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Lawyers in the Perfect Storm

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Mark A. Sargent

Abstract

The multiple corporate collapses and scandals of recent years, for which "Enron" is a convenient shorthand, resulted from a perfect storm in which regulatory oversight, the law of fiduciary duty, gatekeepers, market discipline, and contractual incentives all failed to prevent gross self-dealing, conflicts of interest, and deception, or themselves produced perverse consequences. The story of this simultaneous failure of the structures in place since the New Deal and before, has received considerable attention in both the popular and scholarly literature, but is summarized here to provide a context for consideration of the contributions that lawyers made to the perfect storm. The contribution of lawyers has received less attention than that of gatekeepers such as auditors and research analysts, perhaps because their complex role as both advocates and gatekeepers does not lend itself to a relatively simple morality tale, as did the failures of the auditors and analysts. This article attempts to identify the various types of failures by lawyers in these cases, and argues that there is no single way to describe or explain them; lawyers contributed to the perfect storm in at least several different ways. This complexity suggests that the SEC's new professional standards for lawyers, while perhaps helpful, do not provide a comprehensive solution to the problems that produced a significant contribution by lawyers to the perfect storm.

LAWYERS IN THE PERFECT STORM

Mark A. Sargent[*]

INTRODUCTION

People steal. People cheat. Then they lie about it. When they can steal, cheat and lie in a big way, they do it. When people can steal, cheat and lie behind the protective facade of the corporation, they *really* do it. The concentration of wealth and power in public corporations, when combined with the separation of ownership and control and the consequent diminishment of accountability, creates, almost by definition, a gigantic moral hazard. This is nothing new. So why should we be startled or even particularly troubled by the wave of corporate scandals for which the word "Enron" is a convenient shorthand?

History shows us that corporate scandals have developed symbiotically with the corporation, from the antics of the railroad barons of the mid-nineteenth century through the scandals of today. To suggest that there was a golden age of corporate probity, in which the norms governing the behavior of managers were somehow more stringent than today's norms, may be indulging a fantasy. Economics, as well as history, should preclude such fantasies. Neoclassical theory of the firm teaches that while the public corporation is a useful nexus of contracts,[1] it is abuse-prone, because the separation of ownership and control inevitably produces

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[*] Dean and Professor of Law, Villanova University School of Law. I would like to thank Dean Dennis R. Honabach for the invitation to deliver this paper as the 2003 Foulston & Siefkin Lecture, and the participants in the Villanova Faculty Workshop who commented on a draft. Thanks also to Jason Acevedo for his research assistance. Mistakes are my own.

[1] This basic principle derives from Ronald Coase, The Theory of the Firm, 4 Economica (N.S.) 386 (1937). The legal consequences of the principle are elaborated in Frank H. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 Colum. L. Rev. 1416 (1989) which also cites much of the leading economic and legal literature.

substantial agency costs.[2] The managers of such firms, each of which is a rational *homo economicus*, and a person who does not have the same interests as the owners of the firm, tend to maximize their own utility rather than that of the shareholders by self-dealing and shirking, through devices both subtle and blatant, such as undue risk avoidance, conflict-of-interest transactions or (my favorite) consumption of excess perquisites. Indeed, the central problem of corporate law has been that of defining how agency costs can be controlled, and everyone recognizes that the task is not an easy one.[3]

It also may be that at least some of the recent cases were unique examples of unusually bad corporate governance, not a general failure of corporate governance. As Professor John Coffee pointed out,

> Enron's governance structure was sui generis. Other public corporations simply have not authorized their chief financial officer to run an independent entity that enters into billions of dollars of risky and volatile trading transactions with them; nor have they allowed their senior officers to profit from such self-dealing transactions without broad supervision or even comprehension of the profits involved. Nor have other corporations incorporated thousands of subsidiaries and employed them in a complex web of off-balance sheet partnerships.[4]

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[2] The classic article on agency costs is Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structures, 3 J. Fin. Econ. 305 (1976).

[3] There are, of course, different schools of thought about how and the extent to which corporate law should play a role in controlling agency costs. For a concise explanation of the different approaches of the neo-classical, managerialist, transaction cost and political theory schools, see William A. Klein & John C. Coffee, Jr., Business Organization and Finance 172-178 (8th ed., 2000).

[4] John C. Coffee, Jr., Understanding Enron: "It's About the Gatekeepers, Stupid," 57 Bus. Law 1403 (2002) at 1403.http://www.law.columbia.edu/law-economicstudies. For more detailed discussion of the implications of Enron's extraordinarily bad corporate governance, see generally Jeffrey N. Gordon, What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections, 69 U. Chi. L. Rev. 1233 (2003). For an insider's view of Enron's unusually dysfunctional corporate culture, see Mimi Swartz with Sherron Watkins, Power Failure, The Inside Story of the Collapse of Enron (2003) (Watkins was the key whistleblower at Enron).

The problem presented by Enron may simply be one of determining why some boards are so much worse than others, not whether there has been some systemic breakdown of corporate governance.

So why be surprised about Enron and its progeny, and why believe that something fundamental has been altered, requiring major changes in our system of corporate governance? One answer may be that the scale, rapidity and pervasive impact of these corporate collapses seem unprecedented and radical. The dimension of the collapses, however, can be partially accounted for by the violent bursting of the economic bubble on which some of these companies rose, particularly technology firms such as WorldCom and Global Crossing, rather than defects in corporate governance, which may never have been detected if rising markets continued to mask all sins. But the burst bubble does not account for all of the current disenchantment. The widespread disillusionment caused by the bubble bursting was exacerbated by a pervasive sense of deceit and corruption in the highest reaches of corporate America.

Most disturbing has been the sense of systems failure, of a thorough breakdown of all the mechanisms designed to control agency costs, to prevent corporate managers from using other peoples' money in their own interests to the massive detriment of shareholders, employees, home communities and everyone else effected by their behavior. It may be that Enron was unusual, but it had many successors in disaster, suggesting that something about the failure was systemic, and not idiosyncratic. The world of Enron and the others was a world swept by a perfect storm[5]

[5] The term "perfect storm" is taken from the bestseller about an unusually violent storm in the Atlantic Ocean and the fate of fishermen caught in it. Sebastian Unger, The Perfect Storm: A True Story of Men Against the Sea (1997). Dean Nancy B. Rapoport, however, writes that the "'perfect storm' metaphor [as applied to Enron] irks me to no end," apparently because it was used by an Enron executive in a self-exculpatory manner . Nancy B. Rapoport, Enron, *Titanic* and *The Perfect Storm*, 71 Fordham L. Rev. 1373, 1375 (2003). She maintains "that what brought Enron down - at least as far as we know - wasn't a once-in-a-lifetime alignment of elements beyond its control. Rather, Enron's demise was a

in which regulatory restraints, fiduciary obligation, market discipline, contractual incentives and professional gatekeepers all simultaneously failed to produce their intended beneficial effects.

My principal goal in this paper is to consider the contribution to the perfect storm of one particular group of gatekeepers, the lawyers who represented Enron and the other corporate malefactors. I will then offer some tentative conclusions about the potential usefulness of the attorney whistle-blowing rules Congress has required the Securities and Exchange Commission (SEC) to adopt in response to its perception of those lawyers' ethical and professional failures. Consideration of the lawyers' failures, however, must be contextualized by first trying to understand the other failures that constituted the perfect storm.

I. THE PERFECT STORM

A. The Failure of Law

The elements of this perfect storm are by now clear. First, the federal regulatory framework inherited from the New Deal to ensure that public companies produce and disseminate accurate, material information into the marketplace about the companies' financial condition failed to extract the kind of information needed to allow the market to detect the fundamental problems with Enron and the other corporations that so suddenly turned success into disaster. The reasons why the mandatory disclosure system administered by the SEC failed

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synergistic combination of human errors and hubris; a *Titanic* miscalculation, rather than a 'perfect storm.'" Id. I think Dean Rapoport is taking her metaphors a little too seriously. The term " perfect storm" is not used here to suggest that this was some sort of unique event that just "happened" to Enron. It is used here as a metaphor, through which the simultaneous and virtually complete failures of both external regulatory and internal self-regulatory systems (in some cases because of human error and hubris, and in others because of the defects in those systems) can be compared to the concatenation of weather forces that produced Unger's perfect storm. My use of the metaphor is not an attempt to deflect responsibility from the pirates (to continue the nautical metaphors *ad nauseam*) whose arrogance and dishonesty ultimately sunk Enron. Furthermore, while quibbling about metaphors is perhaps a little silly, I would suggest that insistence on comparison of the Enron debacle to the tragicomedy of human errors in the sinking of the *Titanic* underestimates the importance of the systemic failures that allowed the malign leadership of Enron to produce such an enormous disaster.

are numerous and complex. They range from the inherent difficulty of contending with determined and sophisticated fraud, to the excessive plasticity of accounting standards that allowed the financial condition of issuers to be obscured in an apparently legal manner,[6] to the atrophy of the auditing function that was supposed to ensure the quality of the information fed into the disclosure system,[7] to a market euphoria that kept attention away from the danger signals,[8]Coffee, *supra* n. 4, at 17. to the limitations of an SEC not equal to its oversight and enforcement responsibilities.[9]

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[6] See, however, William W. Bratton, Enron and the Dark Side of Shareholder Value, 76 Tulane L. Rev. 1275,1340-48 (2002), where it is argued that the primary problem was not primarily with the substance of the accounting rules, but with Enron's failure to follow them. But see the following analyses of how Enron apparently followed the existing rules to produce highly undesirable results: Daniel Altman, Enron Had More Than One Way to Disguise the Rapid Rise in Debt, N.Y. Times, Feb. 17, 2002, at A1 (citing Enron's use of existing accounting rules to avoid treating swap exchanges as debt); Floyd Norris & Joseph Cohn, Rule Makers Take on Loopholes That Enron Used in Hiding Debt, N.Y. Times, Feb. 14, 2002 at A1 (citing Enron's use of the "3% Rule" to keep the liabilities of its special purpose entities out of its financial statements as debt). The argument has also been made that certain questionable accounting decisions had been made, and were justifiable, because other companies in the same industry were allegedly doing the same thing. WorldCom, Inc., for example, apparently treated "line charges" (charges for using other phone networks) as capital expenses rather than operating costs, allowing the company (allegedly) to claim $5 billion in profit during a three-year period in which it was losing money. In pleading not guilty to fraud charges WorldCom's former CFO asserted this "everybody was doing it" defense. See Brooke A. Masters, Officer Pleads Not Guilty; Sullivan's Trial Put Off Until 2004, Wash. Post, Apr. 23, 2003, at E01.

[7] See discussion of this problem *infra* at 33-38.

[8] In particular, market euphoria compromises or even destroys the effectiveness of gatekeepers such as auditors, lawyers and securities analysts, as Professor Coffee has pointed out:

> Indeed, in an atmosphere of euphoria in which stock prices ascend endlessly and exponentially, gatekeepers are largely a nuisance to management, which does not need them to attract investors. Gatekeepers are necessary only when investors are cautious and skeptical, and in a market bubble, caution and skepticism are largely abandoned.

[9] See Report of the Staff to the Senate Committee on Governmental Affairs, Financial Oversight of Enron: The SEC and Private Sector Watchdogs (October 8, 2002) at 29-68, (hereinafter Financial Oversight Report) for a critical evaluation of the SEC's performance with respect to Enron.

Second, reliance on the concept of fiduciary duty, a legally enforceable obligation designed to protect shareholders from the self-seeking behavior of corporate officers and directors, seems to have been misguided, at best. The duty of loyalty imposed little restraint on officers who extracted huge sums from the company for their personal benefit in the form of "loans," cash payments or lavish perks,[10] rammed through lucrative conflict-of-interest transactions,[11] manipulated financial data to prop up the stock price to boost the value of their options, or dumped their stock before the bad news of their mismanagement or financial deception became public.[12] Similarly, the duty of care had little impact on the directors of these corporations, particularly independent directors who allowed all of this malfeasance to take place on their watch.[13]

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[10] The most notorious recent example of this behavior is perhaps that of Adelphia Communications, where the founders of a public company used their control over the board to secure approval of millions of dollars worth of unjustifiable personal loans and other benefits to the CEO and his family. The CEO has challenged this characterization of his dealings with the corporation. See Andrew Ross Sorkin, Fallen Founder of Adelphia Tries to Explain, N.Y. Times, April 7, 2003 at C1.

[11] The conflict of interest transactions benefitting Enron senior executives and approved at their request are by now well-known. For analysis of how senior executives benefitted from such transactions and how they deceived the board of directors (which also failed in its oversight functions), see the report prepared by a special board committee chaired by William F. Powers, Jr., Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. (February 1, 2002), at 148-77 (hereinafter Powers Report). Particularly questionable was the Enron's board's willingness to suspend the corporation's own code of ethics in order to avoid the conflict of interest rules that would have precluded board approval of certain major transactions that benefitted the chief financial officer. See A. Larry Elliott & Richard J. Schroth, How Companies Lie 100-01 (2003).

[12] Whether officers or directors (particularly independent directors) will be held liable under the federal securities laws for such insider trading, however, remains to be seen as of this writing. In the case of In re Enron Corp. Securities, Derivative, and ERISA Litigation, 235 F. Supp. 549 (S.D. Tex. 2002), the court dismissed shareholders' claims that the independent directors of Enron sold stock based on inside information about the company's financial condition. The court found that the complaint nowhere asserted facts giving rise to a strong inference of scienter for any of the independent directors.

[13] For strong criticism of the performance of the Enron board of directors, see Report Prepared by the Permanent Subcommittee on Investigations of the Committee on Governmental Affairs United States Senate, The Role of the Board of Directors in Enron's Collapse (July 8, 2002) (hereinafter Role of the Board Report). The report concluded that:

B. Market Failure

The perfect storm involved more, however, than a failure of law, whether it was federal securities law or state law of fiduciary obligation. It was also a case of market failure, which, for some, is a more serious problem. Critics of regulatory intervention into corporate governance

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> [M]uch that was wrong with Enron was known to the Board, from high risk accounting practices and inappropriate conflict of interest transactions, to extensive undisclosed off-the-books activity and excessive executive compensation....[T]he Enron Board failed to provide the prudent oversight and checks and balances that its fiduciary obligations required and a company like Enron needed. By failing to provide sufficient oversight and restraint to stop management excess, the Enron Board contributed to the company's collapse and bears a share of the responsibility for it.

Role of the Board Report at 59.

The extent to which the independence of the Enron Board, and its willingness to exercise its monitoring function, was compromised by personal and financial ties between supposedly independent directors and key executives remains to be determined. See Richard W. Stevenson & Jeff Gerth, Safeguards Failed to Detect Problems at Enron, N.Y. Times, Jan. 20, 2002 at A1.

