IMPLEMENTATION OF SARBANES-OXLEY: NEW RULES FOR LAWYERS AND WHAT LAWYERS THINK

by Olga Yevglevskaya-Wayne

INTRODUCTION

"I believe we can do better."
Donald T. Nicolaisen, Chief Accountant, US Securities & Exchange Commission[1]

The ethical and financial disasters of Enron, Worldcom, and others put a huge dent in the trustworthiness of public corporations. After these very expensive and morally troubling debacles, public focus and government attention turned quickly to reforming corporate governance, with special emphasis on enhanced monitoring of corporate insiders, the directors and the managers, by outsiders, the accountants and the lawyers. The Public Company Accounting Reform and Corporate Responsibility chapter of the United States Code[2], commonly known as Sarbanes-Oxley Act of 2002, (SOX), represents the culmination of Congressional efforts to curb corporate malfeasance, and contains provisions addressing the conduct of just about everybody playing a part in the corporate enterprise. SOX does not merely promulgate new rules, however. It also delegates greater powers to the Securities and Exchange Commission (SEC) to do so.[3]

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[1] Jay Seliber, John W. White, *Accounting Disclosure Practice*, 1455 PLI/Corp. 125 (WEST 2004).

[2] Sarbanes-Oxley Act of 2002, H.R. 3763, 107th Cong. (enacted), is named for its sponsors, senator Paul Sarbanes from Maryland, and congressman Michael Oxley from Ohio. The unofficial version of the Act can be found at 15 U.S.C.S. §§ 7201 et seq. (LEXIS 2005).

[3] *Id.*

Up to date, the SEC is still figuring out exactly how best to translate the mandate of Congress into practical reforms. Most notably, the SEC is exploring ways to redesign standards of professional responsibility for attorneys practicing before the Commission. [4]

This paper explores the relationships among the SEC, the lawyers, the public corporations, and the public in light of these recent scandals and reforms. The discussion will focus on the new rules for attorneys practicing before the SEC. This paper consists of two parts. The first part of the paper contains brief summaries of SOX, the rules of professional responsibility issued by the SEC, the changes in the Model Rules, and the changes in standards of liability for attorneys, interspersed with various suggestions for additional changes, and views on the new rules from renowned practitioners in the field of securities.[5] The second part of the paper reviews some theories explaining the downfall of Enron in order to ground the discussion of what had prompted recent reforms in the structure and governance of public corporations.

INTRODUCING THE LAWYERS

This paper contains views from four distinguished securities lawyers. In alphabetical order, Ed Ellers is an adjunct professor at Temple Law School. He teaches securities, gaming law, and various corporate transactional classes. He is a partner at Klehr, Harrison, Harvey,

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[4] The Securities and Exchange Commission, Final Rule: Implementation of Standards of Professional Conduct for Attorneys, http://www.sec.gov/rules/final/33-8185.htm (accessed February 15, 2005) (adopting final rules, with explanations, and extending the comment period for some provisions) [hereinafter SEC Release]. Plain text of the rule is codified as 17 C.F.R. § 205 et seq. (LEXIS 2005) [hereinafter Rule 205].

[5] Originally, this paper also planned to include views from the SEC. However, "the staff [of the SEC] is not permitted to publicly opine on the views of the Commission." Email from Carol Rosenblat, Atty., SEC's Philadelphia office to Olga Yevglevsakaya-Wayne, student, Temple Law School, *Sarbanes-Oxley* (Apr. 26, 2005, 4:59 p.m. EDT).

Branzburg. & Ellers, a former attorney at the SEC, and a founder of his own public company. He is extensively experienced in diverse securities and corporate law issues.

Justin Klein is a partner-in-charge of the Securities Group at the Philadelphia office of Ballard Sparh, Andrews & Ingersoll. He served for over nine years at the SEC, and was also a court appointed trustee in SEC enforcement matters. Mr. Klein has chaired various Bar Association committees related to securities law, and is an appointee to the Attorney Advisory Committee of The Pennsylvania Securities Commission.

Jason Shargel is a partner at Wolf, Block, Schorr & Solis-Cohen, in the Corporate/Securities practice group. He too is a former attorney at the SEC. He worked for the Commission's Enforcement Division right after law school. He is a member of the Pennsylvania Bar Association and represents public and private clients in a wide variety of corporate and securities matters.

Carl Schneider is Of Counsel at Wolf, Block, Schorr & Solis-Cohen, where he was partner since 1965, and Chair of the Corporate Law Department. He is a former Special Advisor to the SEC's Division of Corporation Finance. He is widely published in securities and corporate law matters, and lectures on these subjects at the University of Pennsylvania Law School. Mr. Schneider is one of *The Best Lawyers in America*, according to *Who's Who in America*. He is considered an icon by his colleagues.

STRUCTURE OF THE PAPER

I. NEW LAWS, REGULATIONS, AND RULES WITH COMMENTS AND SUGGESTIONS

A. Overview of SOX

SOX, signed into law in 2002, contains eleven titles mandating new standards in corporate law.[6] First, the Act calls for the establishment of a Public Company Accounting Oversight Board (PCAOB) to set up quality controls and oversee accounting practices of all publicly traded companies.[7] Second, the Act designates standards for independence of financial auditors from the companies they review.[8] The third title, aptly named Corporate Responsibility,

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[6] H.R. 3763 §§ 1-1107.

[7] *Id.* §§ 101-109. By November 2004, large companies were for the first time required to submit the initial report assessing internal quality controls over financial reporting under the new standards set by the PCAOB; by July 2005, small companies must follow suit. 1455 PLI/Corp. 125.

defines various standards of practice for corporate directors and officers, audit committees, and even attorneys.[9] In addition to section 305, which allows the SEC to ban particular individuals from serving as directors or managers of public companies,[10] this title contains the much-debated section 307, which prescribes minimum standards of professional responsibility for attorneys practicing before the SEC, and grants the SEC authority to do the same on a more specific level.[11] Under section 307, attorneys privy to material violations of state or federal laws by anyone within the company are first required to report their knowledge to the company's Chief Legal Officer (CLO), or chief executive officer (CEO), or an equivalent.[12] The next part of this paper reviews the latest SEC rules adopted pursuant to section 307.

Title IV of SOX provides for more timely and detailed financial disclosures, requiring, for example, certain transactions by corporate insiders owning more then ten percent of the company's stock to be publicly disclosed within two business days.[13] Section 404,[14] the so-

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[8] H.R. 3763 §§ 201-209.

[9] *Id.* §§ 301-308.

[10] Described as "[perhaps] the most significant remedy under the Act." Thomas O. Gorman & Heather J. Steward, *Is There A New Sheriff in Corporateville? The Obligations of Directors, Officers, Accountants, and Lawyers After Sarbanes-Oxley of 2002*, 56 Admin. L. Rev. 135, 159 (Winter 2004) [hereinafter *New Sheriff in Corporateville*].

[11] Section 307.

[12] *Id.*

[13] H.R. 3763 §§ 401-409. Presumably, this will function an alarm bell for investors: if the insider of a company begins to sell off his ownership share–he probably knows something (bad) that the outsiders do not. For example, Kenneth Lay, founder, chairman, and CEO of Enron, sold most of his Enron holdings in 2001, and did not disclose the fact to the public. Faith Stevelman Kahn, *What Are the Ways of Achieving Corporate Social Responsibility? Bombing Markets, Subverting the Rule of Law: Enron, Financial Fraud, and September 11, 2001*, 76 Tul. L. Rev. 1579, 1595 (2002) [hereinafter *Bombing Markets*]. Recent news, however, indicate that this provision of SOX left at least some loopholes. Soon after Merck took Vioxx, one if its

called "internal controls" provision, delegates authority to the SEC to promulgate rules regarding mandatory control mechanisms for quality financial reporting within public companies, as well as disclosures of these mechanisms. Another section of Title IV requires disclosure of whether the company has its own code of ethics, and if not, the reasons for its failure to adopt one.[15]

Title V, containing a single section, addresses the "treatment of securities analysts by registered securities associations and national securities exchanges."[16] Title VI broadens the power, both legal and financial, delegated to the SEC.[17] Title VII provides for specific studies and reports on the activities of public accounting firms, credit rating agencies, and investment banks.[18] Section 703 authorizes a study of violations of federal securities laws that took place during the period from January 1, 1998, to December 31, 2001.[19] Section 703 also specifies that "a report based upon the [Section 703] study... shall be submitted to the Committee on Banking, Housing, and Urban Affairs of the Senate, and the Committee on Financial Services of the House

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major drugs, off the market in 2004, company CEO Raymond V. Gilmartin "realized" $ 34.8 million from his stock option compensation scheme. Although this total amount was calculated based on the publicly disclosed difference between the company's stock price and the price of the option, it was not disclosed whether Mr. Gilmartin, had, in fact, exercised the option and actually sold the stock. Associated Press, *Update 1: Merck CEO Realized $ 34.8M in 2004 Options*, http://www.forbes.com/associatedpress/feeds/ap/2005/03/10/ap1877728.html (accessed Mar. 10, 2005).

[14] H.R. 3763 § 404.

[15] *Id.* § 406. This provision "will practically guarantee that issuers will actually adopt such codes." *New Sheriff in Corporateville* at 149. "A 'code of ethics' is defined to mean standards that will promote honest and ethical conduct, full and fair disclosure in periodic filings, and compliance with government regulations." *Id.*

[16] H.R. 3763 § 501.

[17] *Id.* §§ 601-604.

[18] *Id.* §§ 701-705.

[19] *Id.* § 703.

of Representatives... ."[20] Other studies related to understanding the effectiveness of various reforms of accounting principle*s* are authorized throughout the Act.[21] However, no studies of violations of federal or state laws by corporations at any future time are specified.

Titles VIII-IX and XI of SOX deal with criminal accountability and penalties for various violations of securities and other laws.[22] Title X requires Chief Executive Officers to sign corporate tax returns.[23] This provision will presumably bar CEOs in the future from pleading ignorance of what had gone wrong during potential future investigations.[24]

Mr. Klein calls SOX "Full Time Employment Act for Securities Lawyers." SOX requires more care and more process by public companies, who must also keep up with new rules promulgated by the SEC, the states, and the stock exchanges. Also, SOX has ushered a change in attitude by public companies, who are very concerned about compliance and liability. Mr. Klein points out that SOX has made it much easier for lawyers to give advice to and persuade corporate clients because of these new concerns, and that clients are more welcoming of lawyers, inviting them to board meetings, for example, which was very rare in the past.

