The Lawyer's Role in Preventing Corporate Fraud

*Given By Roger C. Cramton**

Many years ago, during my third year of law school at the University of Chicago, a prominent Washington lawyer gave the after-dinner talk at the law review banquet. Thurman Arnold was in the final years of an illustrious career. A cowboy from Wyoming, he became a law professor at Yale, a trust buster for FDR in the New Deal years, a federal judge, and, finally, began private practice as a founder of Arnold & Porter. Arnold's final remarks in his reminiscences have always remained fresh in my mind.

> There may come a time in your practice of law, when, despite your very best efforts on behalf of your client, someone must go to jail. Remember! ... when that time comes, ... make sure it's the client!!

Arnold's message, of course, was that the lawyer's job is to represent the client diligently and competently "within the bounds of the law." If the lawyer assists or further's a client's crime, fraud or other misconduct, the lawyer risks going to jail with or instead of the client.

My remarks today fall into two parts: a brief statement of my views of a lawyer's obligations under the SEC's implementation of § 307 of Sarbanes-Oxley ("SOx") followed by some unsolicited advice to you as corporate lawyers.

A. "Reporting Up" and "Reporting Out" Under State Ethics Rules and SOx

§ 307 of the Sarbanes-Oxley Act of 2002 directed the SEC to adopt a rule requiring a lawyer "to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal officer (CLO) or the chief executive officer (CEO) of the company (or the equivalent thereof)."[1] If the CLO or CEO does not "respond appropriately" to the report, the attorney must report the evidence up the corporate ladder to higher authority and, if no appropriate action is taken, to the board of directors.

The SEC rule implementing this requirement states in part:

> If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or any officer, director, employee, or agent of the issuer, the attorney shall report such evidence to the issuer's chief legal officer (or the equivalent thereof) or both the issuer's chief legal officer and its chief executive officer (or the equivalents thereof) forthwith.[2]

The other key component of § 307 – the up-the-ladder reporting requirement if the CLO or CEO does not "appropriately respond" to the reporting lawyer – was implemented by an SEC rule which states that the reporting lawyer "shall report the evidence of a material violation" to the board or relevant board committee, unless the lawyer "reasonably believes that the chief legal officer or the chief executive officer . . . has provided an appropriate response within a reasonable time."[3] The lawyer who reports up the ladder must also "explain his or her reasons" for believing that the issuer has not made an appropriate response to those to whom the report was made. On the other hand, if the lawyer "reasonably believes" that "an appropriate and timely response" has been made, the lawyer "need do nothing more . . . with respect to his or her report."[4]

Moreover, the SEC, pursuant to the statutory directive that it promulgate "minimum standards of professional conduct for attorneys appearing in practice before the commission," included a "reporting out" provision that is consistent with the ethics rules of the vast majority of states. Section 205.3(d)(2) provides that a lawyer may, without the issuer's consent, reveal confidential information to the SEC related to the representation that the lawyer reasonably believes necessary:

> - to prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interests or property of the issuer or investor;
> - to prevent the issuer, in an SEC investigation or proceeding, from committing perjury or another illegal act that is likely to perpetrate a fraud on the SEC; or
> - to rectify the consequences of a material violation by the issuer that caused, or may cause, substantial injury to the financial interests or property of the issuer or investors, in furtherance of which the lawyer's services were used.[5]

As you know, bar leaders have attacked the SEC rules implementing SOx in colorful but misleading terms such as "betraying" or "ratting on" a client. I disagree.[6]

First, the obligations and permissions conferred on securities lawyers by the SEC's adopted and proposed rules are consistent with and reflect the duties of lawyers under state corporate law and the ethics rules of the vast majority of the states.[7] The characterization of those rules as novel requirements that would result in a fundamental change in the relationship of a lawyer to a corporate client is hot air: a hullaballoo stirred up primarily to defeat or limit a new vehicle of regulation that, unlike the disciplinary process of the states, might provide a substantial deterrent to lawyer assistance of corporate fraud and criminality.