The ability of a board of directors to meet its fiduciary obligations of care, furthermore, can be compromised when the officers and their professional advisers do not provide the board with the information it needs to do its job, particularly when they are motivated to withhold data that might reveal their conflicts of interest. This may have been why the board of Global Crossing failed to "comprehensively address the implications of [certain questionable] transactions, in the aggregate, for the company's overall financial position, until it was too late to take remedial action if it chose to do so." See Report of the Special Committee on Accounting Matters to the Board of Directors of Global Crossing Ltd., Global Crossing's Response to Olafson's Allegations (Feb. 18, 2003) Tab 3, at 15 (hereinafter Global Crossing Report). Professor Jeffrey N. Gordon has argued, however, that among the Enron board's principal governance failures was its willingness to approve an "opaque" disclosure policy while also authorizing a managerial compensation strategy highly dependent on stock price changes that, as a result of Enron's opaque disclosures, did not reflect material information about the issuer, while itself declining to intensely monitor the company's highly complex operations and financial practices. Jeffrey N. Gordon, Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley, Columbia Law School Center for Law and Economic Studies, Working Paper No. 216, http://ssrn.com/abstract=391363 (March 2003) (forthcoming 33 Conn. L. Rev.).

insist, after all, that the problem of agency costs is best resolved through a combination of market discipline and private contracting.[14]

1. The Limitations of Market Discipline

Corporate managers are disciplined, some argue, by the operation of the market for corporate control, which compels managers to maximize shareholder value at the risk of losing control.[15] There was always an element of overstatement in these theories of market discipline because the takeover phenomenon has been explained in different ways that have nothing to do with the disciplinary hypothesis,[16] but, the limitations of market discipline as a means of aligning

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[14] The body of contractarian thought that emphasizes the efficiency of private contracting as opposed to government intervention in corporate governance through mandatory as distinct from enabling rules derives from Ronald Coase, The Problem of Social Cost, 3 J.L. & Econ. 1 (1960). A comprehensive elaboration of the contractarian approach to corporate law is Frank Easterbrook and Daniel Fischel, The Economic Structure of Corporate Law (1991). For a critical analysis of the contractarian approach, see John C. Coffee, Jr., The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role, 89 Columbia L. Rev. 1618 (1989).

[15] The pioneering article arguing that the disciplinary impact of the market for corporate control is an important means of controlling agency costs is Henry G. Manne, Mergers and the Market for Corporate Control, 73 J. Political Economy 110 (1965). Empirical evidence supporting the thesis that corporate takeovers have the effect of replacing poor managers can be found in Kenneth J. Martin and John J. McConnell, Corporate Performance, Corporate Takeovers, and Managerial Turnover, 46 J. Fin. 671 (1991). For an argument that recognition of takeovers as a method of monitoring management performance requires a rule of managerial passivity in response to a hostile tender offer, see Frank H. Easterbrook and Daniel R. Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 99 Harv. L. Rev. 1161 (1981). For versions of this argument that recognize the importance of the monitoring influence of the market for corporate control, but argue against a rule of pure passivity, see Ronald J. Gilson, Seeking Competitive Bids Versus Pure Passivity in Tender Offers Defense, 35 Stanford L. Rev. 51 (1982); Lucian A. Bebchuk, The Case for Facilitating Competing Tender Offers: A Reply and Extension, 35 Stanford L. Rev. 23 (1982).

[16] For an excellent overview of the literature and excerpts from some of the key articles, see Roberta Romano, Foundations of Corporate Law 221-57 (1993). It has been argued that the recent wave of corporate fraud is at least partially attributable to the demise of the hostile takeover as a disciplinary mechanism as a result of the wave of antitakeover regulation in the 1980s and 1990s. See Larry E. Ribstein, Market v. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002, 28 J. Corp. L. 1, 55 (2002). Professor Ribstein argues that the recent spate of corporate fraud was not caused by market failure, but by prior regulatory intervention into corporate governance that gutted the effectiveness of an important market mechanism of managerial discipline. Professor Ribstein has extended that critique of prior regulatory interventions to a critique of the most recent Congressional

managerial and shareholder interests became particularly obvious in light of the gross misbehavior of corporate managers in the recent debacles.

Also obvious are the limitations of the theory that firms' private incentives to disclose accurate information are sufficient to ensure transparency in corporate disclosure. Undoubtedly, most firms recognize that deceptive disclosure is costly, because eventually it will be detected, diminishing the firm's credibility and producing uncertainty about the value of its securities. The uncertainty discount will then increase its cost of raising capital. Supposedly, this private incentive for truth-telling is so powerful that it renders a government-mandated disclosure system unnecessary.[17] The incentive to disseminate accurate information may be sufficient in most cases, but recent experience suggests that the private incentives for deception can be equally powerful, at least under some circumstances. Those circumstances include situations in which senior managers can benefit enormously in the short term from increases in the stock price, even if those increases are short-lived. They include cases of over-optimism, in which managers believe that future improvements in operations or financial condition will eventually

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response to the market excesses of the last few years. He suggests that the post-Enron legislation may be similar to the misconceived regulatory responses to the bursting of previous market bubbles. See Larry E. Ribstein, Bubble Laws, 40 Houston L. Rev. 77-79 (2003) ("In each case, regulation was passed without due consideration either to the benefits or costs of regulation, and it likely constrained the market's recovery from the crash.")

[17] The leading articles arguing that SEC-mandated disclosure under the Securities Act of 1933 for new issues was superfluous were George Stigler, Public Regulation of the Securities Markets, 37 J. Bus. 117 (1969); Greg Jarrell, the Economic Effects of Federal Regulation of the Market for New Securities Issues, 24 J.L. & Econ. 613 (1981). Se also George Benston, Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934, which found that SEC-mandated disclosure under the Securities Exchange Act by already-public companies was of no apparent value to investors. For a comprehensive critique by legal scholars of the alleged benefits of the mandatory disclosure system, see Frank H. Easterbrook and Daniel R. Fischel, Mandatory Disclosure and the Protection of Investors, 70 Va. L. Rev. 669 (1989). For a rejoinder that is more sanguine about the benefits of the system, see John C. Coffee, Jr., Market Failure and the Economic Case for a Mandatory Disclosure System, 70 Va. L. Rev. 717 (1989).

resolve the problems that are inadequately disclosed or even misrepresented.[18] Most important, perhaps, are the situations in which secretiveness, truth-trimming and even outright deception have become part of the corporate culture, so that public dissembling becomes entirely normative. This may seem irrational, but we know from the insights of behavioral economics that in the financial world the irrational can seem perfectly rational.[19] It seems obvious from recent experience that the irrational has seemed rational to at least some corporate managers, with disastrous consequences for the quality of corporate disclosure.

2. Stock Option Compensation and Perverse Incentives

Even more obvious has been the failure of the principal contractual mechanism for controlling agency costs: executive stock options. Stock option compensation seemed a brilliant, non-regulatory solution to the problem of how to provide managers with the incentive to maximize shareholder value. One commentator has described the premises of stock option

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[18] For a concise analysis of the cognitive biases that produce over-optimism and poor decisions among corporate managers, see Dan Lovallo and Daniel Kahneman, Delusions of Success: How Optimism Undermines Executive Decisions, Harv. Bus. Rev., July 2003, at 56.

[19] The leading texts in the emerging field of "behavioral finance" are Andrei Shleifer, Inefficient Markets: An Introduction to Behavioral Finance (2000); Hersh Sheffrin, Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing. An interesting application of these theories is Robert Shiller, Irrational Exuberance (1999). Professor Donald C. Langevoort has drawn upon the insights of behavioral finance to question the basic premises of the efficient market hypothesis, upon which most theories of market discipline depend. (For an exposition of that thesis and its significance for regulation of public corporations and securities markets, see Ronald J. Gilson & Reinier Kraakman, The Mechanisms of Market Efficiency, 70. Va. L. Rev. 549 (1989)). Langevoort proposes instead an *inefficient* market hypothesis, which would form the basis for what he calls "behavioral securities regulation," which would acknowledge the cognitive biases of both persons involved in issuing securities and investors. Donald C. Langevoort, Taming the Animal Spirits of the Stock Market, 97 Nw. L. Rev. 135, 140 (2002) See however, Stephen J. Choi & A.C. Pritchard, Behavioral Economics and the SEC, University of Michigan John M. Olin Center for Law & Economics, Working Paper No. 03-002, http://ssrn.com/abstract_id=358442 (2003) (forthcoming Stan. L. Rev.), who argue that recognition of behavioral biases within securities markets should not necessarily lead to greater regulatory intervention in those markets, because regulators (particularly monopolistic regulators such as the SEC) suffer from their own behavioral biases.

compensation succinctly, albeit ironically when he explained that: "once endowed with a generous grant of these wonderful instruments, a senior executive would no longer think of himself as a mere hired hand but as a proprietor who had the long term health of the firm at heart. That was the theory, anyway."[20] Instead of being a shirking, risk-avoiding bureaucratic time-server, interested only in his own salary and perks and not in maximizing shareholder value, the manager/option-holder would profit with the shareholder from the increased value the now-entrepreneurial manager's efforts would generate.

While stock option arrangements can be complex, the basic agreement is simple, as the following description shows:

> [a]n executive stock option is a legal contract that grants its owner the right to buy a stock in his or her company at a certain price (the "strike price") on a certain date in the future. Take a company with a stock price of fifty dollars that grants its chief executive the right to buy a million shares three years hence at the current market price. Assume the stock price rises by ten per cent each year, so that after three years it is trading at about sixty-six dollars and fifty cents. At that point, the chief executive can "exercise" his option and make the company sell him a million shares at fifty dollars. Then he can sell the shares in the open market and clear a profit of sixteen and a half million dollars.[21]

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[20] John Cassidy, The Greed Cycle: How the Financial System Encouraged Corporations to Go Astray, The New Yorker, Sept. 23, 2002 at 64, 68. This article is an excellent journalistic account of the perverse effects of the stock option compensation arrangements of the 1990s. For further analysis of those effects and their damage to both shareholder and social welfare, see also Lawrence Mitchell, Corporate Irresponsibility 8-9, 109-11, 223-25 (2001). These critiques fly in the face of much conventional wisdom that favored the use of stock option compensation. For examples of the literature on executive compensation question, including the role of stock option compensation, see Jennifer N. Carpenter & David L. Yermack (eds.), Executive Compensation and Shareholder Value: Theory and Evidence (1999). For a concise survey of the arguments pro and con regarding stock option compensation, see Randall Thomas and Kenneth Martin, the Determinants of Shareholder Voting on Stock Option Plans, 35 Wake Forest L. Rev. 31, 40-46 (2000). For arguments that the largest component of directors' compensation should be in the form of stock options, see Nat'l Ass'n of Corp. Dirs., Report of the NACD Blue Ribbon Commission on Director Compensation 15 (1995); Charles M. Elson, The Duty of Care, Compensation, and Stock Ownership, 63 U. Cinn. L. Rev. 649, 652-53 (1995).

[21] Cassidy, supra note 20, at 68.

Stock option arrangements thus blew off the ceiling on potential executive compensation, to managers' delight. They were equally delightful from the corporation's standpoint. Stock options did not have to be treated as an expense for accounting purposes, unlike executive salaries, allowing corporate earnings to be goosed upward.[22]

Beginning around 1990, stock options began to take off as the principal method of compensating senior executives, dwarfing cash salary payments in significance.[23] Once installed throughout corporate America, stock option arrangements caused executive compensation to balloon wildly. The gross disproportion between senior executive pay and that received by everyone else caused plenty of controversy,[24] but that was only one problem. Serious as it was, it merely formed a backdrop to the most dangerous dilemma: stock option programs not only failed to meet their avowed goal of aligning managerial and shareholder interests, they created perverse incentives for abusing shareholders.

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[22] The question of whether options should be expensed to reduce earnings became controversial in the 1990s, but no meaningful change in the rule was achieved. See Faith Stevelman Kahn, Bombing Markets, Subverting the Rule of Law: Enron, Financial Fraud, and September 11, 2001, 76 Tulane L. Rev. 1579, 1605 n. 73 (2002) and the authorities cited therein. Post-Enron, however, serious consideration of changing the accounting rule began. See note 32 infra.

[23] See Richard H. Wagner and Catherine G. Wagner, Recent Developments in Executive, Director and Employee Stock Compensation Plans: New Concerns for Corporate Directors, 3 Stan. J. L. Bus. and Fin. 5, 6-7 (1997); David M. Schizer, Executives and Hedging: The Fragile Legal Foundation of Incentive Compatability, 100 Colum. L. Rev. 440, 442 (2000).

[24] For a thorough critique of this disproportion and it effects, even before the post-1990 boom in stock option compensation, see Graef S. Crystal, In Search of Excess (1991). For a more recent critique of the gap and its economic and social effects, see Susan J. Stabile, One for A, Two for B, and Four Hundred for C: The Widening Gap in Pay Between Executives and Rank and File Employees, 36 U. Mich. J.L. Reform 115 (2002). There is some evidence, however, that the recession that began in 2001 has begun to reduce average CEO compensation, both because of reduced payouts of performance-related bonuses and because so many stock options are under water. See Special Report, Executive Pay, Bus. Week, April 21, 2003 at 86 (reporting a 33% decline in average CEO pay packages). Shareholders have also begun to use the SEC proxy mechanism to challenge executive compensation arrangements. See Executive Pay: Labor Strikes Back, Bus. Week, May 26, 2003, at 46.

For example, some corporations indulged in the practice of repricing executives' stock options so that they would still be able to exercise their options profitably when the stock price fell.[25] Managers thus benefited whether the stock price went up or down, although the shareholders only profited when the price went up. It was a kind of "heads I win, tails you lose" scenario, in which the notion that options made managers' and shareholders' interests congruent became laughable. Even in the absence of repricing, the use of stock options created an incentive to use accounting devices designed to prop up the stock price[26]It should also be noted that compensation schemes other than stock option arrangements can have similarly perverse effects. Enron, for example, used a program of one-time cash bonus payments to senior executives (its "Performance Unit Plan") as a reward for hitting stock-price targets. Apparently over $320 million of such cash payments were made during the year preceding Enron's bankruptcy, the time when the company was making some of its most misleading accounting decisions and financial disclosures in order to meet stock-price expectations. See Kurt Eichenwald, Enron Paid Huge Bonuses in '01; Experts See a Motive for Cheating, N.Y. Times, March 1, 2002, at A1. in the short term just long enough to allow quick and

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[25] Naturally, this practice has excited criticism. See Charles M. Yablon, Overcompensating: The Corporate Lawyer and Executive Pay, 92 Colum. L. Rev. 1867, 1880 (1992). Note, however, that such repricing apparently has been relatively uncommon. See Todd Perry and Marc Zenner, CEO Compensation in the 1990s: Shareholder Alignment or Shareholder Expropriation?, 35 Wake Forest L. Rev. 123, 124 (2000). Perry and Zenner point out, however, that companies may avoid repricing because it might be embarrassing when publicly disclosed, but that they achieve much the same effect by issuing new options at a lower strike price ("reloading"). Id. at 141.

[26] See Thomas & Martin, supra note 19 at 44.

> Stock option compensation may lead managers to manipulate earnings or other accounting figures so as to insure that the company meets or exceeds analysts' expectations and that the company's stock price rises. Executives holding options also have a tendency to avoid dividends and engage in share repurchases. This raises important questions about whether managers are running the company to increase the value of their stock options or to raise the value of the common stock held by the shareholders.

highly profitable option strikes while the public shareholders were left holding the bag when the price fell.

The use of option repricing thus ensured that the stock option compensation would fail to meet its avowed purpose: giving managers a strong personal incentive to maximize the value of the assets under their control and hence the stock price for the benefit of the shareholders. Even worse than repricing, however, was the incentive that stock option compensation created for managers to manipulate and falsify financial disclosures to raise the stock price to keep or put their options in the money.