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[20] *Id.*

[21] *See discussion* in Lawrence A. Cunningham, *Symposium: Crisis in Confidence: Corporate Governance and Professional Ethics Post Enron Sponsored by Wiggin & Dana: The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work)*, 35 Conn. L. Rev. 915, 917-918 (2003) [hereinafter *Crisis in Confidence*].

[22] H.R. 3763 §§ 801-906; 1101-1107.

[23] *Id.* § 1001.

[24] *New Sheriff in Corporateville* at 137. The Act focuses a great deal on *personal* accountability of corporate insiders and outsiders. *Id.* at 138. "Intent of [various section of SOX] is clear–to bring a new ethical standard to the marketplace by forcing corporate executives to take responsibility for the financial information published by their companies." *Id.* at 156.

Mr. Klein finds the internal controls Section 404 of SOX has been most demanding in terms of implementation. Section 402, a prohibition on short term loans to corporate officers, has been most "asinine." Also, the emphasis on auditor independence has had a chilling effect on the ability of public companies to get informal advice about various transactions from their auditors; that is, auditors are reluctant to act as sounding boards for various transactions contemplated by companies employing them, due to fear of liability.

Mr. Klein notes that deadlines for many disclosures have shortened, a reform contemplated years before Enron and SOX. Securities has always been a more risky legal practice, according to law firms' insurance carriers. "It is risky to represent people who raise money from other people," says Mr. Klein. He adds that tightening of the rules has made it even more risky.

Law firms have certainly responded to SOX, Mr. Klein adds. In addition to intra-firm educational initiatives, there is a "cottage industry" of law firm memos related to SOX on the internet, and circulating among various law firms. At least in Philadelphia, lawyers at various firms form a "friendly, collegial network," and actively share opinions on the optimal implementation of SOX.

Mr. Shargel seconds this response. There is a great deal of awareness-raising initiatives within and among law firms regarding the new rules and regulations. Corporate managers and directors are definitely more concerned about understanding and properly adhering to the new regulations, which has caused a greater dependence on lawyers, and has correspondingly enhanced the lawyers' influence over their clients. Lawyers are giving more advice about how corporate boards must meet their obligations to the shareholders, and companies listen carefully.

Mr. Shargel notes that although the process of implementing some changes, such as Section 404 internal controls, has been "expensive and muddled", much of it is a one-time deal, which will not be too difficult to update. Redrawing audit committee charters and setting up codes of ethics, for example, need only be done once. On the other hand, complying with enhanced conflict of interest provisions, such as restrictions on short-term loans to corporate officers, will require more tweaking. The SEC does not define the term "loan," for example, and in practice, the term is ambiguous, raising a disproportionate number of issues compared to the policy behind this rule, which is hard to discern in the first place.

Mr. Schneider notes that SOX and associated reforms have signaled a change in focus by corporations. Attention and care is heeded to such items as executive compensation packages and other similar perks and benefits to corporate employees. It is no longer acceptable to charge a manager's wife's birthday party as a company expense, for example, although this kind of issue was hardly material in the past. Sensitivity to these kinds of maters is coming to the fore.

Mr. Schneider agrees that implementing internal controls, under Section 404, has been challenging for public companies and for lawyers. Rules promulgated pursuant to this provision of SOX are brand new and very time consuming. Forcing corporate executives to take personal responsibility for various disclosures is another novel change.

Mr. Ellers lauds the establishment of the PCAOB as one of the most important and meaningful provisions of SOX. He says that new rules for accountants and corporate officers, though not lawyers, are rightfully the first line of defense against fraud.

One academic criticism of SOX is that while it thoroughly addresses conflicts of interest between various corporate actors, it ultimately fails to recalibrate incentives for people to act in ways that will actually deter fraud and malfeasance.[25] At the same time, SOX is lauded for introducing a shift from rule-based to principle-based actions.[26] That is, instead of dictating the precise course of action for various corporate actors to follow, SOX seeks to motivate corporate actors to be guided by context-specific judgments adding up to standards of objective reasonableness and fairness. Where Congress has left off, the SEC has picked up the struggle to promote healthy corporate practices.

B. Latest for Lawyers from the SEC: Rule 205.

The SEC has opined that "by passing [SOX], Congress has implicitly concluded that the benefits of setting minimum federal standards [of professional responsibility for attorneys practicing before the Commission] justify their costs."[27]

1. Rule 205, the Basics

After rounds of arguments between government administrators, corporate officers and attorneys of all kinds, the SEC promulgated "final" rules "prescribing minimum standards of professional conduct for attorneys appearing and practicing before [the Commission]."[28] The highlight of the rules is a mandatory reporting "up the ladder"[29]

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[25] John C. Coffee, Jr., *Gatekeeping Failure and Reform, The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. Rev. 301 (2004) [hereinafter *Gatekeeping Failure*].

[26] *Id.*

[27] SEC Release, § IV. Costs and Benefits.

[28] SEC Release, § I. Executive Summary.

[29] SEC Release, § II. Section-by-Section Discussion of the Final Rule.
Federal securities laws consist of the Securities Acts of 1933 and 1934, SOX, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, and the Securities Investor Protection Act of 1970. *New Sheriff in Corporateville* at 139-140.

requirement, triggered when an attorney becomes aware of objective evidence of material violations of federal or state securities laws by the issuer or its constituents. In elaborating the meaning of both "evidence" and "material," the SEC notes that the reporting requirement is only activated when the violative conduct on the part of the issuer or its constituents is fairly egregious, not merely questionable.[30] In view of the SEC, "material" is a legal term with a clear and well-established meaning.[31]

"Up the ladder" reporting begins when an outside counsel becomes aware of objective evidence of material violations of state or federal laws and relays this information to the company's CLO, or its CLO and CEO, or its Qualified Legal Compliance Committee (QLCC).[32] The QLCC is a special, independent committee within the company, set up at the company's option for the specific purpose or receiving reports about potential wrongdoings and recommending a course of action to the managers of the company.[33] The outside counsel making the report is aptly called the reporting attorney. Reporting is called "up the ladder" because when the initial report does not affect a remedy, the reporting attorney must relay the information to more senior company management, and then to the board of directors.[34]

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[30] SEC Release, § II.

[31] *Id.*

[32] *Id; see* Albert S. Dandridge, III, *Securities and Exchange Commission Rule Regarding Standards of Professional Conduct for Attorneys*, in *Two Years of Sarbanes-Oxley: Real Reform or Window Dressing?* 441-446 (Pennsylvania Bar Institute, 2004).

[33] SEC Release, § II.

[34] *Id.*

The SEC notes its intent to not disrupt traditional corporate governance (created by state law [35]) by not empowering the receiver and investigator of the initial complaint from the reporting attorney to authorize the company to take action.[36] Although the QLCC is technically a new, federally-created branch of corporate government, either it, or the CLO is empowered only to recommend the proper course of action in response to the complaint, and not to direct its implementation.[37] Ultimately, company managers, people traditionally empowered to run daily corporate affairs,[38] must decide whether to adopt the remedial recommendations of the CLO or the QLCC.

After receiving the initial report from an outside attorney, the CLO or the QLCC must investigate it, and then communicate an "appropriate response" to the reporting attorney.[39] Essentially, an "appropriate" response is either a cure of the fraud with measures to prevent its recurrence, or the hiring of the reporting attorney to review the evidence of violations and assert a colorable defense in any investigation or lawsuit of the company or its employees.[40] Hiring the attorney to assert a colorable defense, however, does not by itself constitute an "appropriate

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[35] *See generally* James D. Cox & Thomas Lee Haze, *Corporations*, § 1.02 (Aspen Publ., 2nd Ed., 2003) [hereinafter *Corporations*].

[36] *Id.*

[37] *Id.*

[38] *See generally Corporations*, §§ 8.01-8.12.

[39] SEC Release, § II.

[40] *Id.* This retention of the reporting attorney must be made with the consent of the board of directors or a committee consisting of board members, or the QLCC. *Id.*

response."[41] Nor may the company utilize the reporting attorney to conceal violations of law or further illegal conduct.[42]

In the event the reporting attorney does not receive an "appropriate response" after her initial reporting, she must report evidence of material violations of state or federal laws to higher authorities within the company.[43] The SEC specifically explains its intent that attorneys exercise reasonable judgment with respect to both the decision to initiate "up the ladder" reporting and the evaluation of "appropriate response," including the time it took to receive it.[44]

2. A Note About Reasonable Time

Rule 205 explicitly mandates that at attorney's choice to report "up and ladder" and her review of corporate response is to be evaluated under the standard of objective reasonableness.[45] While a principle-based provision, it remains a highly manipulable one absent some grounding in time. Arguably, an "appropriate" response need not follow all that promptly. In fact, there is no incentive for the corporation to respond as promptly as it possibly could. For example, while curing an imminent violation of financial disclosure laws a day late might be an "appropriate" enough response to satisfy the attorney's reporting obligations, that day might nevertheless be sufficient to manipulate the market. This absence of any timing limitations on the nature of corporate response, aside from the manipulable concept of reasonableness, opens a wide door not only for the perpetuation of some fraud, but also for getting time to hide it, and then, if a lawsuit

[41] *Id.*

[42] *Id.*

[43] *Id.*

[44] *Id.*

[45] *Id.*

follows, for hiding behind an affirmative defense of appropriate response having been provided to the reporting attorney.

Although perhaps curbing major violations, "reasonable" and "appropriate" criteria, not grounded in more precise principles of time or some other specification, set up incentives to stretch the concepts of reasonableness and propriety to the extent of defeating their very purpose. It is true that reasonableness varies with respect to violations of different kind of laws. It is also true, however, that left unchecked, reasonableness could evolve into abused discretion. Further grounding of this concept is needed; time of response is perhaps most relevant.[46]

Just like there is a market for stock there is a market for law firms. Clients choose those firms that represent their interests best, and public corporations probably have their most permissive favorites. An insufficiently grounded standard of reasonableness creates a competition among law firms to be at best most patient, and at worst most inappropriately reasonable. After all, there are not many checks on lawyers, and even fewer incentives for them to not accommodate their clients by being satisfied with responses to their reports of barely passing grades. This is true especially if whatever damage might be done wouldn't be too terribly bad, because no one will probably find out about it anyway. Although many lawyers will probably resist pressures from their clients to push the limits of reasonableness, the current version of the rules regulating conduct of attorneys does not empower lawyers with special incentives to do so, aside from a strong sense of ethics. However, SOX and the rules that followed are evidence that ethical principles alone are not enough to prevent wrongdoing. For these reasons, it might be worthwhile to try to set up the rules so that corporate actors do not

[46] *But see* Timing the Attorney-Client Privilege, *infra.*

want to commit any fraud in the fist place, and so that lawyers want and can keep a truly independent and watchful eye while serving their clients within reason.

