rule, the SEC invited public comment.

On December 18, 2002, the ABA filed its initial comment letter with the SEC regarding the original proposed rule, and the full text of this letter is available at http://www.abanet.org/poladv/priorities/initial_comment.pdf. In its comment letter, the ABA offered numerous suggestions for clarifying and refining the “up the ladder” reporting requirements contained in the rule. In addition, to avoid creating conflicts with the existing state court ethical rules that protect the attorney-client privilege and the investing public, the ABA urged the SEC to defer action on that portion of the proposed rule that exceeded the congressional mandate, including the Commission’s so-called “noisy withdrawal” proposals.

After receiving comments from the ABA and others, the SEC released its final up-the-ladder reporting rule on January 29, 2003. The final rule narrowed the scope of coverage by excluding many foreign attorneys and other types of attorneys who are not directly involved in SEC matters. In addition, the SEC also issued an alternate “noisy withdrawal” proposal that would still require the attorney to withdraw if the company fails to take appropriate remedial action, but would instruct the company—not the attorney—to notify the SEC of the withdrawal. The SEC then invited further comments on both of its noisy withdrawal proposals.

On April 2, 2003, the ABA filed its second comment letter with the SEC, and the full text of that letter is available online at http://www.abanet.org/poladv/priorities/second_comment.pdf. In that letter, the ABA expressed its continued opposition to both SEC “noisy withdrawal” proposals on the grounds that both alternatives would erode the attorney-client privilege and the relationship of trust and confidence that is so vital. The ABA also praised the SEC for incorporating a number of significant improvements to its final “up the ladder” reporting rule and stated that the agency “struck the right balance” by requiring attorneys to report corporate violations of law to company officials and permitting the attorneys to further report to the SEC if the company fails to correct the violations. While the SEC’s final “up the ladder” reporting rule became effective on August 5, 2003, the agency deferred further action on its “noisy withdrawal” proposals.

Concerns Raised by the ABA to the “Noisy Withdrawal” Proposals

Although the ABA expressed general support for the SEC’s final “up the ladder” rule in both its December 18, 2002 and April 2, 2003 comment letters, the ABA expressed a number of serious concerns regarding the Commission’s two alternate “noisy withdrawal” proposals. In particular, with regard to the SEC’s original noisy withdrawal proposal—in which the attorney would be

required to withdraw from representation, notify the SEC of the withdrawal, and disaffirm any tainted documents—the ABA cautioned the agency that the likely effects would be to:

- Destroy companies' trust and confidence in their attorneys by creating conflicts between the attorney's personal interest in avoiding civil litigation or potential state discipline and the desire of management to operate the business effectively;
- Encourage companies to avoid consulting with attorneys on close issues or to withhold necessary facts when they do consult attorneys;
- Remove the flexibility attorneys need to have in order to counsel clients effectively on compliance with law in complex matters such as those involved in practicing before the Commission;
- Encourage premature withdrawal by attorneys in order to escape the mandatory noisy withdrawal threshold rather than encourage them to continue to counsel on difficult issues when the company most needs their services; and
- Risk serious and unfair harm to the company and its shareholders and disruption in the market for the company's securities as a result of withdrawal and disclosure when further consideration might have proven the attorney wrong in believing a material violation would occur or had not been rectified.

The ABA further explained that most of the disruptive aspects and adverse consequences of *mandating* noisy withdrawal and disclosure by attorneys are avoided with a *permissive* disclosure rule, as adopted by the Commission in Section 205.3(d)(2) of its final rule. Such a rule is less intrusive on the attorney–client relationship because the client knows that it can rely on the attorney's exercise of his or her professional judgment independent of concern over violating a mandatory federal rule of professional conduct. Without the discretion afforded by permissive disclosure, it is more likely that clients will view the attorney as a potential adversary and keep the attorney out of critical deliberations in which the attorney would have been able to counsel legal compliance.