Enron's deceptive accounting has received lots of attention because of its subtlety and scale. The company's unorthodox and dubious use of special purpose entities for more than securitizing specific corporate assets (a relatively common corporate financing technique[27]) created a distorted picture of the corporation's financial condition. This is just one example of how Enron managers kept the stock price floating on a column of hot air.[28] Enron also indulged

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[27] A "special purpose entity" (SPE) is used in the process of asset securitization, which is a form of corporate debt financing designed to protect the whole range of the borrower's assets from the claims of the lenders in that financing, and confine potential liability to specified assets. This is achieved by placing a pool of assets, such as commercial leases or consumer receivables, in a separate entity, the SPE. The lender who lends on the strength of the cash flow from that pool of assets has recourse only to those assets in the event of the default, not the other assets of the originator. For detailed analysis, see Steven L. Schwarz, The Alchemy of Asset Securitization, 1 Stanford J. Bus. L. & Fin. 133 (1994); Steven L. Schwarz, Structured Finance, A Guide to the Principles of Asset Securitization (3d ed. 2002). For a concise guide to the legal considerations in structuring special purpose entities to ensure that the originator remains "bankruptcy remote," see Steven L. Schwarz, Structured Finance: The New Way to Securitize Assets, 11 Cardozo L. Rev. 607, 621-26 (1990).

[28] Indeed, Professor Schwarz has argued that Enron's use of SPEs was significantly different from that of normal asset securitization, and failed to provide the transfer of risk (and hence bankruptcy remoteness) that would prevent these highly risky transactions from burying Enron itself under the SPEs' liabilities in the event of default:

> To the extent securitization is used to keep debt off a company's balance sheet, it superficially resembles Enron's use of SPEs. But there are important differences because securitization, unlike the Enron-SPE transactions, unambiguously transfers risk from the

in accounting practices very familiar to corporate CFOs, such as reporting revenues prematurely or speculatively, as the company did with risky derivative contracts that might not pay off in an indefinite future. Critics of corporate accounting practices have identified a host of similar games that have been played to give a misleadingly positive picture of the corporation's financial condition in order to keep the stock price up and options in the money. Some examples include adding fanciful items to revenue, treating a one-time payment from the sale of an asset or other windfall as if it were ongoing income, failing to record liabilities in whole or in part; treating ongoing liabilities as a special charge, and shifting current expenses or liabilities to a later period. Some companies treated operating expenditures as capital expenditures, the cost of

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> company to the SPE and its investors; and transfer of risk is central to the accounting determination of non-consolidation. In Enron's SPE transactions, it was at least debatable whether risk was shifted on the hedged assets owned by Enron; although Enron had the right to require the SPEs to buy these assets at a pre-determined price should their values fall, that right was precarious because the SPEs were capitalized solely with Enron stock. Thus, when Enron's asset and stock values simultaneously fell, the SPEs were unable to perform their hedges. In contrast, a company originating a securitization transaction transfers actual risk by selling financial assets – including the risk of non-payment or delayed payment associated with such assets – to the SPE.

Steven L. Schwarz, Enron, and the Use and Abuse of Special Purpose Entities in Corporate Structure, 70 U. Cinn. L. Rev. 1309, 1315-16 (2002).

Professor Schwarz also points out that the allocation of risk in conventional SPE asset securitization is fully disclosed so that lenders can assess their loan risk and investors in the originating company can assess the significance of the SPE for the value of the originator's equity securities. In Enron, disclosure about the SPEs was either intentionally minimized to hide the conflicts of interest that pervaded their SPE arrangements (a case of fraud), or, more fundamentally,

> Enron's structured finance transactions were so complex that disclosure is necessarily imperfect - either oversimplifying the transactions or providing detail and sophistication beyond the level of an ordinary investor in Enron's securities.

Id. at 8. In either case, the Enron SPE disclosures (or non-disclosures) deeply impaired the market's ability to assess Enron's financial condition.

which can be spread over years, rather than reflected in the current period.[29] The temptation to use such chicanery to maintain the stock price was exacerbated during the market bubble, when soaring stock prices and price-earnings multiples imposed tremendous pressure on managers to keep up with the market at all costs. The perceived pressure from Wall Street to report positive earnings to sustain the market price was, for some companies such as HealthSouth, Xerox and WorldCom, so irresistible that the financial misrepresentations were not even subtle.[30]

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[29] For a survey of these and other accounting tricks, see Howard Schilit, Financial Shenanigans: How to Detect Accounting Gimmicks and Fraud in Financial Statements 63-175 (1993) (describing the "seven shenanigans" of corporate accounting). For a discussion of how easily pro forma accounting, in particular, can be manipulated to produce such results, see Elliott & Schroth, supra note 11, at 37-42. For an example of how one company used several of these devices, see In re Arthur Andersen LLP, Exchange Act Release No. AE–1405, June 19, 2001, 2001 WL 687561; SEC v. Arthur Anderson LLP, Exchange Act Release No. AE 1410, June 19, 2001, 2001 WL 687562 (pre-Enron case in which Waste Management used improper capitalization of expenses, a failure to amortize and improper reserve techniques). See also Xerox's inappropriate acceleration of revenues from long-term equipment leases. Mark Maremont, Xerox Overstated Pretax Income by $1.41 Billion, Filing Reveals, Wall St. J., July 1, 2002, at A3.

[30] A particularly egregious example of this kind of blatant and relatively straightforward lying that came to light after Enron was that of HealthSouth Corp. Beginning in 1997, HealthSouth executives began to be concerned about the gap between HealthSouth's actual earnings per share and Wall Street's earnings' expectations. According to the criminal information filed by federal prosecutors against company executives, the defendants regularly used various accounting devices to overstate (in 2002) the company's cash by $300 million and total assets by $1.5 billion. The former CFO has pled guilty to those charges. See Former CFO of HealthSouth to Plead Guilty to Fraud; SEC Sues Over $1.4 Billion Scam, 35 Sec. Reg. & L. Rep. (BNA) 504 (2004).

Xerox similarly overstated its profits by $1.4 billion over four years, a period during which senior executives gained millions by selling Xerox shares and being paid bonuses for meeting profit targets. See Floyd Norris, 6 Former Xerox Executives to Pay $22 Million, N.Y. Times, June 6, 2003, at C1.

A special report commissioned by WorldCom and prepared by Wilmer Cutler & Pickering showed that WorldCom made repeated efforts to boost revenue to meet Wall Street expectations through an exercise called "Close the Gap." The company apparently recorded revenues from transactions that had not yet been approved, and reported revenue from one-time transactions while telling investors no such revenue had been included. The report alleges that the CEO, Wolfgang Ebbers, was directly involved in these activities. See Rebecca Blumenstein & Susan Pulliam, WorldCom Report Finds Ebbers Played Role in Inflating Revenue, Wall St. J., June 6, 2003, at A1.

All of these accounting tricks were available to corporate managers eager to keep their options not just profitable, but extraordinarily profitable. The possibility of not just wealth, but immense wealth for the average CEO or senior executive created an ongoing moral hazard, an Alice-in-Wonderland universe in which debt disappeared mysteriously, revenue popped up out of rabbit holes, stock prices possessed only a theoretical relationship to earnings, financial statements could say whatever management wanted them to say, and lordly compensation came to feel like an entitlement. Perhaps the perspective of hindsight lends too much of an air of inevitability to the malign effects of the stock option compensation practices of the 1990s, but it seems that options had an enormous influence on the kinds of accounting and disclosure practices which led so many investors, and the market in general, to overvalue so many companies.

These practices also led, some would argue, to a problem even more fundamental than inadequate disclosure. The argument is similar to the one frequently heard in the 1980s during the heyday of hostile corporate takeovers, to the effect that an obsession with maintaining the stock price at a high level (to forestall tender offers at a premium) leads to short-term planning and decision-making, to the long-term detriment of the corporation. Here, the argument would be that over-reliance on stock option compensation also has led to an equally unhealthy preoccupation with short-term maintenance of stock prices.[31] A possible response to both of these arguments might be that if the firm really was sacrificing the long-term interests of the corporation for short-term benefits in an unjustifiable way, the market would recognize that fact, and discount the price of the firm's securities appropriately. This answer presumes, however,

[31] For critical discussion of the impact of an excessively short-term focus on earnings in corporate America, see Mitchell supra n. 18. at 116-19.

that the market has sufficient information about the firm to make such a discount, certainly a questionable presumption these days. An additional problem is whether the market is sufficiently efficient to process the information rationally, a questionable presumption in light of the insights of behavioral finance into market behavior. There is at least an important question as to whether the widespread use of very substantial stock option compensation has created a short-term bias that needs to be explored. Whether the experience of the last couple of years will lead to significant changes in both compensation and accounting practices relating to stock option compensation remains to be seen.[32]

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[32] There is some evidence of a shift from the use of stock options as incentive compensation to the use of restricted shares and so-called "performance" shares. Restricted shares do not have to be set against earnings and do not dilute common shares, and not as many have to be issued as with options. They convert to full shares after a 3-5 year period and, unlike options, retain some value even if the stock price falls. Performance shares are granted only when specified performance goals are met. See Robert D. Hof, Stock Options Aren't the Only Option, Bus. Week, April 14, 2003, at 60.

Professor Brian Hall has argued that compensation in the form of stock as opposed to stock options is preferable for several reasons:

> The problem isn't that stock options don't have any downside risk. The problem is that they have so much. They have value when granted and can fall out of the money very quickly and end up worth nothing. Then boards feel pressure to either reprice them or give additional grants to make up the difference–practices we all hate, for good reasons. Stock is much less fragile–it never falls under water and creates no repricing pressures. Stock is also more transparent to shareholders and to the board, which helps them make better decisions. Stock is also more understandable to a lot of executives. There's no need to rely on a highly complex model to understand its value. Accounting rules have skewed compensation awards in favor of options for far too long. Once we start treating options as a real expense, we're going to see a lot more stock and a lot fewer options.

Charles Elson (moderator), Roundtable: What's Wrong With Executive Compensation?, Harvard Business Review, Jan. 2003, at 69, 73.

The accounting question is whether companies will voluntarily choose or will be required to deduct the value of stock options from earnings. In the summer of 2002, the Coca-Cola Company announced that it would voluntarily treat management stock options as an expense. See Floyd Norris & Sherri Day, Coke to Report Stock Options as an Expense, N.Y. Times, July 15, 2002, at A1. A major

B. The Failure of Gatekeepers

Market discipline and legal obligations are not the only constraints on the self-serving and deceptive behavior of corporate managers. Independent professionals also function as gatekeepers, performing functions that help ensure the accuracy and reliability of the information disseminated by the firm into the marketplace. The failures of auditors and securities analysts to perform those functions with respect to Enron and its progeny is by now well known, and has led to the destruction of one of the world's largest accounting firms and a massive legal settlement by some of the leading securities firms.

The auditing profession owes its status as a profession to the requirement of the federal securities laws, beginning in 1933, that issuers of securities provide financial statements certified by independent auditors. The new legal requirement of independence gave auditors leverage against domination by their corporate clients, and the ability to make disinterested decisions and reach conclusions on the basis of their expert knowledge of generally accepted accounting

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shift in this direction would have a significant impact on the calculation of corporate earnings. It has been estimated that if companies treated options as a cost, "the earnings per share of the companies in the Standard & Poors 500 stock index would have been 20 percent lower in 2001 than they actually were...." Devid Leonhardt, Options Calculus: Who Gets it Right?, N.Y. Times, March 30, 2003, Section 3 at 1. As companies have begun voluntarily to expense stock option costs, furthermore, controversy has arisen over the proper methodology for calculating the cost that should be reported. Id.

As of this writing in the Summer of 2003, the question of whether companies will be required to expense the value of stock option compensation remains. The Federal Accounting Standards Board backed off from adopting such a requirement in the mid-1990s (see note 20 supra), but on March 12, 2003 announced a study of accounting for stock options, expected to be completed by March 2004, which will address the issue. See FASB Votes to Start Major Project on Accounting for Stock Compensation, 25 Se. Reg. & L. Rep. (BNA) 463 (March 17, 2003). For a summary of the current debate over the desirability of and appropriate methodology for expensing options, see Witnesses at House Hearing on Options Disagree at Every Turn on Expensing Options, Sec. Reg. & L. Rep. (BNA), June 9, 2003, at 35.

principles and auditing standards.[33] The purpose of the legislative mandate for auditor independence was to provide an external check on the quality of financial disclosure by management. The presumption, naturally, was that auditors would, in fact, act independently. Auditors were given a significant incentive to do so through the establishment of liability for them under the anti-fraud provisions of the federal securities laws. The apparent failure of Arthur Anderson in the Enron case to act as any kind of real check on management's approach to financial accounting, and, rather, to facilitate misleading financial disclosures,[34] suggests that other incentives can overwhelm the auditors' incentives to act independently.

The other incentive cited most frequently has been accounting firms' interest in obtaining consulting work from companies they are auditing. In at least some cases, the consulting work is more lucrative than auditing work, creating an incentive for the firm to be compliant with or even facilitative of the clients' desire to stretch or even exceed the boundaries of generally accepted accounting principles or auditing standards. Recognition of that clash of incentives has

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[33] See Thomas K. McCraw, Prophets of Regulation 188-92 (1984), which describes how the mutually beneficial relationship of federal securities regulation and the accounting profession evolved, and how it fostered the independence, reputation and growth of the profession.

[34] The extent of Arthur Andersen's failure is by now well-established. See Financial Oversight Report, supra note 8, at 28 ("One of the major concerns about Andersen as the auditor of Enron has been that it did not exhibit sufficient independence and objectivity in discharging its responsibilities.... Enron's auditor failed to discharge its role of verifying the accuracy of Enron's books.") A committee of independent directors of Enron also concluded that "Andersen did not fulfill its professional responsibilities in connection with its audit of Enron's financial statements...." Powers Report, supra note 11, at 24. See also Bratton, supra note 6, at ___ (Enron's auditors "manifestly should have refused to give a favorable opinion on Enron's financials....It is clear that Enron had captured its auditor, denuding the relationship of its necessary adversary aspect.") For discussion of the actual accounting violations, see id. at 63-68. Professor Bratton points out that in most cases either Enron or Andersen, or both, simply failed to follow the existing rules. Bratton, supra note 6, at ___. In other cases, the rules were followed, but the rules were defective substantively and need reconsideration. See also Floyd Norris & Kurt Eichenwald, Fuzzy Rules of Accounting and Enron, N.Y. Times, Jan. 30 2002, at C1, C6 (citing the need to develop more effective rules).

drawn considerable attention,[35] resulting in changes in law and practice designed to mitigate the conflict.[36] Most problematic, however, is the possibility that the culture of auditing may have changed even without reference to the desire to generate or preserve consulting business.[37] One of the indirect effects of over-reliance on stock option compensation may have been the

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[35] See, e.g., Financial Oversight Report, supra note 8, at 28 ("In 2000, Andersen earned $52 million in fees from Enron. Less than half that amount, $25 million, was for audit work; $27 million related to consulting services....[I]t is difficult to comprehend how such large consulting fees could not have created a serious conflict of interest for Enron.")

[36] Sarbanes-Oxley Act §201(a), 15 U.S.C.A. §78j-l(g)-(h) (2002) sets out a new list of non-audit services that auditors are proscribed from providing. The SEC adopted rules effective May 6, 2003 implementing those proscriptions, including a prohibition on financial information systems design and implementation services; a prohibition on internal audit outsourcing services; and a restriction on certain types of "expert" services. SEC Rel. No. 33-8183 (Mar. 31, 2003), 68 Fed. Reg. 6006, 6010. Note, however, that an auditor may still provide financial information system design and implementation, as well as internal outsourcing services, if it is reasonable to conclude that the results of the service will not be subject to audit procedures during an audit of the client's financial statements. Id. at 6011. The new rules also create a requirement for pre-approval of audit and non-audit services to be provided by the auditor. Id. at 6010. These measures fall far short of the full severance of auditing and non-auditing services some thought to be necessary. See, e.g., Special Report, Accounting in Crisis, Bus. Week, Jan. 28, 2002, at 44, 46 (urging a bar on consulting services to audit clients). Note, however, that all of the Big Five accounting firms have placed their own restrictions on the sale of consulting services to their clients, particularly internal audit services. See Jonathan D. Glater, Deloitte Is Last Big Audit Firm to Revamp Consulting Business, N.Y. Times, Feb. 6, 2002, at C1.