Second, the reporting-up obligation of the SEC's SOx rules has already served a valuable function. It has forcefully reminded corporate lawyers that under corporate law and state ethics rules their fundamental obligation is to the corporate entity, not to the officers who temporarily direct its affairs. Informing the ultimate authority – the board of directors – of a prospective or ongoing illegality that will cause substantial harm to the corporation is not a radical new idea but a restatement of the loyalty to the entity client required by both corporate law and state ethics rules.

The congressional premise was that too many inside and outside lawyers had fallen into a practice of "see no evil, report no evil." SOx's reporting-up requirement is a return to the traditional view that the lawyer should bring independent legal judgment to bear to ensure that corporate managers act within and not without the bounds of the law.

My major problem with the SEC's rules is that they contain major loopholes inconsistent with congressional intent that may result in noncompliance and ineffective enforcement. The standard that triggers up-the-ladder reporting is muddled and weak, and the inappropriate breadth of the "colorable defense" exception endangers the efficacy of the reporting-up requirement.[8] If corporations are to have loyal and faithful representation, reporting up the ladder is essential: no corporation should embark on an illegal course of conduct without the ultimate authority – the board – being informed, warned and responsible.

Third, although required "reporting up" is the most important aspect of the new regime, the existing and proposed "reporting out" provisions have received more attention and criticism. Most lawyers do not understand that current ethics rules in every state in the Midwest – and 41 states overall – permit disclosure to prevent a client's criminal fraud.[9] An even larger number of states (44) require such disclosure when continued representation would assist an ongoing criminal fraud.[10] In short, the SEC's present permissive disclosure provision is consistent with the ethics rules most or all of you are supposed to be operating under today. So is the SEC's proposed rule which would require "noisy withdrawal," a fact that most lawyers do not understand.

Fourth, it is virtually unheard of for a lawyer to blow the whistle on a client even when current law requires it to be done. Only a few of the many corporate failures over the last ten years involved a whistleblower of any kind, and they were disaffected employees, not the inside or outside lawyers who may have been in a better position to know that some illegality had occurred.

Fifth, if maximum deterrence of corporate illegality is desired, lawyers should be required both to report up the ladder and to disclose in the extraordinary situation in which an adamant board refuses to heed the lawyer's advice. What board will go ahead when a lawyer reports the facts and law that make the proposed conduct illegal,[11] or do nothing when the lawyer then threatens to withdraw and inform the SEC that he has done so "for professional considerations"? Skeptics worry that a rogue lawyer or one of bad judgment might provoke a situation that would be embarrassing and harmful to the company. My view is that inside or outside lawyers will never (or virtually never) pursue a matter up the corporate ladder and threaten to disclose the claimed illegality unless there is substance to the claim. The consequences for that lawyer would be effective banishment from the profession: unemployment as a lawyer.

In conclusion, the SOx regulations are designed to reinforce the corporate lawyer's basic duty to prevent corporate agents from committing law violations that will harm the corporation. And that's the lawyer's job under corporate law and legal ethics rules as well as under SOx.

B. Some Unsolicited Advice

I am an academic lawyer and my own limited practice experience was with the federal government with a federal agency and the people of the United States as my client. I have never had to deal with earning my living by obtaining and retaining corporate clients which may have managers who are difficult and demanding. Yet I have studied corporate fraud situations over many years and have served as an expert consultant on lawyer conduct in a substantial number of civil cases in which law firms were charged with assisting a corporate fraud. I have been fascinated by the lawyer's role as a business counselor in preventing or failing to prevent a corporate fraud from occurring. In every major corporate fraud, lawyers have played an essential role: structuring and documenting the fraudulent transactions, providing legal opinions required for the transactions to occur, and drafting and approving the required securities filings concerning the transactions, offerings and financials.[12]