The drawback of grounding the concept of reasonableness in more precise guidelines about the timeliness of the appropriate response, again, is that responses to reports of different kinds of misconduct will vary with respect to violations of different kinds of laws. Different kinds of violations have different stakes, and lend themselves differently to remedies. One could go on hypothesizing about the different possibilities where timeliness might or might not matter, but the bigger point is that there is not enough information available about the kinds of violations that take place in corporations, or about their frequency. There is also no guarantee lawyers themselves appreciate the potential for how their clients might stretch (or might pressure the lawyers to stretch) the limits of reasonableness, because, ultimately, the clients are better business experts than the lawyers, and they have succeeded in the past in diluting the watchfulness of lawyers. Without some "industry custom," some understanding of what really goes on, it will probably be difficult for courts potentially reviewing lawyers' reporting and corporate responses to fairly and consistently adjudicate these issues of reasonableness and propriety. Most likely, as between corporate lawyers, their clients, and the courts, judges are least well versed in business dealings, perhaps with the exception of judges on the Delaware Chancery Court.

But establishing an industry custom of attorney-client monitoring is easier suggested than done. The lawyer's reporting obligation stops when she receives an appropriate response: this event signals the end of the problem. The downside of this process is that some potentially very valuable information is never disclosed. The upside is that working out problems on the inside does not involve disclosure of privileged information. It must be noted, however, that overall, the general trend in law today is in the direction of an eroding attorney-client privilege, particularly in the business context.[47]

Mr. Ellers comments that the way to go about reform is to punish the Boards of Directors, not to attack the attorney-client privilege. "If anybody is in privity with the SEC, it is the Board."

The real issue behind reporting obligations is who the client is, and to whom and by whom obligations are owed. Most commonly, it is the Board who hires the outside attorney, and his obligations are to the company by way of the Board of Directors. Boards make critical judgments at the highest level, and they are the ones who ought to be reprimanded for misconduct, not the lawyers. In part, SOX recognizes this because many of its provisions are aimed at enhancing accountability of corporate officers.

The reason lawyers are not the best line of defense against fraud, Mr. Ellers explains, is because they are not always in the best position to evaluate or obtain all the

[47] Molly McDonough, *Flying Under the Radar: After Percolating Quietly, These Legal Issues may Grab Headlines in 2005*, 91 ABA J. 34 (Jan. 2005). Rule 205 itself is a major part of this trend. It does not require client consent as a predicate of an attorney being permitted to report privileged information to the SEC when other requisite conditions are met. Sarah Plotkin Paul, *Dawn Raids Here at Home? The Danger of Vanishing Privacy Expectations for Corporate Employees*, 17 St. Thomas L. Rev. 265 (2004). Aside from changes in attorney-client privilege, there are other reasons the expectation of privacy of intra-corporate communications is eroding in this age of computers and electronic communications. *Id.*

information that is needed to evaluate the overall integrity of a corporate client. Again, whom they represent and for what purpose matters a great deal. Outside lawyers are hired for specific projects, and their access to information, as well as their duties to become informed are defined by the nature of the task for which they are retained. Lawyers have no subpoena power, or enforcement/investigation power of any kind. What is reasonable conduct by a company overall is not always clear, but burdening lawyers with any excess reporting or monitoring obligations puts them in a position where they are not motivated to obtain as much information about a client as they can to provide the best advice to the client, for fear of incurring a duty to blow the whistle. The 'if I look too hard I must disclose, so I better not look too hard' practical implication of making lawyers accountable is not helping anybody. Also, it is not always clear what exactly terms like "objective evidence" or "material violations" mean. Making lawyers pay for the fraud also makes legal charges increase, and this is ultimately a cost borne by the shareholders. Overall, Mr. Ellers is troubled by the approach of making lawyers a part of the solution, as opposed to other professionals, such as accountants.

Mr. Ellers contrasts his views with those of former SEC Chairman Harvey Pitt. Mr. Pitt believed that lawyers' obligations are essentially to the shareholders and to the public at large; that the attorney-client privilege in the corporate context is largely irrelevant because ultimately, the shareholders are the true clients possessing an inherent right to be informed about what management does.

Mr. Ellers disagrees. He argues the Boards of Directors are the best proxies for personifying the representation of corporate entities. He suggests that shareholders have a right to hire their own lawyers, and to demand information about internal company operations when they are concerned about wrongdoing. Mr. Ellers points out that larger public companies are owned in substantial part by sophisticated institutional investors who are well versed in obtaining all kinds of information about companies in which they invest. In reality, institutional investors have their own lawyers, and corporate law allows them to make demands for information. Those who invest large sums of money into public corporations go to great lengths to obtain a great deal of information about them.

Mr. Ellers uses Enron as an example. He says that sophisticated investors knew well in advance about many of the problems with the company. And, the shareholders were the ones who pressured companies to keep stock prices high by any means necessary in order for the value of shareholders' assets to stay at high levels. "Sometimes, shareholders don't want to know bad news; they don't want to be protected." Sometimes, they must admit their own role in the problems.

Mr. Shargel takes a slightly different view. First, he notes the good news: in the real world, corporate clients will listen when lawyers advise them about the illegality of certain types of conduct. Although there does exist a level of general discomfort about lawyers imposing their judgment and questioning that of corporate officers, lawyers do stay well-attuned to where the law draws lines, and the majority of them do not turn a blind eye to situations when clients may wish to cross them. "People do not push the boundary if they are told they are over the line." And, once again, the general level of awareness is quite high in today's corporate environment.

The lawyers *are* the gatekeepers, says Mr. Shargel, and accountability is important. Although corporate clients are sometimes personified as particular corporate officers because these are the people with whom lawyers deal on a day-to-day basis, lawyers can and do remember their obligations to the corporate entity overall.

Mr. Shargel asserts that reporting "up the ladder" is an appropriate solution to the recent wave of corporate scandals, and, that it is consistent with the notion of serving the best interest of the corporation as the client. The idea behind this regulation is to promote internal solutions to problems, without imposing on the attorney-client privilege by way of mandating or even permitting disclosures of confidential information. In reality, the vast majority of problems will most likely be fixed before or at the level of bringing some problem to the attention of the Board of Directors.

Mr. Shargel admits there is a level of ambiguity associated with terms such as "material" or "reasonable." These terms are "absolutely *not* completely clear." He says, however, that overall, the SEC did as good of a job defining these terms as it could, and it is the lawyers' task, after all, to deal with ambiguity.

"I spend twelve hours a day worrying about shades of grey," says Mr. Klein, who explains that interpreting the meaning of words that are less then absolutely clear is precisely the job of the lawyer, who uses his judgment and experience to come up with answers. "What is material and not is all over the place." There is a quantitative as well as a qualitative component to these terms. But, the day of a securities lawyer is spent figuring these things out and advising clients about what must be and what need not be disclosed. Part of the problem is figuring out what the SEC wants, and reading the dinner speeches may be as important as reading the rules.

Mr. Klein agrees with Mr. Shargel that lately clients are more receptive to lawyers' advice. "Everybody is rolling in the same direction here." Mr. Klein also agrees that lawyers represent corporations as separate entities, no matter whom the lawyers deal with on a daily basis. "You have to be sensitive to situations," says Mr. Klein, "admittedly, there are situations of conflict, a management buyout is an example. Sometimes, you do question the CEO's authority, but not often."

On the issue of representing corporate clients, Mr. Klein adds that law firms have the power to select and fire clients just like clients have this power over lawyers. Lawyers try to pick clients with whom they can establish an honest rapport, avoiding those who are likely to get everyone in trouble. There have been times, says Mr. Klein, when clients have been fired, not because they violated the law, but because the lawyers were uncomfortable with them.

Mr. Schneider describes materiality as a judgment call, which is in part economic. What is immaterial to a billion dollar company may be material to a smaller one. "Materiality is not just a numbers test, is also has to do with what the issue is."

Lawyers must make judgments regarding less then clear terms. Generally, this task is handled well, but it is very important "to be clear about what matter that you are working on. You don't want to make representations that go beyond the issue of your engagement."

Mr. Schneider explains that when outside lawyers are retained by corporations, they are often retained for a specific, delineated purpose. Most companies are not in a position to do all of their work internally, they need a lot of expertise. But, just because a lawyer is employed by a company, does not mean he is in a position to evaluate materiality of certain items, if that is not the job for which he is hired. "You know only so much as you need to know for one dispute, one contract, one regional issue. When auditors write to you, there is tension in what you can answer because you were only engaged in project X, and you don't know much about [the company's] disclosures or accounting." Thus, when outside lawyers have obligations as watchdogs, matters may get complicated.

Mr. Schneider explains that generally, lawyers have incentives to be cautious in their judgment calls because they do not want to be second-guessed. The current regulatory environment has "put the lawyers in a frame of reference where they don't want to make hard judgments. They have to ask questions, but they may be acting self-protectively. It gives them a lot of incentive to be less then vigorous advocates."

Yet, Mr. Schneider admits that he does not have personal objections to the way the balance has ultimately been struck. "When the screws are tightened, there are a lot of squeals."

Mr. Schneider explains that a lawyer simply cannot watch a client do something significantly illegal and say nothing about it. "You can't just sit still. The role of counselor is not to help the client do something illegal. A lawyer must become convinced that what is going on is ok, and be prepared to defend that judgment, [although] in the real world, judgments can get very close. The professionals are under enormous scrutiny." The right to practice law is on the line, and this is not to be taken lightly. Lawyers do serve as gatekeepers.

Mr. Schneider also reminds lawyers they have to remember that they represent the corporation as a whole, not its individual officers or directors. It is true that daily contacts are with the CEO or with another executive, "but you really have to make it very clear to the CEO that you are representing the company, not him personally. If there are things questioning the CEO's performance, you [must] advise him to have his own lawyer.... You have to be extremely sensitive to these situations." In practice, when there is a lawsuit, because a lawyer initially retained to represent a company has had so much contact with a particular executive, he may end up representing him, while the company, usually by way of the Board of Directors, hires someone else. Whom a lawyer represents and for what purpose affects his responsibilities and obligations.