The Sarbanes-Oxley Act also added new requirements for rotation of audit partners after five years (§203), selection of auditors by board audit committees (§202), more detailed reporting by auditors to boards (§206), and the presence of a "financial expert" on the audit committee (§§204,407).

[37] For an argument by the former head of the ethics consulting unit at Arthur Andersen that a firm once renowned for its revenue became so obsessed with generating revenue and internal competition over fees that it abandoned its own ethical principles, see Barbara Ley Toffler with Jennifer Reingold, Final Accounting: Ambition, Greed and the Fall of Arthur Anderson (2003). For discussion of how Anderson became complicit with the fraud being perpetrated by the corporation's executives, with respect to whom they became "part of the family," see Elliott & Schroth, supra note 11, 89-99 (2003), and of how they accepted Enron executives' spurious materiality arguments regarding earnings overstatements, see Noam Scheiber, Peer Revue, New Republic, Jan. 28, 2002, at 19, 20.

Recognition of the sins of Andersen, however, should not preclude recognizing the many failures of a similar type by other large accounting firms. See, e.g., Floyd Norris, Ernst Partners Accept Limits on Audits, N.Y. Times, Apr. 25, 2003, at C1 (describing settlement of SEC allegations that auditors approved the financial statements of CUC International when they knew that they did not conform to GAAP).

corruption of the auditing function, as auditors faced extraordinary pressure from managers to approve questionable treatments of earnings and debt to sustain the stock price. When this took place during a stock market boom in which rising prices covered all sins, the risk of liability may have seemed slim to auditors eager to preserve positive relationships with managers, repeat business and a reputation for being "reasonable." This attitude resulted in a tendency to go along, rather than to resist managers insisting on questionable accounting treatment and financial disclosures. There was also a conflict between a firm's interest in maintaining its reputation for auditing integrity and individual partners' desires to maximize their income within the firm, when a partner's income is heavily dependent on billings from one client.[38] Whatever the reason, it seems clear that auditors were frail obstacles, at best, to the degradation of financial disclosure that became epidemic in the scandals of 2002.

The impact of conflicts of interests seems even more obvious in the case of securities analysts. A major settlement initiated by the New York State Attorney General involving several major securities firms was the response to the practice of touting stocks of companies with whom the analysts' firms had a significant investment banking relationship, regardless of the analysts' negative view of those issuers. The practice of tying analysts' compensation to revenues generated by investment banking business significantly distorted analysts' incentives to provide disinterested, critical reports on the issuers they were evaluating, and induced them to delude the investing public with essentially false analyses.

Once again a conflict of interest undermined an incentive to act independently of the issuer of securities. Securities analysts, theoretically, have a strong incentive to provide accurate

[38] See Ribstein, supra note 16, 28 J. Corp. L. at 13-14. Ribstein also considers the possibility that the auditor may be afflicted in those circumstances by a "self-serving bias" that prevents recognition of problems, rather than affirmative dishonesty. Id.

information and advice. If what they offer is deemed unreliable, presumably its market value will diminish. This dynamic alone should have been sufficient to ensure analysts' probity, especially when the incentive was protected from erosion by the supposed wall between the analysis and investment banking functions in their firms. Apparently, the incentives created by the prevailing compensation system were sufficient in many cases to render the incentive to tell the truth less powerful than it should have been.[39]

The failures of auditors and securities analysts as gatekeepers are notorious. Relatively less attention has been paid, however, to the lawyers and law firms who advised the fallen corporations. To be sure, some of those lawyers have come in for their share of scrutiny and criticism, and some are enmeshed as defendants in civil litigation brought on behalf of shareholders. Bolstering the role of lawyers in forestalling corporate law-breaking also has

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[39] In response to this problem, on February 2, 2003 the SEC adopted Regulation AC , 17 C.F.R. 242, which requires research reports to contain certifications by the research analyst that: (i) the views expressed in the report accurately reflect the analyst's personal views; and (ii) the analyst did or did not, as the case may be, receive compensation or other payments in connection with the analyst's recommendations or views. SEC Rels. No. 33-8193, 34-47384 60 Fed. Reg. 9482. Note, however, that Regulation AC does not impose substantive requirements on research analyst's regarding the content of their research reports or their manner of compensation. The new rules thus fall short of mandating the separation of research and investment banking function.

A major enforcement action spearheaded by the Office of the Attorney General of the State of New York and joined by the SEC and other regulators, however, led to a settlement in 2003 with ten major securities firms that not only extracted in excess of $1.4 billion from those firms, but required those firms to substantially sever the links between research and investment banking, particularly with respect to analysts' compensation. See Joint Press Release of the SEC, the State of New York Attorney General, NASAA, the NASD and, the NYSE, Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (April 28, 2003) http://www.sec.gov/news/press/2003-54.htm; SEC, Statement Regarding Global Settlement Related to Analyst Conflict of Interest (April 28, 2003) http://sec.gov/news/speech/spch042803com.htm. For discussion and comments, see Stephen Labaton, 10 Wall St. Firms Settle With U.S. in Analyst Inquiry, N.Y. Times, April 29, 2003, at A1.

It is likely that the parties to this settlement will also face private claims from investors. For an argument that analysts' undisclosed conflicts of interest should give rise to liability for securities fraud, see Jill I. Gross, Securities Analysts' Undisclosed Conflicts of Interest: Unfair Dealing or Securities Fraud?, 2002 Colum. Bus. L. Rev. 631.

become the focus of federal legislation.[40] But lawyers do not seem to have figured in the same relatively simple morality plays as the auditors and the securities analysts. While their behavior has raised serious questions, the answers to those questions about lawyers are not transparently obvious. This is because the lawyers' roles were more complex and ambiguous.

Auditors' roles, when boiled down to their essence, are straightforward. They must play a quasi-adversarial role versus their auditing clients. Their job is not to help the managers of the company achieve their goals. The auditors' responsibility is to protect the investing public by casting a dispassionate, disinterested eye on management's accounting and financial disclosures and placing their own reputation on the line by certifying the corporate financial statement. They function, in essence, as reputational intermediaries, drawing on their professional reputations to vouch for their auditing client's financial disclosures.[41] Similarly, the securities analyst's job is to pierce through the appearance projected by the corporation and to be the one who says that "The emperor has no clothes!" Their relationship to the issuer of securities must be more detached than that of the auditor, and their responsibility flows not to corporate management but to those members of the investing public who rely on their analysis. To the extent that conflicts of interest led auditors and analysts to place currying favor with corporate managers ahead of their clear obligations to investors, they failed their essential tasks. In other words, to the extent they became advocates, they failed as auditors and analysts.

That, of course, is the basic difference between the auditor's roles and the role of lawyers that makes lawyers' participation in the perfect storm of systems failures more ambiguous, and

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[40] See text accompanying notes 98-108 infra.

[41] See Ribstein, supra note 18, 28 J. Corp. L. at 13, regarding the auditing firm's incentive not to forfeit their "reputational bonds."

not the subject of a simple morality tale. Lawyers *are* advocates. They have obligations to act on behalf of the corporate client that makes their role quite different from the quasi-adversarial role of an auditor and entirely different from the detached, arms-length function of a securities analyst.[42] Because auditors and analysts are not advocates for the corporation, their decision to act *as if they were advocates* amounted to a betrayal of the public interests they were supposed to serve. It cannot be said that the lawyers in Enron and the other cases, who were in fact supposed to be advocates for their corporate clients, similarly betrayed a public interest simply by virtue of acting on behalf of their clients. That conclusion, however, does not end the analysis. Assumption of the obligations of advocacy does not excuse a lawyer from other obligations.

Lawyers acting in the context of public companies are not only advocates. They are also gatekeepers. They stand at the approaches to the capital markets. As the auditor constrains access to the markets by its power to certify financial statements, and the analyst by its power to make investment recommendations, the company's lawyer has the duty, and at least some power, to constrain unlawful behavior by the company as it seeks access to capital. The lawyer can control market access by withholding cooperation from the potential wrongdoer.[43] She can refuse to do necessary legal work, provide legal opinions or otherwise refuse to associate the law firm's name with the questionable transaction. This will make it difficult for the client to complete the mechanics of the transaction; the lawyer's refusal to vouch for the client by acting as a

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[42] For an example of how an analyst completely lost his detachment from the company he researched, see Landon Thomas, Jr., Ex-Analyst Was Too Close to Tyco, N.A.S.D. Says, N.Y. Times, May 29, 2003, at C1 (Merrill Lynch analyst "went so far at to refer to himself as a loyal Tyco employee and joked that he was indirectly paid by the company").

[43] See generally works by Professor Reinier Kraakman elaborating this definition of "gatekeeper." Reinier Kraakman, Gatekeepers: The Anatomy of Third Party Enforcement Strategy, J.L. Econ. Org. 53 (1986); Corporate Liability Strategies and the Costs of Legal Controls, 93 Yale L.J. 857 (1984).

reputational intermediary will make the transaction less valuable to third parties or less likely to be approved by other professional gatekeepers, higher level corporate decisionmakers or regulators.[44] In addition, a lawyer can act as a gatekeeper more affirmatively by blowing the whistle, reporting the problem to a higher level within the corporate entity or externally to regulators such as the SEC. In many respects, the lawyer-as-gatekeeper in a corporate/securities context has to maintain the type of "healthy skepticism"[45] toward management that should also be characteristic of the auditor. The lawyer thus has both an obligation to the client and a public obligation.

Here is where the complexity lies. Lawyers are both advocates and gatekeepers, with obligations running both to the client (of a very specific kind) and to the public (of a more indeterminate type). Their relationship with the client is thus both one of trust and confidence and one that can be adversarial. This duality can produce conflict within the attorney-client relationship, and multiplies the opportunity for failure. Section 307 and the implementing rules reflect the apparent belief that the existing rules governing the attorney-client relationship made it more likely that lawyers would fail as gatekeepers by not imposing upon them the responsibility to report, in some way, unlawful behavior they confronted in the course of their representation. By creating more robust whistleblowing obligations for lawyers, the section 307

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[44] With respect to the concept of gatekeeper as "reputational intermediary," see Ronald Gilson & Reinier Kraakman, The Mechanisms of Market Efficiency, 70 Va. L. Rev. 549, 612-21 (1984).

[45] For an authoritative statement of this obligation by a leading securities practitioner, see A.A. Sommer, Jr., The Emerging Responsibilities of the Securities Lawyer, Address to the Banking, Corporation & Business Law Section, N.Y. State Bar Ass'n (January 24, 1974), reprinted in Larry D. Soderquist & Theresa Gabaldon, Securities Regulation 617-619 (4th ed. 1999). For a similar statement by two of the leading securities law academics in an authoritative treatise, see Louis Loss & Joel Seligman, Fundamentals of Securities Regulation 1384 (4th ed. 2001) (the securities lawyer should ask "searching questions" about the client's disclosures).

rules attempt to fortify lawyers' positions as gatekeepers. This legislative and regulatory response, however, presumes that the problem in Enron and the other cases was primarily one of insufficient incentives (or legal obligations) to blow the whistle.

That is a questionable presumption. If we look more closely at these cases, we may conclude that lawyers' contributions to the debacles had less to do with the failures as whistleblowers, but with different, and more fundamental problems to which the section 307 rules do not really respond. If we can understand more precisely how lawyers failed in these cases we can then determine whether the legal response to the perceived failures of corporate lawyering embodied in section 307 of the Sarbanes-Oxley Act and the SEC rules makes sense.

II. HOW DID THE LAWYERS FAIL?

Lawyers can be said to have contributed to the perfect storm in at least three basic ways. First, in some cases, they acted as partners in crime with the malefactors in the executive suite and on the board. Second, in others they provided legitimate advice on legal transactions that turned out to have very bad consequences. Third, in yet other cases, they were “merely” negligent, failing in their basic obligation to their clients to provide competent legal advice. In considering these three different scenarios, the question should be asked whether the presence of a more robust whistleblowing obligation would have made a material difference.

A. Partners in Crime

There apparently were situations in the recent cases where lawyers actively and intentionally participated in the wrongdoing perpetrated by corporate managers. Those lawyers apparently knew that managers were deliberately falsifying disclosures, deceiving the board of directors, regulatory agencies or the investing public, misappropriating assets of the corporation or otherwise illegally self-dealing. These lawyers knowingly facilitated the managers' efforts

through the use of their legal expertise in order to benefit themselves. In other words, some lawyers may have chosen to be partners in crime. Given the complexities of the corporate and securities laws, such active connivance by lawyers played a big role in helping corporate managers achieve illicit ends. An example in point may be the general counsel of Tyco International Ltd., who was criminally indicted for allegedly covering up a conflict-of-interest transactions benefiting the chief executive officer and taking for himself an unauthorized $14 million "loan."[46] Another example may be that of the general counsel of an Enron subsidiary who, according to the SEC, directly participated in and benefited from investments in the conflict of interest transactions with affiliates created by Enron.[47] We may also include in this category situations in which there was a less direct, but equally real benefit to the lawyers involved. The best example is the legal advice, drafting services, and "true sale" opinions delivered by Vinson & Elkins in connection with the special purpose entities created by Enron executives.[48] Vinson &

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[46] Otis Bilodeau, After Tyco, the Role of GCS is Under Scrutiny, The Recorder, Sept. 26, 2002 at 3; Jonathan D. Glater, Lawyer Caught in Tyco Tangle Leaves Friends Wondering, N.Y. Times, Sept. 24, 2002, at C1. As of this writing the prosecution against Mark Belnick, the former general counsel of Tyco, remains unresolved. For a more detailed discussion of Belnick's actions and the SEC's allegations against him, see Laurie P. Cohen, How A Tyco Lawyer Channeled Windfall Into Unlikely Cause, Wall St. J., June 4, 2003, at A1.

[47] Miriam Rozen, Allegations Swirl Around Former Enron In-houser, Tex. Law., Feb. 4, 2002 at 21.

[48] Vinson & Elkins' involvement in the construction of Enron special purpose entities has given rise to the claim that the firm is primarily liable for securities fraud under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §7245. See Newby v. Enron Corporation, 235 F. Supp. 2d 549, 656-69 (S.D. Tex. 2002). The plaintiff's claim is that the law firm's level of participation in the transactions and knowledge of fraudulent conduct was so extensive that it amounted to much more than mere aiding and abetting, for which there is no private cause of action for liability. Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994). The complaint alleges that "Vinson & Elkins was not merely a drafter, but essentially a co-author of the documents it created for public consumption, concealing its own and other participants' actions." Newby, supra at 704. This was but one of the allegations in the complaint:

Elkins' participation was a crucial element in the execution of transactions with officers that involved massive conflicts of interest and inadequate public disclosures and which the law firm allegedly knew were fraudulent. The law firm did not invest directly in the transactions, but its participation helped preserve its lucrative relationship with the key officers of one of its largest clients.[49] Purposefully facilitating transactions harmful to the corporation and investors (and

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> Among the complaint's [other] specific allegations of acts in furtherance of the [deceptive] scheme are that the firm's involvement in negotiation and structuring of the illicit partnerships and off-the-books SPEs, whose formation documentation it drafted, as well as that of the subsequent transactions of these entities. It advised making Kopper manager of Chewco so that Enron's involvement in and control of the SPE would not have to be disclosed, drafted 'true sales' opinions that Lead Plaintiff asserts were essential to effect many of the allegedly fraudulent transactions. Vinson & Elkins was materially involved in the New Power IPO, and it structured and provided advice on the Mahonia trades, all actions constituting primary violations of §10(b). In other words, it 'effected the very' deceptive devices and contrivances that were the heart of the alleged Ponzi scheme.

