CORPORATE LAW

The Erosion of Attorney-Client Privilege

Is Sarbanes-Oxley's brand of corporate accountability worth the cost?

By Peter G. Verniero

With much fanfare, Congress enacted the Sarbanes-Oxley Act of 2002, a law designed to ensure corporate responsibility and enhance the confidence of investors. Against the backdrop of widely-publicized allegations of fraud and other abuses against some of America's most prominent business entities, the act's passage was inevitable. Now that the act has been at work for over two years, it is appropriate that we contemplate these fundamental questions: Is the act operating as its drafters had hoped or have there been unintended consequences? Is the act's brand of corporate accountability worth the cost?

Before addressing those questions, we should review the act's basic tenets. Among other things, the act requires chief executive officers and chief financial officers to personally certify the financial statements of their respective public companies. It also requires audit committees, comprised solely of a company's independent directors, to oversee directly the work of the entity's outside auditors. The act also protects "whistleblowers" — those who report perceived improprieties within the company — by immunizing them against retaliatory discharge.

For lawyers, the act's most significant portion is a single provision directing the Securities and Exchange Commission to adopt rules governing the conduct of attorneys who practice before the commission. In response, the SEC has enacted regulations requiring attorneys to report "material violations" of securities rules or breaches of fiduciary duties committed by their corporate clients. This disclosure obligation mandates that attorneys forward their concerns to the company's chief legal officer or chief executive officer.

What happens next is a turnabout in a profession whose rules normally stress a lawyer's duties to the client. Under the act, once he receives the lawyer's report, the chief legal officer or chief executive officer must inform the lawyer regarding the actions taken in response to the lawyer's concerns. Unless the lawyer "reasonably believes" that the actions taken by management are appropriate, he must continue "up the ladder" and report the perceived wrongdoing to the company's board of directors or a designated board committee.

Generally, the attorney's reporting obligation ends at the board level. The rules, however, contain a significant caveat. If the attorney believes that outside disclosure is necessary to protect investors, then the rules permit the attorney to reveal to the SEC, without his client's approval, confidential information received in the course of the representation. The SEC initially proposed going one step further by requiring the lawyer to reveal the information while withdrawing as the company's counsel. (Although this so-called "noisy withdrawal" rule remains merely a proposal, its adoption still is possible.)

No one can question seriously the value of providing investors with honest financial information in the marketplace or the worth of having corporate directors monitor more closely a company's financial health. Moreover, for those corporate managers familiar with New Jersey's strict whistleblower law, the Conscientious Employee Protection Act, the analogous provision of the Sarbanes-Oxley Act, is hardly new. Similarly, New Jersey's ethics rules already authorize attorneys to disclose protected client information to prevent certain fraudulent acts.

But therein lies one of the chief concerns of many practitioners (this author included). The Sarbanes-Oxley Act federalizes certain rules, such as those affecting attorney conduct, which traditionally have been reserved for the states. New Jersey has a comprehensive and informative body of law regarding how attorneys should behave when discharging their professional responsibilities. No such federal body of law exists. That leaves lawyers in the difficult position of having to juggle potentially competing roles with little guidance from regulators. Stated differently, we have never seen a federal statute quite like this one, under which attorneys have been deputized to police the corporate halls while trying to serve their clients' best interests.

Adding to the concern is the erosion of the attorney-client privilege as it relates to corporate matters. Historically, the privilege applied with equal vigor to both individual and institutional clients, including pub-

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licly-traded companies. That has begun to change. Guidelines of the U.S. Justice Department suggest that any business entity that waives the attorney-client privilege in the face of an inquiry will receive favorable treatment by prosecutors. The element of coercion implicit in these guidelines is unmistakable: Surrender the attorney-client privilege or face stern punishment.

We would not tolerate such an approach in other areas of the law, but seem content to endure it — even to encourage it — in the corporate setting. With increasing frequency, we see companies and CEOs being publicly accused of fraud, resulting in immediate damage to their reputations, regardless of whether the accusations have merit. Even the most honest executive now must think twice before reducing thoughts to writing, out of fear that an overzealous prosecutor someday might portray the executive's statements in a negative light. Worse yet, if the erosion of the attorney-client privilege continues, then attorneys might hesitate in giving unfettered advice and some clients might hesitate before asking for such advice in the first place. That dynamic already might be taking root.

In addition to those societal costs imposed by the act, there are financial costs — and the costs are huge. Imposing internal controls, monitoring the books, investigating the slightest hint of impropriety, checking and double-checking and triple-checking the company's financial records — all of that costs money. And money and resources spent on compliance obviously cannot be used for other corporate needs such as research for new product lines and capital formation, to name just two. According to estimates, some companies have seen costs rise in excess of 100 percent in only a few short years since the act's adoption. See Marc Morgenstern and Peter Nealis, *The Impact of Sarbanes-Oxley on Mid-Cap Issuers*, http://www.sec.gov/info/smallbus/mmorgensternmidcap.pdf.

The act is no doubt a boon for lawyers, accountants and consultants retained to ensure compliance or to "bless" management decisions. But it is increasingly described by executives, particularly those heading smaller companies, as a major burden that is doing more harm than good to the average investor. Interestingly, the SEC itself seems to recognize that some modification might be in order. Toward that end, the agency recently announced the appointment of an advisory committee to review whether the costs of complying with the statute are commensurate with its intended benefits. The committee's official mandate, according to the SEC, is "to examine the impact of the Sarbanes-Oxley Act and other aspects of the federal securities laws on smaller companies."

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Which brings us back to the original question: Has the act been worth its cost? The short-term answer is probably yes. When enacted, the statute was a needed tonic that restored a level of trust in the securities market. The shaken confidence of investors seemed to be on display everywhere, even in judicial pronouncements. A week before President Bush signed the act into law, the New Jersey Supreme Court modified the business judgment rule in the context of derivative-shareholder litigation. In so doing, the Court emphasized that it was "well aware of the questions now being raised in the broader marketplace about the objectivity and responsibility of corporate directors." *In re PSE&G Shareholder Litigation*, 173 N.J 258, 297 (2002).

The long-term answer, however, is not as clear. Before the act's adoption, the federal government already regulated significant aspects of the securities markets. From that perspective, the act contributes to an existing maze of rules, enhancing the government's role in regulating corporate affairs to an unprecedented level. The honest executive undoubtedly is frustrated at the high cost of compliance and must feel uncomfortable having a target pinned constantly on his or her back. Over time, those costs and discomfort will result in less risk-taking by entrepreneurs, reduced expansion of corporate enterprises, and less wealth being created for the betterment of society as a whole.

The ultimate answer rests in how the government chooses to administer the law. If it enforces the act in a balanced and fair manner, avoids prosecutorial overreach, and is open to modifying the law to address the legitimate concerns of smaller companies, then the act will be worth the costs. In that regard, the creation of the SEC's advisory panel is a welcomed step. If, on the other hand, the act gives rise to unfair enforcement and a needless spiral of litigation, then we might reach a tipping point where the act's unwieldy architecture and costs overwhelm its laudatory aims. As the saying goes, only time will tell. ■