3. Timing the Attorney-Client Privilege

There is yet another possibility. We need to ask whether it really matters if privileged information about cured misconduct is reported after the statute of limitations for suit has expired,[48] and, whether it is possible or desirable to have documents about reports of violations and curative responses disclosed to the SEC by corporations for educational purposes. It might be useful, for example, to remove the confidential status of violations and intra-corporate problems that are old enough to no longer pose a threat of fraud on investors, lawsuits by them, or catch-22 situations for lawyers with respect to disclosing information when it is still sensitive enough to matter for purposes of the market.

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[48] Section 804 of SOX, found at 28 U.S.C.S. § 1658 (LEXIS 2005) provides the following:

> [A] private right of action that involves a claim of fraud, deceit, manipulation, or contrivance in contravention of a regulatory requirement concerning the securities laws, as defined in section 3 (a) (47) of the Securities Exchange Act of 1934 . . . may be brought not later than the earlier of --
>
> (1) 2 years after the discovery of the facts constituting the violation; or
>
> (2) 5 years after such violation.

Five years after the intra-corporate problem requiring “up the ladder” reporting is solved, the client is probably employing a different outside law firm. If corporate clients know that facts about past internal problems will eventually become public knowledge, they may actually want to rotate its legal representation. As a result, competition would probably diminish among law firms to be most loyal, i.e., most inappropriately reasonable.

Voluntary disclosure of past problems by corporations would allow the SEC or another body to review the actions taken in response to internal reports by both lawyers and corporations, and to comment on them. The database of knowledge about most recurrent and most pervasive problems could prove invaluable. For one, it could generate a discussion about reasonableness and propriety that would keep these concept from stretching beyond their essential meanings. Law firms would have this check of eventual disclosure to prevent them from acquiescing to the pressures of their clients, a task in which they proved unsuccessful leading up to Enron. The disclosed information as well as comments on it would provide attorneys with better guidelines about what “reasonable” means in different types of circumstances. Lawyers less skilled in securities law, who are nevertheless faced with potentially having to initiate “up the ladder” reporting, would actually have some guidance regarding whether or not they must act and how they ought to proceed.

Because reasonableness is a malleable concept, in the early stages of collecting this data about reasonable responses, both initial reporting and evaluations of corporate responses by attorneys will probably vary widely from one set of facts to the next, and from one law firm to the next. Only as more data becomes available could there be some definition to what constitutes a healthy corporate response to problems. Because disclosure would be made after the statute of limitations expires, at least on the federal level, disclosure would not threaten suits and their associated costs. Also, judges presiding over investor suits could likewise become better informed about adequate and reasonable corporate problem-solving than they probably are at this time.

Should mandatory ex-post disclosure of internal reports and responses to them be adopted, "reasonableness" will no longer need to be grounded in more specific descriptions of what a "timely" response means in different kinds of situations.[49] In time and with more information, reasonableness will be grounded in customary practices and comments from those who study them. How much time it will take to have a sizable enough database to constitute a meaningful reference point for what "reasonable" means in practice will depend on how much information the SEC will collect, and how soon it might collect it, analyze it, and comment on it.

Another advantage of making past problems part of public knowledge after the statute of limitations for lawsuits elapses is that this measure could control the market for good managers in ways that ordinary market forces currently cannot. If good monitoring sends signals to the market about effective management,[50] the incentives for corporate managers to exercise less then good faith in response to reports from attorneys will be significantly diminished through a threat of eventual disclosure. People whose names consistently reappear in such disclosures will have a harder time retaining positions of power and threatening the public interest.

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[49] *See* A Note About Reasonable Time, *supra*.

[50] *See* John S. Baker, Jr., *Reforming Corporations Through Threats of Federal Prosecution*, 89 Cornell L. Rev. 310 , 400 (2004) [hereinafter *Reforming Corporations*].

Even if a hypothetical "up the ladder" report about a fraud which had not yet occurred is remedied timely and properly, there are costs associated with an attorney initiating such a report. Although it is appropriate to focus on stamping out fraud before it causes injuries, it is likewise appropriate to install measures which dissuade the temptation to commit it altogether.

This kind of disclosure system, because it would not be accompanied by a threat of lawsuits given the expired statute of at least federal limitations, may not necessarily involve issues of violating the attorney-client privilege. For one, the burden of disclosure could be on the firm, rather then on the lawyer. Also, lawyers represent corporations, not individual officers, and when conduct of particular individuals is at issue, whether the privilege attaches to them personally is a question of their authority within the corporation.[51]

Disclosure is costly. Collection, maintenance, and analysis of information are also costly. On the other hand, companies are the cheapest cost-avoiders[52] when it comes to providing the public with information that, when analyzed, produces the benefits of clear standards for attorneys to follow, and deters corporate officers from walking too closely to the edge of the law on repeat occasions.

The reason managers are traditionally divorced from corporate ownership is to encourage them to take risks, leading to greater payoffs for everyone in the long run. Arguably, excess disclosure would blunt risk-taking because managers would fear their

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[51] *See* William H. Simon, *Whom (Or What) Does the Organization's Lawyer Represent? An Anatomy of Intraclient Conflict*, 91 Calif. L. Rev. 57, 60 (2003) [hereinafter *Organization's Lawyer*].

[52] *Reforming Corporations* at 413 (Easterbrook/Fishel theory).

names appearing anywhere near those reports. It is a question of policy whether risk-taking that triggers concerns of lawyers about violations of state or federal laws is the kind of risk-taking that is contemplated by this tenet of traditional corporate law.

Another general argument against "too much" disclosure is that it provides non-disclosing firms with a competitive advantage.[53] When two firms have equal standing on the market, and one makes a negative disclosure while the other does not, the more forthcoming firm incurs the cost of investor dissatisfaction reflected in the price of its shares.[54] Mandatory disclosure, however, eliminates this dilemma and because of the delay in time between the events and the disclosure, ex-post disclosure may not have any effects on the prices of shares at all.

Certainly issues exist with respect to the form of information delivery and to whom it ought to be delivered. The level of detail contained in these disclosures will probably depend on the nature of the problems, and the SEC could fine-tune its requirements once it begins to accumulate information. Presumably, the SEC or a sub-agency dedicated to studying the practical effects of SOX and its attendant reforms could be the recipient of these reports from companies. SOX does not authorize this directly, but the general delegation of authority to the SEC may provide sufficient authority to defeat any issues of the SEC's power to set up such a research agency. However, it would probably be rather useful for states to get involved as well, and to also have an opportunity to comment on the information received from corporations. For example, an independent commission could be set up consisting of representatives from both the

[53] *Id.* at 412.

[54] *Id.*

federal and the state level. If that commission is charged with producing reports analyzing the information it has received, instead of fighting for power, state and federal representatives would be forced to compromise.

4. Noisy Withdrawal, Still Undecided

The "noisy withdrawal provision" which had appeared in earlier drafts of SEC's rules for attorneys[55] is still under review. The first draft of this rule mandated lawyers to withdraw from client representation when they did not receive an appropriate response from the top of the company's "ladder."[56] The lawyer would also have to disaffirm documents she had submitted to the SEC while representing the company, and notify the SEC of the withdrawal.[57] The new version of the "noisy withdrawal" provision[58] that is currently under review abolishes the disaffirmance requirement, places the duty to report lawyer withdrawal on the company, and mandates withdrawal in more limited

[55] Securities and Exchange Commission, Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys, http://www.sec.gov/rules/proposed/33-8186.htm (accessed Feb.15, 2005). The history of the "noisy withdrawal" provision, including it inception is discussed in *New Sheriff in Corporateville* at 173, n. 211. "Noisy withdrawal" is "one of the most contested provisions [proposed by the SEC]." Jenny B. Davis, *SEC Releases Final Attorney Rule, But Extends Comment Period on Noisy Withdrawal*, 2 ABA J. eReport 4 (Jan. 31, 2003).

[56] *Supra*, n. 55. Also, some attorneys are not qualified to judge whether response from the company is appropriate because litigators who do not specialize in securities simply lack the requisite knowledge and skills. 30 Litig. at 21-23.

[57] *Supra*, n. 55.

[58] 68 F.R. 6324 (LEXIS 2005); *see* Dan K. Webb & Scott Glauberman, *Up the Ladder: Litigator Responsibilities Under the Sarbanes-Oxley Act*, 30 Litig. 21, 27 (Summer 2004) [hereinafter *Litigator Responsibilities*].

circumstances of ongoing[59] or imminent fraudulent activity posing a risk of substantial injury to the company or to the investors.

"Noisy withdrawal," the old and the new versions, are heavily criticized for infringing too much on the attorney-client privilege.[60] A typical criticism goes as follows: "Noisy withdrawal" would "eviscerate the attorney's traditional role as advocate, confidant and advisor. This would drive a wedge between attorney and client. Corporate officers and employees would not be forthcoming and this, in and of itself, would in the long run hurt the corporation and its investors."[61]

Another potential problem, not only with the "noisy withdrawal" provision, but with other parts of various new rules for lawyers, is the term "substantial injury." For example, had no one blown the whistle on Enron to this day, i.e., had the public remained unaware of the problems– there would have been no injury as of yet because the company's stock would still be valuable so far as how the market would price it. On the other hand, had the whistle been blown earlier, the inevitable injury might have been much less egregious. Thus, qualifying the threat of injury by the adjective "substantial" to

[59] "Ongoing" fraud is a manipulable concept because the aftershocks of financial fraud linger on the market for an indefinite period of time. *Litigator Responsibilities* at 27.

[60] *See e.g.* Christin M. Stephens, *Sarbanes-Oxley and Regulation of Lawyers' Conduct: Pushing the Boundaries of the Duty of Confidentiality*, 24 St. Louis U. Pub. L. Rev. 271 (2005) [hereinafter *Pushing the Boundaries*]; Catharine E. Stark, *Regulating Corporate Governance: Amended Rules of Professional Conduct Allow Lawyers to Make the World a More Ethical Place*, 53 Cath. U. L. Rev. 1195, 1197 (2004) [hereinafter *Ethical Place*]; *Comments on Rules Implementing Section 307 of the Sarbanes-Oxley Act: Standards of Professional Conduct for Attorneys Practicing Before the SEC,* 58 The Record 23, 25 (Winter 2003) [hereinafter *Comments on Rules Implementing Section 307*]; Lance Cole, *Revoking Our Privileges: Federal Law Enforcement's Multi-front Assault on the Attorney-Client Privilege (and Why It Is Misguided)*, 48 Vill. L.Rev. 469 (2003).

[61] *Comments on Rules Implementing Section 307* at 25.

trigger the disclosure dissuades more timely remedial measures by attorneys with the help of outside agencies to which they could report misconduct. It is at least possible that the very act of waiting to disclose the information and solicit assistance of the SEC in preventing some ongoing fraud is itself a factor contributing to the injury becoming substantial.