There are a number of constants in many of these cases. The corporation involved is an important client of the firm, paying large fees. The lawyer responsible for the representation develops a close relationship with the dominant manager who retained, directs and can fire the lawyer. Over time the lawyer views the representation and the surrounding environment from the point of view of the manager. When suspicious circumstances occur – and even red flags – the lawyer rejects or minimizes them, acting as an advocate for the manager. If a disgruntled employee, for example, makes credible allegations of wrongdoing, the lawyer relies on the manager's denial or performs a perfunctory investigation that is later viewed as a "whitewash." When the manager pushes for "creative" and "aggressive" interpretation of law in framing transactions and making securities disclosures, the lawyer eagerly complies, arguing that it is the lawyer's job to push the envelope of the law to its extreme if it serves the client's interest. The board of directors is given as little information as possible; it is treated as a body whose only function is to rubber-stamp the actions and proposals of those in control. In essence, the lawyer in treating the manager as "the client" violates the fundamental duty of a lawyer for a corporation: that the lawyer act in the best interests of the entity rather than the interests of those temporarily in control of the entity.

From scenarios such as this I have distilled a number of important lessons for the corporate lawyer. Under the constraints of time, I limit myself here to four major lessons.

First, make sure that the board of directors, or an appropriate committee of the board containing independent directors, signs off on major matters that involve substantial legal risk after being fully informed of those risks. Always bear in mind that your client is the corporate entity and not the managers who provide direction on a day-by-day basis. All corporate frauds start with lawyers treating senior management as the client and failing to communicate with higher authority within management, or if management is the problem, with the board of directors, which is the ultimate authority on all matters except those on which shareholders must act. It is natural for you to defer to the interests and desires of the managers who hired you, direct your work and can fire you. But when facts arise that suggest a substantial legal problem, such as a material violation of law by a division manager or a self-dealing arrangement proposed by a dominant manager, you must be sure that higher authority within the corporation is informed of the situation and has taken appropriate steps to evaluate the situation and, if necessary, prevent or rectify any wrongdoing.

Second, do not assume the attorney-client privilege or work-product immunity will protect legal files or lawyer-client communications. Any transaction can go sour and, if it does, it is likely to be subject to after-the-fact scrutiny. If the SEC or a state or federal prosecutor begins an inquiry, the corporation is likely to "cooperate" with the inquiry. Large corporate frauds almost invariably result in change of control and often in bankruptcy; successors in interest will waive the privilege and confidentiality in an effort to recover assets from the managers who looted the enterprise and the lawyers and accountants who assisted them. Even in the cases where waiver does not occur, the fraud victims probably will be successful in using the crime-fraud exception to penetrate the privilege.

Third, you won't avoid civil liability by portraying your job as a lawyer narrowly and attempting to place the blame on others. Lawyers involved in client fraud situations almost invariably assert that agents of the client lied to them, they did not know of facts indicating fraud, and they reasonably relied on the decisions of officers and directors of the company on business matters and on the judgments of eminent accountants on all accounting-related matters. They were legal technicians – scriveners – not professionals with a broad responsibility. They claim, therefore, that the legal advice they gave was proper under the circumstances and that all the wrongdoing is attributable to other actors. (At the same time, those other actors – the company's officers and directors and the outside accountants – are claiming that they also had limited knowledge and relied on the legal advice of the lawyers.) The "circle of blame" that results is a classic (and generally unsuccessful) attempt at avoidance of responsibility, since each provides evidence against the others. More broadly, lawyers cannot absolve themselves from legal responsibility by pretending that only business or accounting decisions are involved, just as managers and accountants cannot avoid responsibility by claiming that they relied on lawyers. If a series of transactions has no substantial business purpose (i.e., no property or risk is transferred to a second party) and the facts and circumstances suggest that its sole function is to give the company's balance sheet a false boost, legal questions are raised that are not resolved by an accountant's approval.