The ABA also believes that permissive withdrawal and disclosure affords the attorney a better opportunity to achieve client compliance with the law by allowing the attorney greater flexibility to continue to counsel compliance. Requiring the attorney to withdraw reduces the attorney's ability to work with the client to achieve the right legal compliance result.

Furthermore, a permissive approach recognizes the reality that the situations that actually arise are highly complex and involve difficult judgments influenced by a variety of factors, including the content and circumstances of the situation and the consequences of the actions. These judgments must frequently be made on a real-time basis, when emotions are high and when critical facts may be unknown or unclear. These considerations are especially applicable to the situations confronted in practicing before the Commission, for example, the need to make factually-based materiality determinations.

Mandated noisy withdrawal, on the other hand, is unlikely to reflect the complexity and variety of the situations that attorneys practicing before the Commission actually face. In addition, by subjecting attorneys to unwarranted after-the-fact reexamination of their judgments, mandatory withdrawal and disclosure deprives them of the freedom to apply the textured professional judgment that is required.

The effectiveness of a permissive rule should be assessed in the context of the corporate governance and accounting improvements that are taking place. The ABA believes that these improvements, including “up the ladder” reporting by attorneys, will ensure that material violations will come to the attention of responsible corporate officials, including independent directors, so that violations not properly dealt with will be rare. It would be a mistake to fashion a mandatory withdrawal and disclosure regime in order to address the rare situation, particularly when the adoption alone of such a regime would have the potential to impede the ability of lawyers to effectively counsel legal compliance by clients. Effective legal counseling of public companies by their lawyers is critical to the operation of our securities regulatory system, which depends to a large extent on self-regulation through the active involvement of lawyers.

The existing system regulating attorney conduct, which largely utilizes the permissive approach, provides attorneys with the necessary tools to foster legal compliance by clients. Thus, the ABA believes that there is no urgency to mandate noisy withdrawal rather than apply the permissive approach currently utilized by most states and included in the SEC’s final rules.

In its second comment letter to the SEC, the ABA also expressed concerns regarding the alternate noisy withdrawal proposal, which would still require the attorney to withdraw if the company fails to take appropriate remedial action, but would instruct the company—not the attorney—to notify the SEC of the withdrawal. The ABA noted that this alternate proposal would not eliminate the fundamental policy concerns regarding harm to the attorney-client relationship and interference with effective corporate governance. Mandating lawyer withdrawal still would deny lawyers the flexibility they need to counsel clients effectively on compliance with complex securities laws. It would, 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 counsel legal compliance.

Requiring that the lawyer withdraw followed by immediate mandatory reporting by 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 likely consequences—including a full scale SEC investigation and private class action suit. The ABA believes that creating such a situation is not in the public interest.

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While an SEC mandatory noisy withdrawal requirement might make a difference in the rare situation in which it would be invoked, the mere existence of such a requirement would likely make clients reluctant to confide in their lawyers, would cause lawyers to avoid asking the hard questions, and would cause lawyers to withdraw prematurely. For these and other reasons, the ABA believes that both of the SEC's pending proposals would be more likely to harm than protect companies and their investors.

In sum, the American Bar Association has taken a number of concrete steps over the past several years to improve and strengthen the role of attorneys in promoting effective corporate governance. By adopting thoughtful corporate governance reform proposals and significant changes to the ABA's own Model Rules of Professional Conduct, the ABA has endeavored to play a constructive role in the reform effort. As the national representative of the legal profession, the ABA will continue its efforts to improve corporate governance.

Thank you for considering the views of the ABA on these important matters. If you would like more information regarding the ABA's positions on these issues, please contact our legislative counsel for business law issues, Larson Frisby, at (202) 662-1098.

Sincerely,



Robert D. Evans

Attachments

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

The Honorable Barney Frank
Ranking Democratic Member
Committee on Financial Services
U.S. House of Representatives
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All members of the House Financial Services Subcommittee on Capital Markets,
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