Also, it might make a big difference whether the term "substantial" is to be evaluated in relation to the size of companies, or in relation to the holdings of particular investors. In case of the former possibility, a company worth $100 million is probably not "substantially" injured by fraudulent conduct decreasing its true worth by $1 million because the amount is a mere one percent of the overall worth. If this company's misconduct is never disclosed to the public because it is arguably insubstantial and therefore immaterial,[62] the company's stock prices may never be affected at all.[63] If a disclosure about the $1 million fraud is made, however, the stock price would probably drop, reflecting at best a more educated judgment about the company's true worth, or more likely, the worries and dissatisfaction of investors. Even a small drop in stock prices of the company will still affect heavily invested shareholders of that company. If one or several of these heavily invested shareholders had planned to retire using these investments, then any losses resulting from the decrease in the price of the company's

[62] Generally, what companies must disclose to the public is governed by the "materiality" standard set out in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). Information is material when a reasonable investor would find it significant in the context of the "total mix" of information about the company available to the investor. *Id.* at 232-233. Materiality is a fact-sensitive determination to be examined "in light of the totality of the company activity." *Id.* at 238.

[63] Scholars note that on public markets, price is not a perfect index of value. *See generally* Theresa Gabaldon, *The Story of Pinocchio: Now I'm a Real Boy*, 45 B.C. L. Rev. 829 (2004) [hereinafter *Story of Pinocchio*].

stock may nevertheless be "substantial" relative to those investors. This example is based on the sad fate of many Enron employees who, taking this example to the extreme, watched their life-savings melt in the crash.[64] In any event, charging the lawyer with predicting not only the extent of potential losses, but whom they might affect and how, may not be the most realistic expectation.

Another questions still unanswered is what happens when the lawyer reports evidence of material violations of state or federal laws and gets no response from the top of the "ladder." Under the current rules, he must resign in order to resist furthering the illegal conduct. This is the classic crime-fraud prevention rule.[65] But what happens then? The corporation hires another law firm which either assists in the potentially fraudulent transaction without challenging it, or the corporation hides from its new representatives the information which the just-resigned counsel had informed them was not good, or the corporation times the market in some other way that nevertheless injures the interests of investors. If the corporation does not hide information from its new lawyers, and the second set of lawyers also resigns upon hearing it, the corporation probably goes for law firm #3.[66] Withdrawal, it seems, sets off a rather unpleasant cycle that imposes significant costs which ultimately are paid out of the shareholders' pockets.

Instead of attorney resignation, the SEC should mandate disclosure of improper conduct that is triggered by the same extremely high level of misconduct threatening substantial damage which applies to the resignation provision. It seems that aside from

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[64] *See* Anita Bernstein, *The Enterprise of Liability*, 39 Val. U. L. Rev. 27, 62-63 (2004).

[65] *See* New Rules from the ABA, *infra.*

[66] Credit for this idea belongs to Professor Eleanor Myers, Temple Law School.

insuring lawyers do not assist in the perpetration of some fraud, the withdrawal provision ignores the more pressing need of getting the underlying problem solved. Timely intervention of authorities with actual power to initiate injunctive proceedings or at least investigate the potential misconduct seems a more practical solution then a cycle of attorney resignations. It should also be noted that neither the withdrawal nor this potential alternative of mandatory disclosure provision is likely to be used with any frequency, at least not any time soon. Once again, practitioners' reports indicate that in response to SOX, corporate CEOs are asking more questions, are more willing to listen to their lawyers, and are overall more concerned about carrying out their ethical obligations to the public.[67] Also, only the worst kind of misconduct will trigger this kind of response from lawyers. It is also questionable whether an Enron-scale violation is particularly deserving of the protections of the attorney-client privilege. If the privilege reflects a balance between the public and the private interests, in extreme situations the balance is already askew.

5. Permissive Disclosure

Under 205.3(d)(2), a reporting attorney dissatisfied with the response to her reporting may report confidential client information to the SEC to the extent reasonably necessary to prevent the occurrence of a violation that would result in either substantial injury to the financial or property interests of the company, or fraud perpetrated on the SEC, or that would rectify the fraud the attorney was involved in furthering.[68] Such

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[67] *See* Stephanie Francis Ward, *A CEO's Best Friend*, 2 ABA J. eReport 43 (Oct. 31, 2003).

[68] SEC Release, § II. In practice, "may" will probably never be used because it reporting to the SEC would hurt the law firm's business.*Litigator Responsibilities* at 24-

disclosure, although carefully circumscribed, is not mandatory.[69] The SEC points out, however, that permissive disclosure of potentially privileged client information is consistent with professional responsibility rules in most states.[70] The SEC also points out that should some states require apparently contrary rules of professional conduct, the more demanding state or federal regulations prevail.[71] States are free to regulate their attorneys, but they cannot be more lax about it then the federal agency.

6. Disclosure Alternatives

As noted previously, "materiality" and "reasonableness" are terms inevitably requiring human judgment.[72] In close cases, reasonable people inevitably will disagree. In order for the SEC to maintain some control over such disagreements in close cases, it could set up its own ethics "hotline" which attorneys could anonymously and confidentially contact for advice. It is true that most, if not all big law firms have their own internal ethics specialists, however, these specialists are probably not also well versed in the intricacies of securities laws. Because a sophisticated understanding of securities laws is required in order to make an appropriate judgment in close cases, it would perhaps best if the Commission itself takes on this responsibility. If it is feasible that such a "hotline" within the SEC could operate on an anonymous basis, lawyers confronted with close calls may well seek ethical advice from the Commission, rather

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25. Some bar associations explicitly endorse of this permissive provision. *See Comments on Rules Implementing Section 307* at 27.

[69] SEC Release, § II.

[70] *Id.*

[71] *Id.*

[72] See A Note About Reasonable Time, *supra.*

then from an in-firm ethicist who is not always sufficiently knowledgeable about securities law.

On the other hand, Mr. Schneider says that "The last place anybody would want to tell something confidential is the SEC. If a lawyer wanted some independent verification he would be inclined to call another lawyer with a good reputation for a refined sense of ethics." Mr. Klein adds to this that the "SEC only has the power to bind the SEC," and that although a confidential hotline may be helpful, lawyers have to keep in mind that they may not like the answers they could be getting from the Commission. And, Mr. Ellers cautions that although conceptually this idea might make sense, in practice, it will be hard to disclose just enough to get good advice, but not enough to identify your client. These concerns would probably deter the use of such a hotline by attorneys.

Yet, the permissive disclosure to the SEC provision of Rule 205 could also be adjusted in another way. Instead of requiring attorneys contemplating or choosing to disclose confidential information to the agency to disclose details about the nature of some egregious problem,[73] the rule could perhaps allow attorneys to disclose the fact of some intra-corporate problem, without providing further details. The SEC, armed with investigatory and subpoena powers, could then initiate its own inquiry into the nature of the problem within a particular corporation, and prevent the lawyer from being tempted to act in a willfully blind manner so as to avoid accumulating enough information that would trigger the permissive disclosure provision. Even if most lawyers will not act willfully blind, they still do not possess the kind of power that the Commission does to

[73] Permissive disclosure is triggered only when substantial damage is threatened. *See* Permissive Disclosure, *supra*.

uncover and sanction the full extent of corporate misconduct. In cases where a lawyer suspects serious wrongdoing and is not receiving a satisfactory response to his concerns, it might be wise to enhance his options for how to solicit the help of the SEC. Some critics question whether any non-mandatory reporting requirements will ever be used in practice.[74] If an attorney has more options regarding his permissive contacts with the Commission, however, he is at least more likely to do so.

7. Discipline and Miscellaneous Provisions

Rule 205 notes penalties for attorneys failing to comply with these new rules.[75] It also specifies that "good faith" compliance constitutes a complete defense.[76] Rule 205 clarifies that the fact of the attorney-client relationship is a question of federal law,[77] and that an attorney "appearing and practicing before the Commission"[78] owes ethical duties to the company as a whole, not to its shareholders, or individual officers or directors.[79]

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[74] A subordinate's livelihood depends on his relationship with the boss and news within the legal community travel fast. Only the most self- righteous associates will disclose misconduct of superiors unless they must do so. *Litigator Responsibilities* at 25.

[75] SEC Release, § II.

[76] *Id.*

[77] *Id.*

[78] *Id.*

[79] *Id.* An attorney representing a company-client before the SEC represents the company as a whole. 17 C.F.R. § 205.3(a); *see Comments on Rules Implementing Section 307* at 24.

An attorney may, however, represent individual officers or directors, and needs to follow traditional practice of consulting relevant conflict of interest provisions of professional responsibility rules in her state. *See* Sean T. Carnathan, *N.Y. City Bar Issues Opinion on Dual Representation*, 30 Litig. News No. 2 (Jan., 2005). Rule 205, on its face, does not address this issue. Rules covering such representation are complex, and are undergoing changes. *Id.* The focus of rules dealing with multiple representation is on informed consent. *Id*.

Also, the lawyer is not obligated to act in the "best interests" of the company, because judgment of company management, not its legal counsel, defines what those interests are.[80]

Under Rule 205, there is no cause of action by private shareholders against attorneys.[81] In fact, the reporting attorney is not required to document his reporting or the subsequent response,[82] although she might want to do so to prove good faith compliance with the rules in court in the event her conduct is challenged.

Mr. Schneider says "the truth is, there are relatively few official enforcement actions where the lawyer who acts in good faith is punished if he makes a bad decision." Decisions made in bad faith are the primary concern, and it is pretty clear when decisions are made in bad faith. "Most often, when professionals get caught, [the problem] is not corruption but carelessness. There are cases, [for example], when [lawyers] were inadequately informed, but didn't follow up." Civil cases are different. Civil plaintiffs have different interests and incentives. Most investor lawsuits surviving a motion to dismiss settle because it is "so hazardous to go to trial."

On the other hand, Mr. Ellers claims that the Commission has been fairly aggressive in the past in "going after lawyers [it] doesn't like."

8. Subordinate Attorneys

Rule 205 addresses responsibilities of subordinate attorneys who become privy to evidence of material violations. Subordinate attorneys are first to report their concerns to

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[80] SEC Release, § II.