Fourth, in shaping future business transactions for a corporate client, try to work only for clients who want a legal advisor who will chart a prudent course through the shoals of the law. Beware of corporate managers who push you to be "creative and aggressive" in exploring the limits of the law. The business lawyer is a counselor and advisor, not a litigator, and the goal is a sound result that will advance the interests of the client "within the bounds of the law." Wise counseling involves a prudent awareness of the existence of legal risk and not an effort in every situation to test how far the envelope of the law may be pushed. Lawyers who take the latter approach run a grave risk of assisting illegal conduct. If you cast prudence aside and take large legal risks, your work may become the subject of public litigation under very adverse conditions: jurors don't like lawyers or corporate managers and the "hindsight bias" will operate against you.[13] If the transaction has harmed third parties and appears to be fraudulent or illegal, your claim that you did not "know" what the managers were really doing will fall on deaf ears.

Let me repeat: Lawyers who are unduly aggressive in manipulating law and facts to satisfy a demanding client run great risks of assisting corporate crime or fraud. The role of a business lawyer in shaping future transactions is not to push the law to its extreme but to guide the corporate client safely through the shoals of the law.

Just a short time ago, a former Enron executive and four former Merrill Lynch executives were convicted of conspiring to help Enron report bogus profits.[14] The case centered on a single transaction: a purported sale of barges by Enron to Merrill in late December 1999, when Enron was struggling to meet Wall Street's profit projections for the year. When Enron was unable to sell the barges to a third party, Merrill agreed to "purchase" the barges for $7 million in exchange for Enron's secret oral promise to buy the barges back within six months for an amount that would provide Merrill with an interest-like payment that would compensate it for Enron's use of its money. Sure enough, Enron bought the barges back and then included a substantial profit on the "sale" in its report of 1999 income. Lawyers and accountants for Enron and Merrill concluded that the transaction was a "sale" not a "loan" and prestigious law firms gave legal opinions to that effect. This and other transactions were later set aside in Enron's bankruptcy proceeding as having no substantial business purpose other than to provide a cover for a false and misleading report of Enron's income: a fraudulent securities filing designed to mislead investors. How could these lawyers structure, document and approve the legality of this transaction, which could not have been completed without their help?

Lawyers talk themselves into assisting such fraud by manipulating the letter of legal rules in aggressive ways while ignoring the clear intent of the rules involved and the underlying policies that ultimately control their judicial interpretation. An Enron employee provided a colorful illustration:

> Say you have a dog, but you need to create a duck on the financial statements. Fortunately, there are specific accounting [or legal] rules for what constitutes a duck: yellow feet, white covering, orange beak. So you take the dog and paint its feet yellow and its fur white and you paste an orange plastic beak on its nose, and then you say to the accountants and the lawyers, "This is a duck! Don't you agree that it's a duck?" Everybody knows that it's a dog, not a duck, but that doesn't matter, because you've met the rules calling it a duck.[15]

But the rules that distinguish a duck (i.e., a "sale") from a dog (i.e., a "loan") are backstopped by more substantive legal norms: our law provides that a transaction must have a business purpose other than that of misleading investors, and the securities laws ultimately turn on whether what is disclosed, viewed as a whole, is known to be false or misleading. Thus it turns out that the general norms of securities and other law are more decisive than narrow technical rules. When a wooden application of technical rules defeats the fundamental goals of securities regulation and private law, such as honest disclosure or integrity of transactions, the broader principles prevail in the courts.

Preaching to lawyers and bar groups about their moral and public responsibilities has proven to be ineffective. Professional discipline, for a variety of reasons, provides virtually no control over the failure of law firms to monitor the partners who are bringing in juicy fees from corporate clients. The spread of limited liability partnerships accentuates the willingness of partners to ignore the risks that other partners are taking. Today's emphasis on "the bottom line" both in corporations and law firms gives rise to a culture valuing the false sense of prestige and status that flows from the managers meeting market estimates of expected profits and the law firm being among the leaders in the annual listings of profits per partner. From the vantage point of respect for law and public responsibility of lawyers, the current scene runs the risk of a "race to the bottom." The massive corporate failures and frauds of recent years were not the work of a few "bad apples" but a systemic problem that requires systemic solutions.