Id. at 705. The court found in Newby that the forgoing allegations (and others) stated a claim under §10(b), and denied Vinson & Elkins' motion to dismiss. Id. at 705. For discussion of how the assertion of primary liability under §10(b) was designed as an alternative to the aiding-and-abetting argument eliminated by Central Bank, see David E. Rovella, Milberg Guns for Enron's Lawyers, Nat'l L.J., April 15, 2002, at A1. Vinson & Elkins has denied that its involvement in the questionable transactions amounted to legal malpractice, let alone fraud. See Vinson & Elkins Shoots Back, Legal Times, Feb. 11, 2002, at 17 (emphasizing lack of knowledge of any fraudulent conduct and lack of responsibility for accounting determinations). Others have also defended the firm, arguing that "the issues surrounding the Enron work turned on judgment calls based on incomplete information" rather than "obvious fraud," John Schwartz, Enron's Many Strands: The Lawyers, N.Y. Times, March 12, 2002 at C1.

While the factual issues in Newby remain to be resolved, the allegations, if true, would show that the firm went beyond "mere" malpractice, and truly became a "partner in crime" with its client.

[49] Enron was Vinson & Elkins' top client, accounting for more than 7% of the firm's $450 million in annual revenue. One Client, Big Hassle, Bus. Week, Jan 28, 2002, at 38. The plaintiffs in Newby alleged that "Vinson & Elkins chose to engage in illegal activity for and with its client in return for lucrative fees." Newby, supra note 48, at 298.

preparing misleading disclosures about them)[50] to protect an advantageous relationship with corporate officers crosses the line of mere negligence. A lawyer who does that becomes a partner-in-crime, and may become liable as a primary violator, and not simply as aider and abettor of client wrongdoing. Whether that actually happened in the case of Vinson & Elkins and Enron remains to be seen as the facts are developed in litigation. To the extent that it happened, however, it is truly bad.

It is bad, naturally, because no one wants to see lawyers, especially those whose actions affect hundreds of millions of dollars of wealth, deliberately engaged in illegality or criminality, particularly when such behavior benefits the lawyer, directly or indirectly. We would find it instructive to ask why such behavior surfaced in elite law firms and general counsels' offices where, theoretically, there are significant internal and external incentives and restraints that should preclude such a thing. This is the type of question we ask about white collar crime in general, of which this is a specific example.

But, important as such questions may be, the kind of behavior I have just described does not raise novel or even interesting questions about the nature of the lawyers' role or the relationship of a lawyers' obligations to the client and her duty to the public. No one would

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[50] For criticism of Vinson & Elkins' advice regarding the disclosures made by Enron about its SPEs, see the Powers Report, supra note 10 at 26 ("Vinson & Elkins should have brought a stronger, more objective and critical voice to the disclosure process."). See also id. at 178-203 for specific and highly critical discussion of Vinson & Elkins' role in preparing public disclosures about insiders' interests in Enron's related-party transactions. The Report concluded that "the responsibility for these inadequate disclosures is shared by Enron Management, the Audit and Compliance Committee of the Board, Enron's in-house counsel, Vinson & Elkins, and Andersen." Id. at 178.

Even more serious charges of active complicity in generating misleading financial disclosures led to indictment of the former general counsel of HBO & Co., who allegedly helped design and execute an elaborate plan to increase revenue artificially by as much as 500 percent prior to the company's merger with McKesson Corp. The Justice Department called this its first-ever securities fraud indictment of a general counsel. Jason Hoppin, Corporate GC Indicted in Fraud Case, Leg. Intelligencer (Phila.), June 6, 2003, at 4.

suggest that a lawyer knowingly and affirmatively furthering a fraudulent or otherwise illegal scheme is doing anything consistent with a professional obligation to a client. The decision of a lawyer to share in a client's illegality or criminality does not suggest that there is anything wrong with the rules of professional conduct, or that there is a structural problem in the rules governing representation of a public corporation. Such a decision does not involve a question of what the law permits or requires (which should be clear), but of why a lawyer chooses to disobey the law. In short, to the extent the scandals are about lawyers' purposely furthering their clients' wrongdoing we have a problem not of law, but of morality or psychology or the sociology of the profession. This problem is certainly important to explore, but it is not necessarily a problem of whistleblowing. If a lawyer has decided to be partners-in-crime, a legal obligation to blow the whistle is the least of his concerns. He has already crossed a crucial line, and is not likely to inform on himself.

B. Legal Transactions, Bad Consequences

The partners-in-crime scenario should seem relatively clear. A second scenario is based not on the assumption that some lawyers were participating in anything illegal, but that they were engaged in structuring transactions that were entirely legal, but which ultimately had bad consequences. Was the lawyer's participation in structuring those transactions, which presumably needed expert legal advice, somehow problematic?

There are many examples of such “legal” transactions that produced, singly or cumulatively, bad effects. One of the bitterest consequences of the Enron collapse was the destruction of most of the value in ordinary employees' 401(k) plans, which were concentrated in

Enron stock.[51] Exacerbating this problem was the company's policy of partially restricting employees from selling their own shares.[52] The employee benefits lawyers who permitted such concentration and restrictions, however, apparently provided correct legal advice. Are they responsible for what may now appear to be the negative effects of overly-permissive legal rules, and of Enron executives' and trustees' administration of those rules to the detriment of their employees?[53] A similar question may be asked about the lawyers who set up the stock option

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[51] At Enron, employees concentrated 62% of their assets in Enron stock. Jeremy Kahn, Backlash: When 401(k)s Are KO'd, Fortune, Jan. 7, 2002 at 104. This level of concentration was relatively high; in October 2001 only 30% of the $71 billion invested in 1.5 million 401(k) plans was invested in the stock of the sponsoring company. Id. (citing report by Hewitt Associates.) Many financial experts believe, however, that even 25% concentration of assets in employer stock is too high, because most employees would benefit from greater diversification. See How Well Do 401(k) Plans Work, and Who Benefits Most From Them?, Knowledge @Wharton, http://knowledge.wharton.upenn.edu (Winter 2003). Such diversification, however, was not illegal. It was also not unique at the time. See Steven Greenhouse, Enron's Many Strands: Retirement Money, N.Y. Times, Feb. 2, 2002, at C1 (quoting Senator Jon Corzine discussing similar examples of concentration at Sunbeam and Waste Management).

[52] Enron employees were prohibited from selling stock contributed to their 401(k) by the company until they were 50 years old. See Statement of Senator Joseph Lieberman (Feb. 5, 2002) http://www.senate.gov/~lieberman/newsite/press/01101/2002102708.html, at 2. They were also prohibited from selling their stock during a controversial moratorium or "lock-down" period for at least two weeks while Enron was changing its outside administrator. Id. at 3. Enron stock was exceptionally volatile during this period, and only senior executives faced no restrictions in selling their stock. Steven Greenhouse & Stephen Labaton, Enron Executies Say They Debated Freeze on Pension, N.Y. Times, Feb. 6, 2002, at A1.

[53] For critical discussion of Enron executives' promotion of employees' 401(k) investment in Enron stock, see Lieberman Statement, supra note 51 at 2 ("Enron's top management repeatedly promoted its stock through internal publications and communications, even when executives must have know the company was a house of cards"). Enron executives have also been criticized for not delaying the lock-down or "black-out" period when they knew that a prohibition on selling would exacerbate employees' losses. Greenhouse & Labaton, supra note 51. Both the Labor Department and private plaintiffs have initiated action against the 401(k) plan's trustees because of their failure to warn plan participants about serious problems with Enron's accounting and its impending financial crisis. Steven Greenhouse, U.S. Pressing for Enron Plan Trustees to Step Down, Feb. 11, 2002. See also Kathy Chen & Theo Francis, Enron Official Failed to Warn Participants of 401(k) Plan, Wall St. J., Feb. 6, 2002, at C1 (citing argument that trustees also should have stopped offering Enron stock as an investment option and using it as a matching contribution). Whether managers of Enron or the 401(k) plan's trustees violated their fiduciary duties in aggressively pushing investment in Enron or in failing to disclose material risks remains to be seen. The role of their lawyers in advising on their sales practices and disclosure policies also deserves to be explored.

compensation plans that now seem to have created perverse incentives rather than an alignment of shareholder and managerial interests.[54]

What about the lawyers who obtained exemptions for Enron from registration under the Investment Company Act of 1940[55] and the Public Utility Holding Company Act?[56] Registration under either act could have subjected Enron to a much higher level of regulatory scrutiny than it received under the Securities Exchange Act of 1934.[57] In fact, Enron's ability to fall between regulatory tools can be cited as one of the reasons it was able to conduct its business in such an

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[54] See text accompanying notes 20-32 supra.

[55] 15 U.S.C. §80a-6. For discussion of the exemption order issued by the SEC, see Financial Oversight Report, supra note 9, at 57-60. While finding that the "initial grant of the exemption itself . . . was not clearly erroneous and had some Congressional support," id. at 60, the Report expressed concern with the SEC's lack of any means to monitor the continued appropriateness of the exemption." Id. For Enron's application for the exemption order, see Enron Corp., et al., Notice of Application for Exemption Under the Investment Company Act of 1940, SEC File No. 812-10150, Rel. No. IC-22515 (Feb. 14, 1997), 1997 SEC LEXIS 372. For the SEC's order, see In the Matter of Enron Corp., et al., SEC file No. 812-10150, Rel. No. IC-22560 (March 13, 1997), 1997 SEC LEXIS 571.

While the Report indicates that the correctness or wisdom of the SEC's decision to issue the exemption order may be debatable, it does not suggest that there was anything inappropriate about Enron's decision to apply for the order, the disclosures made in its application or the legal arguments made by its lawyers. The lawyers involved thus seemed merely to have helped their client push the limits of the applicable law, but not do anything illegal. This is an excellent example of how "normal" lawyering within the boundaries of the law can produce bad consequences.

[56] 15 U.S.C. §79c. Over a period of ten years, Enron and/or its subsidiaries obtained exemptions under the Act or determinations by the SEC staff that the activities they intended to engage in would not bring them under the definition of "public utility holding company." Financial Oversight Report, supra note 9, at 48. The Report does not find these exemptions to have been wrongfully granted, although it does take the agency to task for delaying action on pending applications, because the delay apparently allowed Enron to collect higher rates during the period of pendency than it would have been able to collect if the application had been acted upon quickly. Id. at 56-57. It also criticizes the SEC for "the lack of coordination between the SEC and FERC [which] permitted Enron to take full advantage of gaps and overlaps in the agencies' jurisdictions." Id. at 57. Enron's lawyers thus seem to have been both creative and persistent in the typical lawyerly endeavor of exploiting the limitations of the various regulatory schemes applicable to their client.

[57] 15 U.S.C.A. ___.

unusual, deceptive and risky manner.[58] Were the attorneys, who made the legal arguments that led to at least arguably correct, if ultimately unfortunate administrative decisions to exempt Enron from regulation, doing anything inappropriate?

The same thing might be asked about the lawyers who structured Enron's byzantine tax shelter transactions, creating tax issues so complex "that the IRS lacked the capacity to deal with them."[59] These "structured" tax transactions were used not only to generate massive tax deductions, but also as a basis for reporting future tax savings as current income.[60] While the tax opinions from major law firms supporting those transactions, as well as the information disclosed to the IRS and the public about them, have been severely criticized,[61] can it be said definitively

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[58] For critical discussion of the consequences of granting an exemption under the Investment Company Act of 1940, see John Berlau, Who Cleared That Exemption? Insight (Wash. Times), March 4, 2002, at 15; Stephen Labaton, Exemption Won in 1997 Set Stage for Enron Woes, N.Y. Times, Jan. 23, 2002, at ___. It should also be noted that Enron also was able to avoid regulation under the Commodities Future Trading Commission by supporting legislation exempting energy trading that was enacted in 2000. See Richard Stevenson & Jeff Gerth, Multiple Safeguards Failed to Detect Problems at Enron, N.Y. Times, Jan. 20, 2002, at ___.

[59] David Cay Johnston, Wall St. Firms Are Faulted in Report on Enron's Taxes, N.Y. Times, Feb. 14, 2002, at ___.

[60] For an excellent summary of the issues associated with Enron's tax transactions, see Mike France, The Rise of the Wall Street Tax Machine, Bus. Week, Mar. 31, 2003, at 84. The key to these transactions was highly complex exchanges of assets between Enron and its SPEs not only to generate future tax savings, but to convert those notional savings into current income. France reports that "the 12 tax avoidance transactions the company did from 1995 to 2001 produced $2.02 billion in tax savings – and were then converted into $2.079 billion in current income." Id. at 86. France's data is derived from a report by the staff on the Joint Committee on Taxation. Report of Investigational Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations, www.gpo.gov/congress/joint/jcs~3~03/vol1/index.html.

[61] See critical comments by Professors Susan P. Koniak, Gregory A. Plesko and Jeffrey Gramlich quoted in Peter Behr & Carrie Johnson, Enron Probes Tax Deals, Wash. Post, Jan. 21, 2002, at E01, and Professor Sheldon D. Pollack quoted in France, supra note 60, at 84. These and other critics have not only questioned the legality of claiming deductions by both Enron and the SPE on the same transaction, and treating tax savings as current income, but also the quality of disclosure regarding those decisions. Without full disclosure of the sleight-of-hand in such conversions, the statement of income is likely to give a misleading picture of the company's profitability.

that the lawyers involved were doing anything more than helping the client minimize tax liability within the applicable rules?[62]

Let's assume, for the sake of argument, that the opinions and advice provided by Enron's tax counsel were legitimate, in that they were not compromised by deceit, conflict of interest or even incompetence. Does that mean that there is nothing left to say about what these lawyers did?

One can envision a theory of lawyering that requires lawyers to take a very long view of what the potential negative consequences of legal transactions might be for persons other than their clients, or for the public interest in the abstract. Application of such a robust theory of

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A particularly troublesome aspect of the tax opinions provided in these transactions was the incestuous relationship among the law firms providing the opinions and the investment bankers or accounting firms promoting the transactions to the clients. The tax opinion is "likely compromised," according to Professor Ronald Pearlman, when the person providing the opinion "is involved in selling the shelter, when that person is paid up front, and when that person's time and effort are involved in selling the shelter." Paul Braverman, The Bleeding Edge, Am. Law, June 2003, at 94, 97 (discussing criticism of the role of the law firm McKee Nelson Ernst & Young in shelter transactions). These opinions raise a question of whether the lawyers were involved in ordinary transactional cost engineering and tax minimization (raising the "legal transaction, bad consequences" problem), or whether the lawyers were so compromised by conflicts of interest as to become "partners-in-crime." For discussion of the possible moral effects of providing opinions that play so close to the line, see text accompanying notes 93-94 infra.

[62] Crucial to the consummation of these transactions were opinion letters provided by major law firms such as King & Spalding and Akin Gump Strauss, Hauer & Feld on the legality of the tax treatment claimed for the transaction. See France, supra note 59, at 84-85, 87. Presumably, the attitude of the firms involved was summarized by Robert J. Hermann, former Enron in-house tax counsel, who said "People can disagree on what works within the written rules . . . If you know the rules, you don't have to break the rules, you just use them. That's what lawyers and accountants do." Behr & Johnson, supra note 60, at E01. While it may be that the legal opinions were legitimate means to achieving the legitimate goal of tax minimization, there is a question of whether it was possible for a firm to give an objective, independent opinion when it was involved in the development of the transaction. France, supra note 60, at 87. Akin Gump has responded to such a suggestion by asserting that it had the "informal consent" of both parties to the transaction. Id. For further discussion of the significance of client consent, see text accompanying note 87 infra.