[81] *Id.*

[82] *Id.*

the supervising attorney, and go "up the ladder" of the issuer only if he reasonably believes the supervising attorney has failed to respond adequately.[83] While seemingly addressing a situation when a junior attorney within a law firm reports first to his supervisor,[84] the SEC explains that a company's CLO is a "supervising attorney" for purposes of the Rule.[85] Thus, this provision reiterates that in the event the CLO fails to respond adequately to reports of evidence of material violations of state or federal laws, the reporting attorney incurs the obligation to make reports further "up the ladder."[86] And again, the reporting attorney may bypass the CLO altogether and report directly to the QLCC, if the company has one.[87]

The "subordinate attorney," however, is defined as one practicing or appearing before the SEC "under the supervision or direction of another attorney (other than... the CLO)."[88] This definition may therefore apply to junior associates working under the supervision of senior partners of law firms retained by companies to represent them before the Commission. This provision may raise a number of special liability concerns.

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[83] *Id.*

[84] *Id.*

[85] *Id.*

[86] *Id.*

[87] *Id.* Some commentators deem this option impracticable. *E.g. Litigator Responsibilities* at 25 ("even if the issuer has established a QLCC, a prudent outside attorney who wants to maintain the relationship with the client, and also the flow of business from the client, must consider whether it makes sense to report first to the corporation's chief legal officer (CLO), who often determines which law firms the corporation will hire. In-house attorneys similarly may wish to consider whether their careers will be damaged by going over the CLO's head.").

[88] SEC Release, § II.

For example, partners may be disciplined for actions of their subordinates if they fail to supervise them closely enough. The D.C. Court of Appeals[89] recently suspended a partner from practice for 30 days for an ethical violation by his subordinate involving a conflict of interest in representing clients before the Patent and Trademark Office.[90] The partner in that case was not aware of violations; his suspension was predicated on a failure to find out about them.[91]

Associates also face new concerns about reporting misconduct by their seniors not just to the SEC, but to the local disciplinary board.[92] Professional responsibility rules require attorneys to report conduct of their colleagues when a substantial issue of honesty is involved.[93] The attorney making the report in this situation, however, must obtain the client's informed consent if the report of the colleague's misconduct involves privileged information.[94] In these circumstances, the attorney-client privilege is paramount.[95] What is unclear, however, is whether the privilege is still paramount after an associate reports privileged information to the SEC under provisions of Rule 205. It is at least questionable that potential dishonesty by that associate's supervisor-colleague (who did not respond to the associate's concerns to trigger the requirements of Rule 205) could or

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[89] *In re Cohen*, 847 A.2d 1162 (D.C. 2004).

[90] *See* Sean T. Carnathan, *Partner Sanctioned for Associate's Errors*, 30 Litig. News No. 3 (Mar. 2005) (discussing *In re Cohen*, 847 A.2d 1162 (D.C. 2004)).

[91] *Id.*

[92] Kathleen Maher, *Duty Calls: Report Colleague's Ethics Breaches Even When Violation Is Not a Practicing Lawyer*, 91 ABA J. 28 (Feb. 2005).

[93] Id.

[94] *Id.*

[95] *Id.*

should go unreported to the local disciplinary board without the client's consent allowing disclosure of privileged information which had already been disclosed to a third party, the SEC .

C. New Rules from the ABA

After Congress passed Section 307 of SOX, the SEC adopted Rule 205. The ABA did not lag far behind. Perhaps as a nod to the spirit of greater watchfulness in the name of protecting the public from future Enrons,[96] or perhaps as an attempt to take back its power over attorneys from an unwanted, but long coveted[97] encroachment by the federal government,[98] the ABA ratified significant changes in the Model Rules of Professional Conduct fewer than 7 days after SOX became law.[99] Whatever the motivation, the changes are harmonious with provisions of both Section 307 and Rule 205. ABA amendments to the Model Rules are addressed in greater detail elsewhere,[100] but a brief overview is offered below.

The newly amended Rule 1.6 reflects an expanded crime-fraud exception[101] and allows attorneys to reveal client confidences "to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial

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[96] *See Ethical Place* at 1195-1196.

[97] *See New Sheriff in Corporateville* at 139 (noting the SEC has wished for a long time to impose greater gatekeeping or whistleblowing responsibilities on corporate attorneys).

[98] *Litigator Responsibilities* at 26-27.

[99] *Litigator Responsibilities* at 26.

[100] *E.g. Pushing the Boundaries at* 271; *Ethical Place* at 1216-1225.

[101] *See Ethical Place* at 1196-1197.

interests or property of another and in furtherance of which the client has used or is using the lawyer's services."[102] A lawyer is also allowed to disclose confidential information to mitigate or rectify the damages of any fraud she had helped further if the damages are likely to be substantial.[103]

The changed Rule 1.3 codifies the permissive reporting of the continuance of illegal activity by the client.[104] Unlike Rule 205, however, it does require that the information be related to the lawyer's representation of the client, and retains the "best interests of the organization"[105] phrase which the SEC has specifically cut from Rule 205.[106]

If acting in "best interests" of the company is a phrase with more restrictive implications than the open-ended language of Rule 205, however, and every lawyer practicing before the Commission is also practicing in a given state, if that state adopts the phrasing of the Model Rules, the intent behind the SEC's leaving out the "best interests" language is essentially defeated because the Commission explicitly states the more restrictive, state or federal rules control. This is just one separation of powers issue raised by the two-tiered system of rules for attorneys. Also, different legal standards would apply to the adjudications of disputes depending on whether the suit is brought in a state or in a federal court. For example, while Rule 205 uses the term "objective

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[102] Model Rules of Prof. Conduct 1.6 (2005).

[103] *Id.*

[104] Model Rules of Prof. Conduct 1.13 (2005). The rule "bespeaks confusion and ambivalence." *Organization's Lawyer* at 80. "May" in reality means "must." *Id.*

[105] Model Rules of Prof. Conduct 1.13.

[106] *See* Discipline and Miscellaneous Provisions, *supra*.

evidence" to specify when the reporting obligation is triggered and when disclosure is permitted, most states apply an "actual knowledge" standard.[107]

In practice, however, Mr. Shargel and Mr. Klein agree that issues of conflict between state and federal rules, based on slight differences in language, have not yet come up, and have not yet been of great concern to attorneys. Mr. Ellers only briefly notes that sometimes "the SEC creeps into [some] areas where they should not be."

While changes in the attorney-client privilege made at the federal level are criticized, at least in the legal literature, as violating the traditional authority of states to deal with lawyers,[108] the state-level initiative to promote fraud-preventing disclosures are criticized for encouraging lawyers to betray the trust of clients.[109] Responding to

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[107] *See* Arnold Rochvarg, *Enron, Watergate and the Regulation of the Legal Profession*, 43 Washburn L. J. 61, 79 (2003) [hereinafter *Enron and Watergate*] (comparing the response of the legal profession to the public need for better lawyers representing organizational clients–after Watergate and after Enron); *Organization's Lawyer* at 72 (noting approaches taken by some state courts to attorney liability).

[108] *See Litigator Responsibilities* at 26-27; Susan P. Koniak, *Regulating the Lawyer: Past Efforts and Future Possibilities: When the Hurlyburly is Done: The Bar's Struggle with the SEC*, 103 Colum. L. Rev. 1236 (2003) (reviewing the conflict over authority over lawyers between the SEC and state bar organizations); *see also* Sara Levy, *The SEC, The States and Attorney-Conduct Rules: An Analysis of Preemption*, 32 Hofstra L. Rev. 1681 (2004) (discussing issues of general federal and SEC authority to pre-empt state ethics rules).

[109] *See Ethical Place* at 1197-1199; *compare* Keith R. Fisher, *The Higher Calling: Regulation of Lawyers Post-Enron*, 37 U. Mich. J.L. Ref. 1017 (2004) (discussing the need for changes in how the legal profession is regulated, lauding the trend to federalize legal ethics, and making additional proposals for change); Chief Justice Norman E. Veasey, *The Ethical and Professional Responsibilities of the Lawyer for the Corporation in Responding to Fraudulent Conduct by Corporate Officers and Agents*, 70 Tenn. L. Rev. 1, 7-14 (2002) (discussing practical reasons it is not only appropriate, but necessary to at least allow lawyers to report corporate clients' misdeeds without getting trapped in "intra-corporate politics").

"State regulation of lawyers has failed to keep pace with the increased complexity and geographic scope of law practice." Larry E. Ribstein, *Ethical Rules, Law Firm* criticisms from the states, it seems short shrift is made of the facts that most changes to disclosure obligations are permissive, and that lawyers are probably aware that courts interpret exceptions to the attorney-client privilege narrowly.[110] We do not yet know whether lawyers will, in practice, disclose their clients' secrets when they are not mandated to do so. Mr. Klein, for example, says that faced with a choice between disclosing confidential information and withdrawal, he would probably prefer the latter. Mr. Shargel adds to this, however, that when a lawyer withdraws from representing an issuer, he need not provide much explanation, because at that point, everybody knows there is a problem.

D. Attorney Liability

In addition to the issues of attorney liability raised in sections B and C, *supra*, a few other checks on attorney conduct are worth exploring to better appreciate the special role attorneys play in this area of the law. This section does not attempt to summarize pre-SOX standards for liability of attorneys, but rather notes the changes ushered by the new law.

Structure and Choice of Law, 69 U. Cinn. L.Rev. 1161, 1161 (2001). Multiple rules impose informational costs and confusion on lawyers working with multiple clients across state lines. *Id.* Issues related to the representation of organizational clients are discussed elsewhere. *See e.g.* Larry P. Scriggins, *Legal Ethics, Confidentiality, and the Organizational Client,* 58 Bus. Law. 123 (2002); George C. Harris, *Taking the Entity Theory Seriously: Lawyer Liability for Failure to Prevent Harm to Organizational Clients Through Disclosure of Constituent Wrongdoing*, 11 Geo. J. Legal Ethics 597 (Spring 1998).

[110] *See Ethical Place* at 1206-1208.

In 1994, in *C. Bank of Denver v. First Interstate Bank of Denver*,[111] the Supreme Court rejected liability, including that of attorneys, for aiding and abetting a violation of securities laws.[112] The case was widely criticized,[113] and then overruled by statute.[114] Eight years later, Judge Melinda Harmon, discussing state and federal laws in *Newby v. Enron*,[115] explained the nature of securities violations:

> Market 'manipulation and willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities.... The basic aim of these securities antifraud provisions is to prevent rigging of the market and to permit operation of the natural law of supply and demand. The gravemen of manipulation is deception of investors into believing that prices at which they purchase and sell securities are determined by the natural interplay of supply and demand, not rigged by manipulators.... Practices constituting manipulation of market includes trades with controlled entities, fictitious trades, wash sales, prearranged matched trades, and painting the tape, together with lending money or securities or borrowing money or securities from a customer, guaranteeing any account against loss, entering purchase or sale orders designed to raise or lower the price of a security or to give the appearance of trading for purposes of inducing others to trade (i.e., marking the close or prearranged trading) and making arrangements to park any security away from the true owner.[116]

Lawyers, as well as other professionals, are involved at various stages of many of these transactions. Judge Harmon discussed the ways to manipulate the market precisely

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[111] 511 U.S. 164 (1994).