One major part of the problem is that accountability to law of the professionals who are responsible for maintaining the legitimacy of corporate transactions and securities filings (accountants, lawyers and bankers) disintegrated during the aftermath of the savings-and-loan crisis. Professional discipline for assisting a corporate fraud has been a total non-starter: lawyers are never disciplined for failing to withdraw when ethics rules require them to do so or for assisting a major corporate fraud.[16] The *Central Bank* case eliminated aiding-and-abetting (secondary) liability of professionals under the federal securities law; lawyers, accountants and bankers are liable only if they can be proven to be active participants in a fraudulent scheme.[17] The Private Securities Litigation Reform Act of 1995, which imposed special pleading requirements on civil plaintiffs in securities fraud actions,[18] may have eliminated a number of frivolous fraud suits but also reduced the prospects of meritorious securities litigation. And the Securities Litigation Uniform Standards of 1998[19] carried things further by reducing the availability to plaintiffs of state securities fraud laws.

The decline of legal risks in the 1990s made professionals less accountable to the law and changes in the provision of professional services created conflicts of interest that adversely affected independent judgment. The result was that "[t]he remnants of a professional ethos in accounting, law and securities analysis give way to getting the maximum revenue per partner."[20]

Conclusion

The congressional premise underlying § 307 of Sarbanes-Oxley was that many inside and outside lawyers had fallen into a "see no evil, report no evil" state of mind. The SEC regulations implementing it remind business lawyers that their fundamental obligation under corporate law and state legal ethics rules is to the corporate entity, not to the managers. Informing the ultimate authority – the board of directors – of a prospective or ongoing illegality that may cause substantial harm to the corporation is not a radical new idea but a restatement of the loyalty to the entity required by law.

The SEC rules implementing SOx are useful precisely because they provide some needed deterrence to lawyer misconduct on behalf of the wrongdoing of corporate managers. The rules have many ambiguities and loopholes, especially the tortured triggering standard and the unwise scope of the "colorable defense" exception to the provision of an appropriate response to a report of a material violation.[21] But it still must be welcomed as a new beginning.

Some years ago, Louis Brandeis was being questioned by a Senate committee about the generality and vagueness of the Sherman Act. Businessmen argued that the law was unfair because its boundaries were not clear. Brandeis replied to them as follows:

> [Y]our lawyers ... can tell you where a fairly safe course lies. If you are walking along a precipice no human being can tell you how near you can go ... because you may stumble on a loose stone, . . . slip and go over; but anybody can tell you where you can walk perfectly safe within a convenient distance of that precipice. The difficulty which men have felt ... has been rather that they wanted to go to the limit rather than that they have wanted to go safely.[22]

This is great advice from a great man!

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Footnotes

[1] Sarbanes-Oxley Act of 2002, Pub.L.No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 18, 28 and 29 U.S.C.). For a fuller treatment of the subject of this Article, see Roger C. Cramton, George M. Cohen & Susan P. Koniak, *Legal and Ethical Duties of Lawyers After Sarbanes-Oxley*, 49 VILLANOVA L. REV. 725 (2004) [hereinafter "Cramton et al., Lawyer Duties After SOx"].

[2] Implementation of Standards of Professional Conduct for Attorneys. 17 C.F.R. §205.3(b)(1) (2004).

[3]*Id*. at §205.3(b)(3).

[4]*Id*. at §205.3(b)(8) and (9).

[5]*Id*. at §205.3(d) (2). In August 2003, shortly after the SEC rules implementing SOx had gone into effect, the ABA amended Model Rules 1.6 and 1.13 in a manner that permits disclosure of confidential information in many of the same situations. See Lawrence A Hamermesh, *The ABA Task Force on Corporate Responsibility and the 2003 Changes to the Model Rules of Professional Conduct*, 17 GEO. J. LEG. ETHICS 35 (2003).

[6]See Cramton et al., Lawyer Duties After SOx, cited supra n. 1, for a fuller statement of my views.

[7]*Id*., at 779-88.