"green" lawyering, as it has been called in a provocative article by Professor David Luban,[63] could provide a response to the problem of "legal transactions, bad consequences," which is something different from intentionally assisting clients perform unlawful acts (the "partners-in-crime" scenario), and even willful blindness to those acts (which could be simply another version of the "partners-in-crime" scenario).[64] In both of these versions of the partners-in-crime scenario the lawyers' duty of non-cooperation should be obvious, although lawyers too frequently justify willful ignorance with highly dubious versions of the "I didn't know" excuse.[65] A truly "green" conception of lawyering, while it would certainly require avoidance of "partners-in-crime" behavior,[66] would go further by requiring a lawyer advising or opining on legal transactions, and engaged in legal minimization of regulatory or tax burdens, to think holistically about the social effects of her actions as part of a system of coordinated actions by others (including the client). She should "take personal responsibility for the systemic consequences to which [her] actions

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[63] David Luban, The Social Responsibilities of Lawyers: A Green Perspective, 63 Geo. Wash. L. Rev. 955 (1995).

[64] See further discussion of this scenario in the text accompanying notes 89-97 infra.

[65] See Luban, supra note 63, at 980:

> When I talk with practicing lawyers or law students about rules forbidding lawyers from knowingly doing something improper on behalf of clients, the retort is invariably that you never really *know* . . . . Ironically, lawyers who pride themselves on their common sense practicality, and who usually have no patience for philosophical abstractions and paradoxes, suddenly embrace a wildly implausible standard of Cartesian certainty – roughly equating knowledge with infallibility – whenever knowing something would prove inconvenient.

[66] See Professor Luban's discussion of the lawyers' "contrived ignorance" in the O.P.M. client fraud case of the 1980's, in which the law firm closed millions of dollars of fraudulent loan transactions on behalf of its client, and did not blow the whistle, despite its awareness of client fraud in connection with previous loans it had closed. Id. at 981.

contribute, even if [her] contribution to those consequences is minimal,"[67] or, I should say, legal. In this "green" view, a lawyer who does not attend to the social consequences of participation in the clients' activities would be socially irresponsible, and hence unethical. Presumably a system of ethical rules that required such a view of lawyers' responsibilities would mitigate the "legal transactions, bad consequences" problem.

Requiring lawyers to serve as the social conscience of the client, however, obviously raises fundamental questions about the nature of the attorney-client relationship and the traditional presumption of the primacy of the client's claim on the lawyer's loyalties. It is entirely consistent with that claim to demand that a lawyer avoid participating in a client's wrongdoing, even passively through contrived ignorance or convenient blindness. It is more difficult, however, to ask a lawyer to serve two masters when the client is not acting wrongfully, and when the other "master" is so poorly defined. For this ethical reorientation to work, the "green" lawyer would have to resolve questions of definition (what is the public interest – or the third party interest – for which lawyers must also be advocates?), standard-setting (what consequences other than legality raise an issue for the lawyer?), balancing (how are client interests and public interests to be balanced?), and forseeability (what should a lawyer do when the social consequences of a cause of action are murky or debatable in principle).[68]

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[67] Id. at 956.

[68] Professor Luban recognizes the foreseeability problem when he points out that "criticizing lawyers because they did not take incalculable long-term effects into account during their representation of clients seems suspiciously like the specious wisdom of twenty-twenty hindsight." Id. at 978. He cites as an example the criticism of M&A lawyers during the hostile takeover heyday of the 1980s. Can it be assumed that if hostile takeovers were bad for the economy and society, then M&A lawyers representing bidders were socially irresponsible? If takeovers turned out to be beneficial, productivity-enhancing transactions, were the M&A lawyers representing entrenched management the socially irresponsible ones? Acknowledging this conundrum, Lubran concludes that

In the absence of the adoption of some theory of "green" lawyering, however, what can we say about lawyers who were pretty much doing what business lawyers usually do - - solving business problems with legal technology, lowering the costs of regulatory compliance and advising their clients about what the law permits?[69] If that is all they did, was their contribution to the perfect storm culpable in a way that demands regulatory response, particularly in the form of a stronger whistleblowing mandate?

C. "Merely" Negligent

Lawyers may also have contributed to the perfect storm in an entirely familiar way - - through bad lawyering. At least some of the lawyers who could have made a difference simply performed their jobs below an acceptable level of professional competence. Perhaps the best known examples of malpractice in the recent scandals were the special investigations conducted by Simpson Thacher & Bartlett for Global Crossing and Vinson & Elkins for Enron in response

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> Given the immense uncertainties involved in macro-economic forecasting, however, it would be preposterous to hold the lawyers morally responsible for "getting it wrong." And if lawyers cannot be expected to get it right, they may as well give their clients the benefit of the doubt . . . There is really no reply to this excuse, for in many instances it is absolutely right.

Id. at 979. The situation of M&A lawyers is analogous to that of lawyers who constructed executive stock option compensation plans that created perverse incentives and 401(k) plans allowing excessive concentration of assets and limiting liquidity. How can lawyers be expected to have foreseen the negative effects of legal transactions that most people thought actually were good for stockholders and employees? When the foreseeability problem is taken into account, the notion of "green" lawyering does not seem to pose a real solution to the problem of "legal transactions, bad consequences" as I have defined it. It does, however, offer a much needed corrective to the more passive, ambiguous form of acting as a partner-in-crime which seems to have been endemic in the recent cases. There is an interesting question of whether the lawyers' role in structuring deals, providing opinions and formulating disclosures falls into the category of "legal transactions, bad consequences," or "contrived ignorance" of wrongful client behavior.

[69] On the concept of the lawyer as "transactional cost engineer," see Ronald J. Gilson, Value Creation by Business Lawyers: Legal Skills and Asset Pricing, 94 Yale L. J. 239 (1984). For elaboration of the concept, see Mark A. Sargent, What Does it Take? The Hallmarks of a Business Lawyer, Bus. L. Today, July/August, 1996, at 11.

to the allegations of whistleblowers. In both cases, the negligence was compounded, or even caused by the firms' conflict of interest. In a report[70] commissioned by independent directors of Global Crossing, the law firm Coudert Brothers found that Simpson Thacher's investigation of serious allegations about accounting and disclosure irregularities "failed to satisfy its professional responsibilities to Global Crossing."[71] According to the report, Simpson Thacher failed to obtain critical documents and interview key executives involved in the questionable transactions,[72] failed to inform the outside auditor of the allegations in a timely fashion,[73] and neglected to pursue the investigation vigorously.[74] While Coudert Brothers found that the transactions were legitimate, if of little value to the company, and that Simpson Thacher did not intend to conceal any wrongdoing, the firm also found that Global Crossing "suffered significant injuries as a result" of the inadequacy of the investigation.[75] Their report concluded that "causes of action may be asserted against [Simpson Thacher] for malpractice and breach of fiduciary duty."[76] This mess, their report argues, resulted at least in part from the conflict of interest

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[70] See Global Crossing Report, supra note 13.

[71] Id. at 47.

[72] Id. at 37.

[73] Id. at 45.

[74] Id. at 40-41.

[75] The Global Crossing Report concluded that the inadequate investigation and the delays it created "deprived the Company of the benefit of audited 2001 financial statements," which had a negative impact on the valuation of the company in bankruptcy. Global Crossing Report, supra note 13, at 45. In addition, the Report concluded that the whistleblower's allegations "have subjected the Company to reputational damage and adverse regulatory scrutiny it would have been able to avoid or mitigate if Simpson Thatcher & Bartlett had done its job." Id.

[76] Global Crossing Report, supra note 13, at 47.

created by a Simpson Thacher partner serving as Global Crossing's acting general counsel while remaining a partner during the investigation.[77]

That a conflict of interest produced an inadequate special investigation is even more apparent in the case of Vinson & Elkins' investigation into the by-now famous allegations of whistleblower Sherron Watkins.[78] The firm conducted a highly limited investigation into serious allegations about conflicts of interest and accounting problems in Enron's transactions with the

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[77] Id. at 42.

> Brandon served in dual, concurrent capacities. His loyalty did not run exclusively to the company. It also ran to Simpson Thatcher & Bartlett, the law firm of which he remained a partner while he worked as the Company's Acting General Counsel. This circularity precipitated a conflict of interest when Olafson's allegations were not adequately investigated by Simpson Thacher & Bartlett.

Simpson Thacher has vigorously contested the Global Crossing Report's allegations. In a statement to the press, the firm asserted that:

> The report is inaccurate and makes no sense. It unfairly faults Simpson Thacher for not inquiring thoroughly into accounting allegations that the committee itself and the outside auditors have concluded are meritless. It suggests that Simpson, not the company, had the responsibility to bring these allegations to the attention of the auditors. But it ignores the fact that, at our first opportunity, we advised the company to make this disclosure to the auditors. The company chose not to follow our advice.

Simpson Thacher: Report "Makes No Sense," Leg. times, March 17, 2003, at 17. Simpson Thacher has also disputed the Report's claim that the bankrupt company could have been able to obtain audited financial statements but for the firm's allegedly inadequate investigation, and claimed that it was retained only to do an informal, purely internal investigation that the officers back-burnered as Global Crossing approached bankruptcy. Otis Bilodeau, For Two Elites, a Family Feud, Leg. Times, March 17, 2003, at 1.

For critical discussion of Simpson Thacher's performance in this matter, see Michelle Cottle, Private Practice, Why No One Blames the Lawyers, New Republic, Oct. 14, 2002, at 12; Susan P. Koniak, Who Gave Lawyers a Pass?, Forbes, Aug. 12, 2002, at 58.

[78] Letter (originally anonymous) from Sherron Watkins to Kenneth L. Lay, Chief Executive Officer, Enron Corp. (Aug. 14, 2002) (hereinafter Watkins Letter) available at http://news.findlaw.com/hdocs.enron/docs/enron/empltr2lay82001.pdf.

numerous affiliated partnerships in which senior officers invested.[79] Vinson & Elkins' investigation consisted of a review of the relevant documents and interviews with some, but not all of the officers involved in the transactions, as well as its own lawyers and two partners of Arthur Andersen.[80] The firm apparently agreed with the CEO of Enron that there would be no second-guessing of Arthur Andersen's accounting advice, and that there would be neither detailed analysis of the transactions in question or a discovery-style inquiry.[81] While Vinson & Elkins ultimately found some conflicts of interest in the arrangements, and that their "bad cosmetics"[82] created "a serious risk of adverse publicity and litigation," the firm concluded that "the facts disclosed do not, in our judgment, warrant a further widespread independent investigation by outside counsel and auditors." [83]

Serious questions can be raised about whether an investigation so circumscribed from the outset could support such a positive conclusion.[84] It is not clear that such a pollyannaish

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[79] For detailed (and highly critical) discussion of this investigation see Roger C. Cramton, Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues, 58 Bus. Law. 143, 162-67 (2002).

[80] The limited, "preliminary" nature of the investigation is stated in the report setting forth Vinson & Elkins' conclusions. See Letter of Max Hendricks III, Vinson & Elkins, L.L.P. to James V. Derrick, Jr., Executive Vice President and General Counsel, Enron Corp. (Oct. 15, 2001) (hereinafter Hendrick Letter), available at 2001 WL 1764266, at *2. See also Powers Report, supra note 11, at 80 (describing the limited scope of the investigation).

[81] Hendricks Letter, supra note 80 at *1.

[82] Id. at *9.

[83] Id. at *8.

[84] Id. at *6. Vinson & Elkins apparently drew solace from the fact that "the individuals interviewed were virtually uniform in stating that LJM provided a convenient alternative equity partner with flexibility," and that "both the awkwardness and potential for conflict of interest should be eliminated on a going-forward basis as a result of Mr. Fastow's divestment of his ownership interest in the LJM partnerships." Id. It is not clear why the recognition of a putative business purpose and the elimination of future conflicts of interest should have reconciled the firm to relying on the judgment of individuals who were so obviously conflicted.

determination would have been reached if a thorough, professionally competent investigation had been conducted. Particularly remarkable was the firm's apparent willingness to base its conclusion on the finding that "none of the individuals interviewed could identify any transaction between Enron and LJM that was not reasonable from Enron's standpoint or contrary to Enron's best interests,"[85] despite the personal interest the same individuals had in the transactions. Even more clear-cut was the law firm's utter insensitivity to the problems identified by Watkins in her letter to the CEO that triggered the investigation: "Can't use V & E due to conflict, they provided some 'true sale' opinions on some of the deals."[86] Vinson & Elkins' willingness to provide allegedly disinterested reassurance to its client about deals in which it provided an essential legal opinion[87] is hardly consistent with its basic obligations to the client of loyalty and due care.[88]

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[85] Watkins Letter, supra note 78, at 6.

[86] "True sale" opinions are essential to the securitization of assets. A law firm must opine that the assets to be securitized have "truly" been sold to the entity that will hold them. The opinion should not be given unless the firm can make the legal determination that the assets have been separated from the originator who wants to securitize them. If they have not been legally severed, and the originator enters bankruptcy, the assets will be included within the bankrupt's estate, and the bondholders who relied on the assets for security will lose that security. For discussion of the problems with the true sale opinions issued by Vinson & Elkins and other firms for Enron's benefit, see Otis Bilodeau, New Questions Over Lawyering in Enron, Leg. Times, Sept. 30, 2002, at 1.

[87] Vinson & Elkins' willingness to provide such reassurances about transactions in which it played such a crucial is especially remarkable in light of its own acknowledgment that the accounting treatment for the transactions was "creative and aggressive." The law firm has defended its undertaking of the investigation on the ground that the client exercised its right to waive any conflict of interest on the part of the firm. Professor Cramton has argued, however, that the waiver on behalf of the corporate client may have been given by the CEO and the general counsel, both of whom were implicated in the misconduct alleged by Watkins, thus invalidating the waiver. Professor Cramton argues further that even if the consent was valid, the firm's investigation failed to meet "the objective standard that the lawyer reasonably believe the representation will not be adversely affected by the lawyer's conflict of interest." Cramton, supra note 78, at 164. For a summary of Vinson & Elkins' various defenses of its work for Enron, see Otis Bilodeau, Vinson & Elkins Shoots Back, Leg. Times, Feb. 11, 2002, at 17.

[88] For discussion of failure to report wrongdoing to the board as both negligence and an ethical violation, and citation of the relevant sources, see Cramton, supra note 79 at 154-56.

More generally, to the extent that attorneys for public corporations failed to advise their boards about conflicts of interest in officers' self-dealing transactions such as sweetheart loans, usurpation of corporate opportunities, spurious bonuses and excessive compensation, they were negligent in meeting their professional obligations to the board which, after all, is the embodiment of their client, not the officers who hired them. To put it another way, the attorneys' failure to blow the whistle internally on wrongdoing by corporate officers and other senior employees was simply negligence. If that negligence injured the corporate client, those lawyers would be subject to negligence actions brought by newly independent boards, shareholders in derivative actions, or receivers in bankruptcy asserting the corporation's claims for the benefit of the creditors. We may conclude, therefore, that part of the lawyers' contribution to the perfect storm was essentially an epidemic of bad, negligent lawyering.