[112] *See* Charles Murdock, *The Attorney as "Creator" or "Author": Attorney Liability Under Enron*, 17 CBA Record 34 (Apr., 2003).

[113] *Id.*

[114] 15 U.S.C.S. § 78t(f) (LEXIS 2005).

[115] 235 F. Supp. 2d 549, 569-604 (S.D. Tex. 2002).

[116] *Id.*

to explain that when lawyers, or other professionals, are closely connected to the chain of events ultimately resulting in fraud, they too must bear responsibility for it. Judge Harmon further wrote:

> [i]n a complex securities fraud, there are likely to be multiple violators.... Secondary actors, such as lawyers, accountants, banks and underwriters, are not always shielded from [liability].... The absence of aiding and abetting liability [under some provisions of federal securities laws] does not mean that secondary actors in securities markets are always free from liability.... Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device... *may be liable as a primary violator*.[117]

Judge Harmon did not stop there. In addition to noting that professionals involved in the perpetration of fraud may be held responsible as primary violators, she discussed other legal theories which could be used by investors against lawyers and other professionals. For example, "[c]ontrolling persons liability is an alternate ground for liability from that of a primary violation.... The rationale for control person liability is that a control person is in the position to prevent the violation."[118] Also,

> professionals, including lawyers and accountants, when they take the affirmative step of speaking out, whether individually or as essentially an author or co-author in a statement or report, whether identified or not, about their client's financial condition, do *have a duty to third parties not in privity* not to knowingly or with severe recklessness issue materially misleading statements on which they intent or have reason to expect that those third parties will rely.... The law firm's duty [arises] when the law firm undertakes the affirmative act of communicating with investors. Thus, although the firm may not have a duty to blow the whistle on its client, once it chooses to speak, a law firm does *have a duty to speak truthfully*, to make accurate or correct material statements, even where the document does not indicate that the attorney had authored it.[119]

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[117] *Id.* (emphasis added).

[118] *Id.*

[119] *Id.* (emphasis added).

Judge Harmon's decision has been cited in over five dozen law review articles, thirteen treatises, and even an ALR annotation.[120] The language used in this case opens up a broad range of potential liability theories asserted in courts against attorneys. Even if Rule 205 explicitly bars a private cause of action against attorneys,[121] *Newby* may altogether drown out that provision. After all, Rule 205 is a federal regulation and shareholders could avoid its ban on private suits against lawyers by filing *Newby*-inspired claims in state courts.

In addition to possible suits by private shareholders under *Newby*, if not Rule 205, the general augmentation of the SEC's powers pursuant to SOX may mean a continued expansion in the area of attorney liability in the future. Under Rule 205, for example, the SEC sets out new standards for disciplining and sanctioning attorneys practicing before it,[122] but there is no indication the SEC will stop there. After all, the Commission is still considering some provisions regulating attorney conduct, such as "noisy withdrawal."

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[120] Shepards report, LEXIS (last updated February 15, 2005).

[121] 17 C.F.R. § 205.7.

[122] 17 C.F.R. § 205.6. Recent reports also suggest that the SEC is reviving some old and dormant provisions of federal securities laws to combat the problem of corporate fraud. *Report of the Task Force On Exchange Act Section 21(a) Written Statements*, 59 Bus. Law 531, (2004). The SEC has recently resurrected a generally ignored regulation authorizing it to require companies to make certain disclosures about matters investigated by the Commission. *Id.* For a summary discussion of criminal prosecutions of financial crimes, see *Reforming Corporations*.

II. WHY ALL THESE REFORMS ALL OF A SUDDEN? SOME DETAILS ON THE HISTORY THAT HAD PROMPTED THE REFORMS.

The SEC's rules regulating attorney conduct signal that despite efforts to resist the restructuring of attorney-corporate client relationships, attorneys, like auditors and other corporate outsiders, will also have to assume greater gate-keeping responsibilities. The roles of attorneys as gatekeepers and as liable bearers of some of the windfall of corporate malfeasance are topics hotly debated in the legal literature.[123]

Most commentators writing about SOX, corporate reforms, and the new rules for lawyers begin their discussions with an overview of the root causes of Enron, the quintessential example of everything that went wrong. One pair of authors points out that SOX is unusual in that it doesn't have a legislative history; the downfall of Enron and discussions about what had caused it *are* the history of the law.[124] For this reason, the paper discusses Enron in the section below.

A. The Downfall of Enron

Although the examination of factors, including the failures of lawyers, that had brought down Enron might be hindered by hindsight, it is equally hindering not to try to learn from the past. A long list of theories have been put forward[125] to explain how a

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[123] *E.g. Crisis in Confidence*; *Enron and Watergate*; Steven K. Hazen & Nancy H. Worjtas, *Confidentiality of Attorney-Client Relationship, SEC Rule 205 and State Bar Issues: A Summary Report,* 15 ABA Prof. Law. 24 (Spring 2004).

[124] Thomas Gorman & Heather Stewart, *New Sheriff in Corporateville* at 141, 145.

[125] Everyone is fascinated by Enron. *E.g.*; Bethany McLean & Peter Elkind, *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron* (Portfolio, 2004) [hereinafter *Smartest Guys*] (a thorough overview of what went wrong and who was involved); Nancy B. Rapoport & Bela G. Dharan, *Enron: Corporate Fiascos and Their Implications* (Foundation Press, 2004) [hereinafter *Corporate Fiascos*] (collection of essays by various authors); Mini Schwartz & Sherron Watkins, *Power Failure*

company named by Fortune Magazine as "The Most Innovative Company in America" for six years in a row, a company once the 6th largest capitalization machine in the world,[126] a company paying its secretaries $600,000 a year,[127] a company watched by millions of people from all sorts of perspectives, could, in a few short months since its sublimity, state a loss of over a billion dollars in shareholders' money[128] and end up in Chapter 11 courts (among others).[129] But, alas, it did happen, and at one point when Enron's executives were making a PowerPoint presentation recounting recent events, "a complete loss of investor and creditor confidence" was one of those points.[130]

While most explanations offered to explain Enron's demise are economic,[131] some are behavioral.[132] Whatever the nature of the explanation, the causes of the Enron debacle could be classified into proximate and ultimate ones.

(Doubleday, 2003) [hereinafter *Power Failure*] (personalized stories of Enron's executives).

[126] Jeffrey D. Van Niel & Nancy B. Rapoport, *Dr. Jekyll & Mr. Skilling: How Enron's Public Image Morphed from the Most Innovative Company in the Fortune 500 to the Most Notorious Company Ever*, in *Corporate Fiascos* [hereinafter *Dr. Jekyll & Mr. Skilling*]; *Reforming Corporations* at 398-399.

[127] *Power Failure* at 223.

[128] *Dr. Jekyll & Mr. Skilling: Reforming Corporations* at 398-399.

[129] Enron was the biggest bankruptcy filing in U.S. history, *Bombing Markets* at 1579, until Worldcom filed. *Crisis in Confidence* at 1223 n. 56.

[130] *Power Failure*, 336. Enron's 1998 Annual Report read: "EXCELLENCE:... The great fun here will be for all of us to discover just how good we can really be." Smartest Guys, xix. Enron's 2001 Annual Report read, on the cover page: "In Volatile Markets, Everything Changes But Us!"; *Bombing Markets* at 1584-1585.

[131] *E.g.* Matthew J. Barrett, *Enron and Andersen–What Went Wrong and Why Similar Audit Failures Could Happen Again*, in *Corporate Fiascos*; John C. Coffee, Jr., *Understanding Enron, "It's About the Gatekeepers, Stupid"*, in *Corporate Fiascos*; Bala

One proximate reason Enron earned its name as an innovator is because many of its transactions were unique, but also legal, at least initially.[133] At the time Enron began setting up its "special purpose entities" (SPEs) no one could yet call them a fraud. Setting up SPEs is a legal method of isolating a particularly risky aspect of a business and a means of raising revenue.[134] It works in the following manner: A company sets up an independently-managed subsidiary and sells to it some aspect of its business associated with a particular risk. A real estate company, for example, could sell off one of its buildings. The subsidiary company, this so-called SPE, borrows the money to pay for this purchase using the cash flow of the business (building) itself as collateral for the loan. The result is money for the parent company and a decrease in its risk profile: if running that building was a particularly risky business, then it is no longer managed by the parent. Technically, Enron did not manage its SPEs. It was its Chief Financial Officer, Andrew Fastow, who did. This distinction is one without a difference, however, and the result was lack of independence between the parent and the subsidiary, which *was* illegal.[135]

G. Dharan & William R. Bufkins, *Red Flags in Enron's Reporting of Revenues and Key Financial Measures,* in *Corporate Fiascos*.

[132] *E.g.* John C. Coffee, Jr., *Understanding Enron, It's About the Gatekeepers, Stupid*, in *Corporate Fiascos*; Lynne Dallas, *Enron and Ethical Corporate Climates,* in Corporate Fiascos; *Bombing Markets* at 1616; Robert Prentice, *Whither Securities Regulation? Some Behavioral Observartions Regarding Proposals for its Failure*, 51 Duke L. J. 1397 (2002) [hereinafter *Behavioral Observations*].

[133] *See* Jeffrey D. Van Niel, *Enron–The Primer*, in *Corporate Fiascos*; Bala G. Dharan, *Enron's Accounting Issues: What Can We Learn to Prevent Future Enrons?* in *Corporate Fiascos*; *Red Flags in Enron's Reporting of Revenues and Key Financial Measures,* in *Corporate Fiascos*.

[134] *Supra,* n. 133.

[135] *Supra,* n. 133.