[8]*Id*. at 752-64 (critique of the triggering standard) and pp. 771-79 (critique of "colorable defense" exception).

[9]For a tabulation of the position of all 50 states and the District of Columbia on lawyer disclosure of confidential information, see Attorneys' Liability Assurance Society (ALAS), *Ethics Rules on Client Confidences,* reprinted in Thomas D. Morgan & Ronald D. Rotunda, 2003 SELECTED STANDARDS OF PROFESSIONAL RESPONSIBILITY 161-72 (2003). Statements in this article concerning the number of jurisdictions with ethics rules permitting or requiring a lawyer's disclosure of client confidential information are based on this source.

[10]*Id*.

[11]In December 2003, Akin Gump withdrew from representing a corporate client because company officials had refused to include certain information in a securities filing after the firm had warned that doing so would be a material violation of the securities laws. The firm's letter to the client's board of directors "reserve[d] the right to inform the S.E.C. of our withdrawal and the reasons therefore." See *Patrick McGeehan, Lawyers Take Suspicions on TV Azteca to Its Board*, N.Y. TIMES, Dec. 24, 2003 (discussing the first reported instance of required "reporting up" under the SEC's SOx rules and threat of subsequent disclosure to the SEC if the violation was not remedied).

[12]Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, 58 BUS. LAWYER 143 (2002) (discussing the role of lawyers in Enron and other corporate failures or frauds).

[13]The "hindsight bias,"one of the best-established findings of cognitive psychology, leads human beings, when they know that an event has happened, to exaggerate the extent to which the event could have been anticipated in advance. *See id*., at 147 and 174.

[14]See Kurt Eichenwald, *Jury Convicts 5 Involved in Enron Deal With Merrill*, N.Y. TIMES, Nov. 4, 2004, C1 (describing the Enron transaction and the convictions of the executives).

[15]W. Bradley Wendel, *The Jurisprudence of Enron: Professionalism as Interpretation*, Cornell Law School Working Papers Series, Paper 16, p. 10 (2004), available at <http://lsr.nellco.org/cornell/clsops/papers/16>.

[16]Lawyers should ask themselves why lawyers in corporate fraud situations never withdraw from the representation when ethics rules require them to do so (they usually continue the representation at least until the fraud becomes public); why they never act as whistleblowers even when ethics rules permit or even require them to do so; and why they are never disciplined for these relatively clear violations of rules of professional conduct. The answers provide interesting light on why lawyers for corporations are not deterred by rules of professional conduct, which are applied to them only for egregious and old-fashioned crimes such as stealing a client's money.

[17]Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994) (holding that secondary liability under § 10(b) of the Securities Exchange Act of 1934, supported by many years of federal decisions in all circuits, did not exist because no specific statutory language authorized it).

[18]Pub. L. No. 104-67, §21D(b), 109 Stat. at 747. See Jill Fisch, *The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants,* 99 Colum. L. Rev. 1293, 1295-96 (1999).

[19]Pub. L. No. 105-353, 112 Stat. 3227 (preempting state statutory and common law securities fraud claims by requiring class actions involving nationally traded securities to be brought exclusively in federal court under uniform federal standards).

[20]Former Treasury Secretary Paul O'Neill came to this conclusion after reflecting on the "new" and "exotic" financial maneuvers that many professional urged on him in his earlier capacity as a corporate executive. See David Wessel, *Venal Sins: Why the Bad Guys of the Boardroom Emerged in Masse*, WALL ST. J., June 20, 2002, at A1.

[21]For discussion of these important questions, see Cramton et al., Lawyers Duties After SOx, cited supra, n. 1, at 751-64 (triggering standard) and 764-79 ("colorable defense" and other exceptions to an appropriate response to a report).

[22]Louis L. Brandeis, Hearings before Sen. Comm. on Interstate Commence, S. Res. No. 98, 62nd Cong., 1st Sess. 1161 (1911), quoted in Harry First, BUSINESS CRIMES 27 (1990).