When the negligence explanation is joined to the other two possible descriptions of the role of lawyers in the perfect storm - - partners in crime and legal transactions, bad consequences - - we have a multi-faceted description of the lawyers' contribution to the systems breakdowns that afflicted corporate America. That description, however, does not adequately explain the full range of lawyers' failures in Enron and its successors.

III. THE COMMON THREAD: "SEE NO EVIL"

At the extremes, the culpability of lawyers who contributed to the frauds and breaches of fiduciary duty characteristic of Enron and its successors is clear. When lawyers knowingly and intentionally participate in and facilitate clients' wrongful acts, and benefit either directly from the ill-gotten gains or indirectly through fees, they have crossed the line. Civil and, where appropriate, criminal liability can only be expected. In deciding what to do about such cases there is no moral conundrum, theoretical problem or legal/doctrinal issue. There is only the

specific problem of establishing the facts in individual cases and the more general problem of figuring out why there was so much of this behavior in the profession.

At the other extreme, those lawyers who provided legitimate advice on transactions that generated bad consequences would seem to have little culpability, absent a “green” reformation of legal ethics. If the bad consequences flowed from defects in the legal rules permitting the transactions, or if they reflected bad business judgment by the clients, or if the clients manipulated the transactions in a way not anticipated by the lawyer, there is little for which the lawyer can be held accountable.

In between those extremes, however, there is much that needs further analysis. Between the extremes, for example, are the following scenarios:

(1) Willful refusal to recognize wrongful behavior by the client, particularly when the client relationship is lucrative. Such contrived ignorance is a passive, although perhaps ambiguous version of the partners-in-crime scenario. Vinson & Elkins' role in the structuring of and preparing disclosures about Enron's SPEs may be a case in point.

(2) Pushing the envelope in providing advice and legal opinions on transactions at the edge of legality, particularly when the opinion provider is conflicted by multiple roles in the transaction. The opinions provided by Akin Gump and Nelson McKee on Enron's (and others') tax shelter transactions are cases in point.

(3) Negligent representation that involves inadequate inquiry into questionable transactions, particularly when the lawyer is compromised by a conflict of interest, as was the case in different ways in Simpson Thacher's investigation of Global Crossing and Vinson & Elkins' investigation of Enron's affiliate transactions.

(4) Negligent failure to fully inform and warn boards of directors of the dangers inherent in corporate transactions from which the officers will benefit (Enron, Adelphia).

All of these scenarios led to injuries to the corporations the lawyers served, as well as their shareholders. Whether such behavior will subject the lawyers involved to civil or criminal liability under the federal securities laws, malpractice liability, or liability on other grounds

remains to be seen. What is interesting about these scenarios, however, is their common thread. The reluctance, or inability, of lawyers to recognize, confront and act upon questionable or even wrongful acts by their clients was a failure on their part. In many of these cases, sophisticated lawyers seemed determined to see no evil.

The determination to see no evil is nothing new, and has been recognized before. It seems to have been endemic among the lawyers involved in the savings & loan collapses of the 1980s.[89] The tendency to see no evil also has many causes. It may be a problem of social cognition, which arises when a lawyer has internalized the client's worldview, or ego-identified with the client, preventing the lawyer from seeing the world as it really is.[90] It may in some

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[89] See Judge Stanley Sporkin's famous *cri de coeur* in Lincoln Savings and Loan Assoc. v. Wall, 743 F. Supp. 901, 920 D.D.C. (1990):

> The questions that must be asked are:
>
> Where were these professionals, a number of whom are now asserting their rights under the Fifth Amendment, when these clearly improper transactions were being consummated?
>
> Why didn't any of them speak up or disassociate themselves from the transactions?
>
> Where also were the outside accountants and attorneys when these transactions were effectuated?
>
> What is difficult to understand is that with all the professional talent involved (both accounting and legal), why at least one professional would not have blown the whistle to stop the overreaching that took place in this case.

For analyses of the role of lawyers in the savings and loan cases, see Symposium: The Attorney-Client Relationship in a Regulated Society, 35 S. Tex. L. Rev. 571 (1994); In the Matter of Kaye, Scholer, Fierman, Hays and Handler: A Symposium on Government Regulation, Lawyers' Ethics, and the Rule of Law, 66 S. Cal. L. Rev. 977 (1993).

[90] The problem of how the dynamics of social cognition influences lawyers' ability to recognize and respond to wrongdoing by clients has been analyzed in great detail by Professor Donald Langevoort. See Donald C. Langevoort, Where Were the Lawyers? A Behavioral Inquiry Into Lawyers' Responsibility for Clients' Fraud, 46 Vand. L. Rev. 75, 95-110 (1993).

cases be a result of the compartmentalization of legal work by a large company that prevents one law firm from having a complete picture of what is actually going on, assigning different firms pieces of complex transactions, or different transactions in a series of deals. The rapid turnover of deals, the haste to produce public disclosure, and delegation by large, busy firms of important work to inexperienced lawyers[91] may all produce blind spots, particularly when the client's work was extraordinarily complex and novel, as was Enron's.

Some blindness is entirely purposeful. It is a kind of structural or role-blindness, a suspension of judgment about what a client does that allows the lawyer to disclaim any responsibility, on the theory that the lawyer is providing only a narrow "technical" opinion on the law, and that what the client does with it is the client's decision and responsibility. There are a couple of problems with this theory. First of all, it presumes disingenuously that the lawyer is playing a limited, passive role in the structuring of the transactions and deciding how to handle them. As Enron's lawyers' active promotion of the company's tax shelters shows, this is sometimes not the case.[92] Even if those cases represent an unusually blatant conflict between promoting deals and providing allegedly disinterested opinions on those deals, it is not at all unusual for transactional lawyers to play a lead role in devising deal structures. Attorneys know

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[91] A case in point may be a two-page letter agreement amending a loan agreement that was drafted by a fourth-year associate at Vinson & Elkins relating to the transfer of $6.6 million from Enron to Chewco Investments, a major Enron affiliate. Once Arthur Andersen became aware of the letter, it determined that Chewco's putatively off-balance sheet liabilities would have to be consolidated with Enron's, with disastrous consequences for Enron. See Powers Report, supra note 11, at 52-53. For discussion of Vinson & Elkin's role in preparing this letter agreement, see Douglas McCollam, Vinson's Smoking Gun, Am. Law, March 6, 2002 at 20. Vinson & Elkin has denied that it had the responsibility for disclosing the fatal side agreement to the auditor. Letter to the Editor: Vinson & Elkins Responds, Am. Law., March 6, 2002, at 15 (letter of Harry Reasoner). Regardless of what Vinson & Elkins was required to do for purposes of determining any malpractice liability, there is an interesting question of whether a more experienced lawyer would have recognized the dangerous implications of the letter agreement and raised a question with the client and/or the auditor.

[92] See notes 60-61 supra.

exactly what their clients are doing because their advice makes it possible. Furthermore, that theory embodies a stunted view of the lawyer's role. Instead of providing independent professional judgment, which should be the professional norm, some "lawyers take the position that they must do everything that the client's managers want them to do, providing the conduct is permitted by law."[93] The problem with this definition of the lawyer's role, as Professor Roger Cramton has pointed out, is that "by constantly going to the edge of the law and taking a very permissive view of what the law permits, these lawyers gradually adopt a mindset that ignores and may eventually assist the client's managers in illegality that harms third persons and the client entity."[94] The lawyer who becomes used to walking on the edge, and leaving the client to face the risk of liability, dulls his sensitivity to the permeability of the line between the legal and illegal, the moral and immoral, and becomes, gradually but inevitably, a blind man whose stock in trade is his own blindness.

The most important reason for blindness to wrongdoing, however, is simpler. Seeing evil is costly. Because it is costly, people tend to avoid seeing evil. If they see it, they convince themselves they did not see it, or at least pretend they did not. If they cannot pretend, they begin the process of rationalization, for which human beings have an almost infinite capacity. They conclude that the problem was not really *that* bad, that the problem was anomalous, or localized and not systemic, or, optimistically, that the problem will take care of itself, disappear over time, or never be discovered. People, including lawyers whose professional training should prevent it, fall back on these devices when they come to appreciate the true costliness of seeing evil.

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[93] Cramton, supra note 79, at 173.

[94] Id.

The costliness has many levels, and needs to be understood as something more than a threat to lawyers' or law firms' greed. There is, for example, an emotional cost. Recognition that a client is asking one to participate in, approve, or cover up questionable or wrongful acts will jar even a cynical lawyer's sense of the ordinary air of legitimacy that surrounds our everyday professional life. Suddenly, the people who seemed to be reliable, trustworthy and well-intentioned colleagues are now "problems." Awkward accusations and embarrassment seem inevitable. Reluctance to deal with such problems, especially ones that require confrontation with the client, is common when the lawyer's instinct is to present the client with solutions, not problems. The lawyer wants to appear as a problem solver who has internalized the values and goals of the firm, not a bomb-thrower. Similarly, a lawyer's status with the firm depends on his ability not just to attract clients, but to keep them happy. Recognition of a "problem," therefore, creates emotionally fraught role-strain within the attorney-client relationship and status anxiety for lawyers operating within firms. That some lawyers conclude that it is better not to see anything is not surprising.

Another emotional cost may be anxiety about injury both to one's *amour propre* and one's external reputation. It may be exquisitely painful for some lawyers to admit that they have become involved with something questionable.[95] Langevoort, supra note 90, at 102-03. It may be impossible for them to admit that their advice (or that of their partners) was tainted by a conflict of interest, that their opinion letter pushed the limits of the law too far, or that they failed to

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[95] As Professor Langevoort has put it,

> When people voluntarily commit themselves to a certain position, attitude or belief, the subsequent discovery of information that indicates harmful consequences flowing from that commitment directly threatens their self-concept as good, worthwhile individuals. Thus cognitive processes will work to suppress such information if at all possible.

pursue an issue or an investigation as vigorously as they should. Recognition that their involvement contributed materially to a client's wrongdoing may be too much for some lawyers to bear. They also might not be able to bear thinking about the potential threat to their professional reputation. Because these emotional costs are so high, some lawyers will consciously or unconsciously close their eyes to the problem and indulge in all manners of rationalization. The short-term benefit will be outweighed by the long-term cost, but for some, this is not the sphere of rational decision-making, despite lawyers' training in dispassionate analysis.

Other costs are economic, but even these are complex. Recognition of a problem may result in a loss of "sunk costs." By the time a serious problem is recognized, the lawyer and her firm may have sunk considerable amounts of time into a transaction or an ongoing relationship with a client. That time and its attendant expenses may be never paid if the lawyer surfaces problems that might unravel the transaction or even the client. If the sunk costs are considerable, lawyers may decide that keeping silent and hoping it all works out for the best are the only options. This concern about sunk costs would be particularly intense, for example, for the law firms engaged in promoting corporate tax shelters, because their investment is not just in specific transactions but in a whole line of business involving many clients. This is especially true when it starts to become clear that the essence of the law firm's services entailed serious conflicts of interest and opinions at the outer edge of plausibility.

The question of economic cost is also complicated by the potentially conflicting interests of individual lawyers representing problematic clients and the law firm as a whole.[96] A lawyer

[96] A similar point has been made about conflicts within accounting firms between the interests of an individual partner or partners and the firm, using the behavior of the partners in Arthur Andersen's Houston office, who were highly dependent on Enron revenues: "Andersen's Houston office gambled

whose book of business and personal income is dominated by the problematic client is going to bear a disproportionate share of any loss generated by alienating the client or killing a deal or series of deals. While no firm wants to alienate a client or compromise sources of revenue, the firm's other sources of revenue will make the losses more bearable. The firm thus may have a more objective appreciation of the long-term risks for the firm, which might be much greater than the short-term risk to the individual lawyer of losing his major client. Hence, law firms may be particularly vulnerable when the anxiety of the partner-in-charge about loss to himself outweighs his sense of the potential cost to the firm. Of course, this distinction evaporates when the problematic client is also one of the firm's major clients. Firms in that situation then tend to think like partners in charge, and begin making calculations about the comparative risk of relatively certain short-term losses versus larger, but more speculative long-term losses.

The final aspect of the question of economic cost is perhaps the simplest. Some lawyers simply cannot stand to see their greed unfulfilled. Surrounded by corporate princes rolling in wealth often created as if by magic, they fall prey to the corruption of envy, as the princes' lawyers ask "why not me?" Their sense of entitlement makes it very hard indeed to take the actions that would destroy their dreams of wealth.

This discussion should not end, however, with simplistic, censorious assumptions about the prevalence of personal greed, although there was apparently plenty of that.[97] Id. The tragedy

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with the reputation of the partnership as a whole in order to maintain the revenue flow from its profit center." Bratton, supra note 6, at ___.

[97] Professor Langevoort also cautions against simplistic assumptions of venality (or stupidity) on the part of lawyers, arguing that "venality competes not so much with stupidity as with honest, even good faith behavior that only in hindsight seems incredible." Langevoort, supra note 90, at 78. For Langevoort, the key obstacles to lawyers' recognition of clients' wrongful acts are the "blind spots" created by lawyers' problems of social cognition, as he argues for recognition of

of the lawyers' failures in these cases is that many of the lawyers involved were not consumed with greed, but were simply doing their best, often under great pressure and uncertainty, to keep their firms afloat by trying to feed the large law firm's endless appetite for billable hours and fees. The economic demands of sustaining a large law firm had a gradually corrosive effect, numbing not just a lawyer's sense of decency but also his own sense of self-preservation as he succumbs to avoidance of the truth and rationalization of his client's and his own legal and moral failures.

IV. THE REGULATORY RESPONSE: FORCING THEM TO SEE

A. Section 307 and the SEC Rules

In the summer of 2002, Congress enacted section 307 of the Sarbanes-Oxley Act.[98] Section 307 of the Act directs the SEC to issue rules setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, which includes attorneys advising corporations registering securities with the SEC, hence all public companies.[99] Those standards were to include a rule requiring such attorneys to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent to the chief legal counsel or CEO.[100] That rule also was to require the attorney to report the evidence to the audit or other

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> the possibility that lawyers have a diminished cognitive capacity to appreciate the likely harm flowing from their client's actions. Both ego and stress can induce blind spots. By the time the lawyer actually becomes aware of the wrong, his or her complicity already is fixed. Denial and rationalization ensue. Only at the very late stages, if at all, is there something like a conscious cover-up.

[98] 15 U.S.C.A. ___ §307 (2003).

[99] 17 C.F.R. §205.2(a) (2003).

[100] 15 U.S.C.A. ___ §307(1) (2003).

appropriate committee or to the board as a whole if the chief legal counsel or CEO does not appropriately respond to the evidence.[101]

In November 2002, the SEC proposed rules implementing the Congressional mandate for so-called "up the ladder" reporting that included a complex set of definitions, standards and procedures.[102] The Commission went beyond that mandate, however, and also proposed a so-called "noisy withdrawal" requirement.[103] If the attorney representing an issuer reports the matter all the way up the ladder within the issuer and does not receive an appropriate response from the issuer's directors, and if the material violation is ongoing or about to occur and is likely to result in substantial injury to the issuer or an investor, the attorney will be required to withdraw from the representation and notify the Commission that such withdrawal was made for "professional considerations."[104]

As might be expected, the SEC's proposed rules, particularly the noisy withdrawal provisions, provoked an outpouring of formal letters of comment from the bar (mostly con) and the legal academy (mostly pro).[105] The rules, as finally adopted by the Commission on January

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[101] 15 U.S.C.A. ___ §307(2) (2003).