Enron's SPEs were named after Star Wars characters like Chewco, or Jedi.[136] That is not the only thing that made them truly special, however. Instead of selling some aspect of its business to many of its SPEs, Enron sold its own stock. Theoretically, a company's stock is only as good as the underlying business, but in Enron's case the stock *was* the business right until its massive implosion. From an accounting standpoint, the stock, called "shareholder equity" belongs on the liabilities half of the balance sheet. At the end of the day, liabilities must equal the assets, so when some stock is sold to the SPE, the liability is written off and payment received is added to the assets, making the day's activities look good. As far as unsubstantiated paper transactions go, Arthur Andersen, the infamous accounting firm which had audited Enron and is now preparing to defend its choices in front of the Supreme Court,[137] is rumored to have destroyed two metric tons of paper related to its dealings with Enron.[138] And, this was in the age of email, with less paper generated and maintained then in the past.

So many SPEs were set up that what was left of Enron became an investment opportunity with extremely low risk. This, coupled with another innovation– forgetting to restate projected earnings when they didn't materialize–made Enron very attractive, albeit in a very superficial way. But that, apparently, was good enough.[139]

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[136] *Reforming Corporations* at 398-399.

[137] David G. Savage, *On Motives and Memos*, 91 ABA J. 14 (April 2005).

[138] *Id.*

[139] *Supra* n. 133.

An alternative explanations of Enron's downfall is the market bubble theory.[140] A bubble is a sort of anomaly, an exception to the way markets do or should generally function.[141] Keywords used to describe the causes of bubbles are euphoria, exuberance, and irrationality.[142] Things were going well, there was a boom, and people just lost their heads, expecting growth, success, and prosperity in light of innovation and growth which had just happened, rather then basing expectations on new information and relevant financial forecasts.[143]

But it was not just the people's fault. Analysts and professional advisors also got sloppy, and some were plainly dishonest.[144] Many investment advisors received commissioned pay, and this led them to be extra friendly to their customers.[145] Essentially, people were led on to overinvest.[146] As one commentator put it:

> [o]ver generations, Americans have been extraordinarily adroit at adjusting themselves to inequalities perceived to arise from the "fair" accidents of capitalism, as mentioned previously. Most workers can adjust themselves, psycho-socially, to financial losses they perceive to result from bad luck, their own miscalculations, or their "preference" for leisure-as well as gains accruing to others through good fortune or as a result of such persons' diligence or acumen.[147]

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[140] *E.g.* Daniel J. Morissey, *After the Ball is Over: Investor Remedies in the Wake of the Dot-Com Crash and Recent Corporate Scandals*, 83 Neb. L. Rev. 732 (2005) [hereinafter *After the Ball*]; *Understanding Enron, It's About the Gatekeepers, Stupid*, 135-136 in *Corporate Fiascos.*

[141] *Supra*, n. 140.

[142] *Supra* n. 140.

[143] *Supra* n. 140.

[144] *After the Ball* at 732-739.

[145] *Id.*

[146] *Id; see Behavioral Observations*; *Gatekeeping Failure*.

[147] *Bombing Markets* at 1636.

Sometimes there is bad luck, but sometimes, like before a bubble bursts, it looks as if luck is very good.

The stock-option compensation scheme for corporate managers implemented in the 1990s is yet another, psychological way of understanding the mechanics of Enron's collapse. One basic attribute of a corporation is separation between its ownership by shareholders and its control by managers.[148] The wealth-maximizing advantages of this separation are manifold, including better-qualified managers, increased incentives for risk taking that generate bigger rewards, and easier capitalization.[149] The main cost is a conflict of interest between managers and owners.[150] The typical way to deal with this conflict is to monitor managers and impose fiduciary duties,[151] but this, apparently was not enough. Stock options were a direct way to realign interests of managers with those of shareholders, by giving them a share of company ownership if the company performs really well.[152]

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[148] *See Corporations*, § 2.04.

[149] *Id.*

[150] *Id.*

[151] *Id.*

[152] *See Story of Pinocchio* at 849. "[This] method of alignment is based on a common interest in steadily increasing stock prices." *Id.* A focus on shareholders in corporate law is counterproductive and inappropriate. Id. Shareholders in corporate law are cows which must be slaughtered. *Id.*

Recently, some companies are changing using stock options as means of compensating employees. *See e.g.* Eric Dash, *Time Warner Stops Granting Stock Options to Most of Staff*, N.Y. Times C1 (Feb. 19, 2005) (WL 2519322).

As Professor John Coffee, Jr.[153] describes, this compensation scheme was accompanied by unforseen consequences. It created an irresistable incentive for managers to keep up the faces of the balance sheets, whether or not there was substantive company growth to support it.[154] It was not just that individual managers were personally greedy for stock-option bonuses; the problem was that all of them became that way at the same time. Manager of company X had to keep up with manager of company Y to get the same bonus for himself, and then attract enough investors for the company to ensure sufficient capital influx. The reasoning was that unless investors saw the pretty balance sheets, the company would not sell stock and get the cash it needed to implement the reforms with actual substance. So, while the keeping up with the Jones' syndrome, known in economics as "herding behavior,"[155] may well have been spurned by selfish motives of self-profit, the stock-option compensation scheme quickly became a game of survival for any corporation that had adopted it.[156]

For purposes of short-term gains, the company's face on the market matters a great deal to investors for several reasons. One reason is the above-noted need to attract investors. Although over half of Enron's shareholders were sophisticated investment funds,[157] no amount of expertise had sufficed to anticipate that growth reflected on

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[153] *Gatekeeper Failure*.

[154] *Id.* at 304. "As executive compensation shifted to being equity-based, instead of cash-based, a greatly enhanced incentive arose for managers to manipulate earnings - and to induce their gatekeepers to let them." *Id.* The few European companies who had adopted similar schemes–ended up in similar disasters. *Id.*

[155] *Id.* at 329.

[156] *Id*.

[157] *Id.* at 329.

companies' financials might not be grounded in reality given this pressure to perform and show off.[158] The second reason is herding behavior among the larger, more sophisticated investors and analysts themselves.[159] Even if some of them had noticed the warning signs,[160] fund managers had so-called "careerist" reasons to go along with the popular consensus about everything going well and good. It may well have been that any number of smart and sophisticated funds and analysts did indeed pick up on the shadiness of Enron's dealings at the time when its image was still bulletproof.[161] However, the problem was that the wise man who calls that the emperor has no clothes – will quickly have no friends whose coalition of an opinion does not like to be challenged. In a world where networking is key to professional survival, applauding financial fashion trends no matter how bad they may be, these so-called "careerist" reasons can assume very sharp significance.[162]

So, maybe it was a bubble. Maybe it was the fault of irrational, unsatisfied investors. Maybe it was the greed of irrational, unsatisfied managers and brokers. What commentators do agree on is that Enron put a big question mark next to the notion of American markets always being the best in the world.[163] Beyond the technicalities of

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[158] *Id.*

[159] *Id.*

[160] "In fact, some very high-profile investors stayed away from Enron stock because Enron's financial statements were simply not making sense." *Dr. Jekyll & Mr. Skilling,* at 78, n. 4.

[161] *Id.*

[162] *Gatekeeper Failure*.

[163] *Reforming Corporations* at 394.

how Enron may have fallen, scholars would also probably agree with Professor Coffee's notion that the ultimate issue underlying recent corporate disasters was an unbalanced incentive structure for behavior by actors inside and outside of the corporation.[164]

Where were the lawyers?

Gatekeepers are "reputational intermediaries who provide verification and certification services to investors."[165] The incentives for gatekeepers to lie are much more limited than they are for corporate actors engaged in company or self promotion.[166] But presumably because of herding, networking, irrationality, solidarity, competition for corporate clients, or even bribes, Professors Coffee and Robert Prentice point out that gatekeepers in the late 1990s and early 2000s have aligned themselves not with investors to whom they represent the trustworthiness of their clients, but with the clients themselves.[167] It is perhaps for this reason that the vast majority of SOX is dedicated to reinforcing the independence of corporate directors, fraud-investigating committees, auditors, and lawyers. The public relies on a multi-tiered system of checks on the self-interest of corporate managers, which is probably the most limiting aspect of how a corporation works. Independence of these checks is the key to their effectiveness.[168]

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[164] Gatekeeper Failure.

[165] *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 127 in *Corporate Fiascos*.

[166] *Id.*

[167] *Id*; *Behavioral Observations* (also sharply criticizing absence of regulation and investor self-protection (contractarian view) as the proper remedies for market malfunctions).

[168] *Gatekeeper Failure* at 330-331.

As far as their gatekeeping function, however, lawyers are in a rather precarious position. Traditionally, their primary duties are not to the public, but to their clients, although Harvey Pitt may disagree.[169] But, this is exactly why Section 307 and Rule 205 have drawn such sharp criticism for their eroding effects on the attorney-client privilege.[170] After all, attorneys are hired by clients to help clients; arguably, any "duty to the public" lawyers might owe is only a side effect of what their clients do.

CONCLUSION

When financial crimes jump into public focus, one might expect a public desire for vengeance and retribution to befall anybody and everybody, including lawyers who had not exactly enjoyed high public esteem in the first place. On the other hand, financial crimes of the few recent years have profoundly affected not only the well-being of many families, but the framework through which traditional obligations of attorneys are examined. SOX and the variety of new rules and regulations aim to protect the public from fraud, and attorneys, like other professionals, are strongly affected.

New rules for attorneys are criticized for eroding the attorney-client privilege.[171] However, it is important to remember that the attorney-client privilege is a continuum. Recent history perhaps counsels moving the balance a little more toward public disclosure of corporate secrets as an antidote to corporate fraud.[172]

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[169] *See* A Note About Reasonable Time, *supra.*

[170] *See* detailed discussion in Latest for Lawyers from the SEC: Rule 205, *supra*.

[171] *See* A note About Reasonable Time, *supra*.

[172] A great many authors raise this point. *See e.g. Crisis in Confidence*; *Bombing Markets; Ethical Place*; *Gatekeeper Failure*; *Reforming Corporations*; *Comments on Rules Implementing Section 307*.

Judge Harmon in *Newby*[173] quoted the language of the 73rd Congress, which had passed the Securities Act of 1934. "There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the marketplace thrive upon mystery and secrecy."[174] Also, in the words of Justice Louis Brandeis, "sunlight... is the best of disinfectants; electric light the most efficient policeman."[175] Because many provisions of SOX are aimed at improving the disclosure of various kinds of information, transparency remains a big concern today. Hopefully, SOX and the rules and regulations that followed it have institutionalized enough transparency in the corporate world to prevent future disasters of the size of Enron.

[173] 235 F. Supp. 2d 549.

[174] *Id.* at 589.

[175] Quoted in Edward J. Janger, *Brandeis, Business Ethics, and Enron*, 67 in *Corporate Fiascos*. Justice Brandeis was a not a big fan of "evil" corporations. *Id.*