[102] See Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys, SEC Rel. Nos. 33-8150, 34-46868 and IC-25829 (Nov. 21, 2002). 67 Fed. Reg. 1670 (Dec. 2, 2002) available at www.sec.gov/rules/proposed/33-8150.htm. The only alternative to the process of reporting to the chief legal counsel or executive officer and to the audit committee or board is reporting to a "Qualified Legal Compliance Committee" composed of non-employee directors, if the issuer has established such a committee. 17 C.F.R. §§ 205.1(k), 205.3(c) (2003).

[103] Id. at ___.

[104] Id. at ___.

[105] The comment letters are available at www.sec.gov/rules/proposed/S4502.shtml.

23, 2003,[106] included somewhat modified versions of the up-the-ladder provisions but did not include the proposed noisy withdrawal provisions. Instead, the SEC deferred decision on its initial proposal and proposed an alternative that would still require the attorney to withdraw for "professional considerations," but require the *issuer* to report the withdrawal to the SEC.[107] That proposal is still pending as of this writing.

B. Forcing Them to See

How will section 307 force lawyers to see the evil they would prefer not to see? It aims to do so by making *not* seeing more costly than seeing. By imposing an affirmative whistle-blowing obligation, and applying sanctions to lawyers who fail to meet that obligation, the rules are intended to make it more difficult to indulge in willful ignorance, negligent evasion, and insensitivity to their own conflicts of interest that constituted the great middle range of lawyers' failures I have just described.

More concretely, the existence of this obligation may spur the creation of internal systems within law firms for identifying potential client wrongdoing and responding more self-consciously and with more levels of review. Systems of that type may reduce the vulnerability of law firms to the poor decisions of partners whose individual stakes in a client have compromised their objectivity. In other words, the rules may lead to the establishment of institutional bulwarks against avoidance and rationalization.

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[106] See Final Rule: Implementation of Standards of Professional Conduct for Attorneys, SEC Rel. Nos. 33-8185, 34-47276, IC-25919 (Jan. 29, 2003), 68 Fed. Reg. 6296 (Feb. 6, 2003), available at www.sec.gov/rules/final/33-8185.htm.

[107] See Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys, SEC Rel. Nos. 33-8186, 34-47282, IC-25920 (Jan. 29, 2003), 86 Fed. Reg. 6324 (Feb. 6, 2003), available at www.sec.gov/rules/proposed/33-8186.htm, at ___.

The rules are likely to have their greatest influence in ambiguous situations involving lawyers' passivity. Presumably, the reporting mandate would make it more difficult to fall back on protestations of ignorance of client wrongdoing. The rules would not have much effect on a lawyer who has decided to participate in a client's misdeeds and share in their benefits, but it may influence those who have half-convinced themselves that they and their clients are not doing anything wrong.

While the rules seem to impose new constraints on lawyers' discretion, they actually seem intended to empower lawyers in their roles as both advocates and gatekeepers. The up-the-ladder internal reporting requirement directly addresses the tendency of lawyers from outside firms to identify the senior managers who hired them as the client, rather than the board. It also provides some check on the apparent tendency of some general counsel to maintain insufficiently critical detachment from officers and other senior managers, preventing them from giving the board the frank advice it needed to perform its own monitoring function.[108] To the extent that senior managers controlled the lawyers, such lawyers failed to meet their obligations as advocates for the corporation, the real client. The up-the-ladder reporting requirement, therefore, does not do any violence to the confidence and trust a corporate client should be able to place in its advocate, and might make lawyers more effective advocates for the real client by making sure that those involved in violating the law know that their lawyers ultimately will have to raise questions with disinterested decisionmakers. The apparent futility of the few attempts by

[108] The alleged failure of the Tyco general counsel to disentangle himself from the CEO's self-dealing, and to advise the board properly, helped lead to his indictment. See note ___ supra. James V. Derrick , Jr., Enron's general counsel, also has been criticized for being too deferential to the CEO and CFO who were most involved in the questionable self-dealing transactions with Enron's affiliated entities. See Miriam Rozen, An Unenviable Position, Tex. Law., Feb. 6, 2002, at ___, ___.

lawyers and others to raise questions internally in the recent cases[109] suggests that the whistleblower's position needs to be fortified. Lawyers may even find that this leverage is helpful, because it seems clear that they cannot use the defense of futility to a charge of breach of fiduciary duty when it is clear that they should have withheld cooperation and raised questions up the ladder.[110]

By attempting to compel lawyers to represent their clients more effectively, the up-the-ladder requirement is also intended to make them more effective gatekeepers. By honoring their obligation to convey evidence of wrongdoing to disinterested decisionmakers charged with considering the evidence, the rules theoretically will enable, indeed require, the board to take appropriate and timely action. The board's action will not only protect the corporation from potential liability, but also will help protect the shareholders and the investing public from fraud and the consequences of senior managers' breaches of fiduciary duty. The presence of a noisy withdrawal requirement, furthermore, would provide an ultimate fail-safe, designed to ensure

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[109] For example, key Enron executives apparently wanted an in-house lawyer fired because he attempted to negotiate vigorously on behalf of the corporation in dealings with an affiliated entity in which the CFO (their supervisor) had a major personal interest. Tom Hamburger and John Emshwiller, Enron Officials Wanted In-house Lawyer Fired Due to Partnership Negotiations, Wall St. J., Feb. 7, 2002, at A3. When that lawyer's supervisor, the general counsel of Enron Global Finance, raised serious questions about both the conflicts of interest and accounting in that and other transactions in which senior officers had stakes, he was essentially ignored. Richard A. Oppel, Jr., Lawyer Warned Enron Officials of Dubious Deals, N.Y. Times, Feb. 7, 2002, at ___. A junior accountant at HealthSouth also had little luck in getting the company's auditor to take seriously his claims that the company was falsifying assets. See Carrick Mollenkamp, Accountant Tried in Vain to Expose HealthSouth Fraud, Wall St. J., May 20, 2003, at A1.

[110] See In re American Continental Corporation/Lincoln Savings and Loan Securities Litigation, 794 F. Supp. 1424, 1453 (D. Az. 1992)

> Jones Day contends that it would have been futile to act on these fiduciary obligations because those controlling ACC/Lincoln would not have responded. Client wrongdoing, however, cannot negate an attorney's fiduciary duty.

that boards confronted with a serious problem actually meet their responsibility to do something about it.

All of that seems to be the theory behind the section 307 rules as originally proposed. They were intended to force lawyers to see, or at least give them an incentive to see, and to do something about what they see. This goal is laudable. The rules are a worthy experiment, but before declaring the experiment a success we should spend some time speculating about the rules' potential efficacy and importance.

V. SPECULATIONS AND CONCLUSIONS

In speculating about section 307 rules, it may be helpful to ask three questions. First, how do the rules compare to other possible approaches to preventing the types of lawyer failures that surfaced in Enron and the other cases? Second, are there internal problems with the rules that will make them less effective than they could be? Third, will the rules have unintended, perverse consequences that will make lawyers even less effective as gatekeepers and a positive influence on corporate governance?

A. Are There Better Approaches?

If we could design from scratch a legal framework that would make lawyers more accountable and better gatekeepers, what would it be? It might include a whistle-blowing rule that includes both an up-the-ladder reporting requirement and a noisy withdrawal mandate, but other aspects might be more important. While a whistleblowing rule addresses the see no evil problem, it does not address the partners-in-crime problem. The key to reducing that behavior would require Congressional enactment of an aiding and abetting liability provision under the anti-fraud provisions of the federal securities laws that would legislatively overrule *Central*

Bank.[111] In addition, there would need to be a broader range for primary liability under the federal securities laws than currently exists.[112] These changes would create a greater disincentive for intentional participation in client wrongdoing. A lawyer who has decided to engage in such behavior, as argued above,[113] is not likely to blow the whistle on a client when that would mean blowing the whistle on herself. Fear of liability to private plaintiffs as to SEC enforcement action would be far more significant.

A fear of that kind of liability would also create greater incentives for avoiding the various types of see-no-evil behavior. While avoiding recognition of client wrongdoing may not itself provide a basis for primary liability, it could conceivably be characterized as aiding and abetting under a legislatively-revived theory of such liability. Once again, the fear of either private liability or public enforcement may have more of a deterrent effect than a whistle-blowing requirement. That fear of liability under the federal securities law would have a bracing effect on lawyers tempted to give questionable disclosures a pass.

It is also worth noting that section 307 and the SEC rules have an inherently limited scope. There is no reporting requirement unless there is evidence of some kind of violation of law. Even if this standard is broadly construed, the reporting obligation would have no impact on the legal transactions, bad consequences problem that arises when there is no law violation, but somehow the client's use of the lawyer's expertise produces malign results. To the extent that

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[111] For discussion of the holding in Central Bank, and an argument for statutory overruling of the decision in order to reestablish liability for damages in aiding and abetting cases, see Cramton, supra note 79, at 169-70.

[112] The scope of primary liability for securities fraud on the part of lawyers is currently quite limited. For analysis, see Cramton, supra note 79 at 170-73. That range should at least include primary liability when the attorney drafts false representations relied upon by investors, even though he does so anonymously, if the attorney is aware of their falsity. The courts are divided on this issue. Id. at 169.

[113] See text following note 50 supra.

this is a problem, section 307 is no answer, because it is useful only when the lawyer confronts behavior such as fraud or self-dealing. Section 307 and the SEC rules thus do not embody a belief that the corporate lawyer should recognize a duty to be the critical, public conscience of the client. It can be debated whether a green revolution in lawyers' ethics is desirable, but it is indisputable that section 307 does not start one.

B. Internal Problems With the Rules

As of this writing, the SEC has not yet determined whether it will adopt the proposed noisy withdrawal requirement. If it does not, the impact of the up-the-ladder requirement will not be as profound as Congress and the SEC hoped. An up-the-ladder reporting requirement may not have real much influence without the threat of mandatory noisy withdrawal behind it. Lawyers may take their obligations seriously, but if the board or key members of the board are unwilling (or unable) to respond constructively to an attorney-whistleblower's allegations, only the threat of required noisy withdrawal will wake them up. This observation is not a conclusion that requiring noisy withdrawal is necessarily a good idea, because requiring it might make the perverse consequences described in the next subsection even more likely. It is a prediction, however, that the up-the-ladder requirement alone may not have much effect on lawyers' behavior.[114]

[114] The potential tension between the SEC's present permissive disclosure rule and state rules that are more restrictive of disclosure of client information was seen recently in a proposed interim formal ethics opinion issued in July 2003 by the Washington State Bar Association. The opinion warned Washington lawyers not to disclose to the SEC information that the SEC's rules would permit them to disclose, unless the disclosure is also allowed by the state's own professional conduct rules. Those rules permit disclosure of client confidence only to "prevent the client from committing a crime." The opinion also states that a Washington attorney cannot avoid this limitation by claiming to be complying in good faith with the SEC's rules, if the attorney acts contrary to the opinion. Washington State Bar Association, Proposed Interim Formal Opinion [CITE], http://www.wsba.org/formalopinion.doc. The SEC General Counsel responded to the Washington opinion with a public statement to the effect that the Supreme Court has consistently upheld the authority of federal agencies to implement rules of conduct that diverge from and supersede state laws addressing the same conduct. He also argued that an attorney who

The effectiveness of the up-the-ladder reporting requirement may be compromised by the ambiguity of its key triggering provision. The language of that provision leaves much wiggle room for interpreting away the lawyer's obligation to report up the ladder. It is theoretically an objective standard for determining when an attorney has an obligation to report up the ladder, but the language is complex and confusing. If an attorney concludes that there is credible evidence that would make it *un*reasonable 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, the attorney will have an obligation to report the evidence of the violation. The words "credible," "material" and "reasonably likely" leave plenty of room for judgment, or self-serving rationalization, depending upon how you look at it. The use of the double negative in the formulation of the standard, furthermore, could create interpretive haze useful to justify inaction.[115] Some lawyers may not need much haziness in order to conclude that they do not have any obligation to take action.

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discloses client information in good faith reliance on the SEC rule will also have a good faith exemption from the state's non-disclosure rule under the preemption doctrine. Giovannia P. Prezioso, Public Statement by SEC official: Letter Regarding Washington State Bar Association's Proposed Opinion on the Effect of the SEC's Attorney Conduct Rules (July 23, 2003) http://www.sec.gov/news/speech/spch072303gpp.htm.

The question of the relationship between permissive or mandatory external disclosure rules under the SEC and state rules governing disclosure of client information is complex, in part because of the great variation in the state rules. For a discussion of the variations, see Cramton, supra note __, at 156-58. For a discussion of the background to the American Bar Association's (ABA) struggles with this issue, see Larry P. Scriggins, Legal Ethics, Confidentiality and the Organizational Client, 58 Bus. Law. 123 (2002). In August of 2003 the ABA finally amended Rule 1.6 of the Model Rules of Professional Conduct to follow the lead of many states in allowing the disclosure of client information when the lawyer believes such disclosure necessary to prevent fraud injurious to a third party's financial interests. See http://www.abanet.org/media/aug03/081203_1.html. The ABA's initiative on this point may make the SEC feel less obligated to adopt a mandatory noisy withdrawal rule.

[115] See 17 C.F.R. §205(e)(2003).

C. The Possibility of Perverse Consequences

Let's assume for the sake of argument that the section 307 rules actually work, the lawyers and clients come to believe that the rules effectively compel lawyers to be much more aggressive about reporting corporate wrongdoing, making it much more likely that the wrongdoing will become public. The hope, of course, is that lawyers will become more effective gatekeepers, ultimately reduce the amount of self-dealing and securities fraud perpetrated by the managers of public corporations. It is worth considering the possibility, however, that imposing a reporting requirement with teeth, particularly a noisy withdrawal requirement, may have the opposite effect.

Managers concerned about the possibility of exposure by their lawyers may tend to marginalize the role of lawyers in their activities. Corporate managers may exclude lawyers from their most sensitive discussions. They may divide legal work among a larger number of firms, creating a compartmentalization that prevents anyone from developing a sense of the whole picture. Once a new type of transaction is developed with lawyers' assistance, clients may exclude lawyers from future iterations, as the client manipulates the transaction in ways the lawyers would not have expected or approved. Managers also may engage in even more determined efforts to hide the true facts from their lawyers. The net result is that lawyers might have less of an opportunity to influence their clients' actions positively than they do now.

Law firms themselves may even attempt to reduce the possibility that they would encounter something that they would have to report. Firms are likely to establish “Section 307 committees” and procedures that routinize consideration of whether there might be reportable evidence of a material violation upon which the firm would be compelled to act. That would seem to be a good thing. It would seem, however, that firms, and their risk managers, are likely

to use these committees and procedures to find ways of avoiding the situations in which they would have the uncomfortable responsibility of blowing a whistle. For example, firms might circumscribe more narrowly the scope of their representation. They may decline to take on tasks that require substantial due diligence. They may increasingly define themselves as providing highly specific technical advice rather than independent professional judgment. This would indeed be a perverse consequence. The goal of the section 307 rules is to give lawyers an incentive to withhold cooperation from client wrongdoing and increase the risk of public exposure, thus making it more difficult and costly for clients to act wrongly. If lawyers' fear of having to turn whistleblower causes them to absent themselves from the kinds of situation in which their duty of non-cooperation and reporting might be significant, little will have been accomplished. Indeed, they might become less effective gatekeepers than they were.

It is too early, however, to predict that these perverse consequences will ensue, or, if they do, whether their effects will be marginal. The dismal record of lawyers in Enron and its successors, and their material contribution to the systems failure I have called the perfect storm, suggests that the existing framework of legal rules and lawyers' private incentives for doing right are inadequate in the context of representing public companies. The process of practical adaptation by both law firms and clients to the section 307 rules should tell us, before too long, whether anything has changed.