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The Post-Enron Identity Crisis of the Business Lawyer

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COLLOQUIUM

ETHICS IN CORPORATE REPRESENTATION

INTRODUCTION: THE POST-ENRON IDENTITY CRISIS OF THE BUSINESS LAWYER

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The practices and institutions of business lawyering are undergoing a reassessment and revision as radical as anything that has occurred since the late nineteenth century, when the modern professional association and the modern corporate law firm were born. The pace of change has intensified, but its directions remain contested. The articles in this colloquium depict a corporate bar torn between competing role conceptions along a variety of dimensions. The key axes of controversy are these:

I. WHO IS THE CLIENT? MANAGER OR INSTITUTION?

A distinguishing feature of business practice is that it typically involves organizations, rather than individuals. Organizations are different from individuals because they usually consist of multiple constituencies with potentially conflicting interests. Lawyers cannot act simultaneously for multiple conflicting interests. They need some way of deciding which constituent interests are the organizational client's interests.

A powerful tendency discussed in these articles and in the scandals that prompt them is to conflate the client with the managers who retain and instruct the lawyer. The lawyer has obvious material incentives to adopt this course, and powerful psychological forces promote it. Personal solidarity with the people you collaborate with is one of the most satisfying rewards of high-status work.

Every lawyer, however, knows that in principle the manager is not the client. He knows that the client is "the entity." Yet few lawyers have been clear about what it means to represent an entity. The tendency to identify client with manager has persisted in part because of the vagueness of the entity conception. It is remarkable how little effort the bar made before the Sarbanes-Oxley Act of 2002[1] to clarify matters. Before Model Rule of Professional Conduct 1.13 appeared in 1983, there was virtually no

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1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (to be codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

doctrinal guidance on how an organizational client differed from an individual one. Model Rule 1.13 was ambiguous on virtually every point it addressed, and these ambiguities persisted until Sarbanes-Oxley forced clarification of some of them.[2]

The key precept of Model Rule 1.13 is that the lawyer represents the organization "acting through its authorized representatives." The touchstone appears to be authority. Since the board has something close to plenary authority, one tendency was to look to the board in situations where managerial behavior is questionable or plainly wrongful. As originally enacted, the rule gave discretion to go to the board, without requiring it. Some lawyers, looking for a rule of thumb to replace the conflation of entity and manager, started to think of the organization as tantamount to its board.

Sarbanes-Oxley has intensified this trend without resolving key ambiguities. Sarbanes-Oxley now mandates up-the-ladder reporting in a broad range of situations where the bar would have preferred to keep it optional.[3] At the same time, Security and Exchange Commission ("SEC") regulations encouraged, but did not require, the adoption of structures that make a board (Qualified Legal Compliance) committee of independent directors the primary recipient of such reports.[4] The trend toward greater reliance on the board is further reflected in the growing practice of hiring separate outside counsel for independent director committees.

On the other hand, the trend has been resisted, and not just by inside counsel. Robert Rosen's article here shows that most public corporations have declined to adopt special committees and have charged inside counsel with responsibility to receive up-the-ladder reports.[5] Too much compliance responsibility at the board level may not be optimal. Outside directors and counsel have less information than insiders and are less able to integrate compliance decisions with other business policies. Robert Rosen, Deborah DeMott, Sung Hui Kim, and Manuel Utset show the range of current practice and the complexity of policy considerations.[6]

Nevertheless, even after the allocation of authority between managers and the board (or insiders and outsiders) is settled, issues of client identity will persist. In theory, it is no more correct to conflate the organization

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2. *See generally* William H. Simon, *Whom (or What) Does the Organization's Lawyer Represent?: A Taxonomy of Intraclient Conflict*, 91 Cal. L. Rev. 57 (2003); William H. Simon, *Wrongs of Ignorance and Ambiguity: Lawyer Responsibility for Collective Misconduct*, 22 Yale J. on Reg. 1, 19-20, 29-34 (2005) [hereinafter Simon, *Wrongs of Ignorance*].

3. *See* Simon, *Wrongs of Ignorance*, *supra* note 2, at 29-34.

4. *Id.* at 30-33.

5. Robert Eli Rosen, *Resistances to Reforming Corporate Governance: The Diffusion of QLCCs*, 74 Fordham L. Rev. 1251 (2005).

6. Deborah A. DeMott, *The Discrete Roles of General Counsel*, 74 Fordham L. Rev. 955 (2005); Sung Hui Kim, *The Banality of Fraud: Re-situating the Inside Counsel as Gatekeeper*, 74 Fordham L. Rev. 983 (2005); Rosen, *supra* note 5, at 1251; Manuel A. Utset, *A Model of Time-Inconsistent Misconduct: The Case of Lawyer Misconduct*, 74 Fordham L. Rev. 1319 (2005).

with its board than to conflate it with its management (though in general the former is less harmful). Where the lawyer is confronted with questionable conduct that the board lacks authority to approve (because it requires a shareholder vote, or breaches a fiduciary duty, or is otherwise illegal), the board cannot be regarded as the conclusive spokesperson for the organization. Yet the bar finds it difficult to contemplate any role for the lawyer in this situation beyond remonstrance and withdrawal. Pre-Sarbanes-Oxley, the state bars divided on whether lawyers had discretion to go beyond the board to the organization's shareholders, or a regulator, when such a move seemed necessary to protect the organization's interests. The SEC's Sarbanes-Oxley rules insist lawyers have discretion to go outside, but declines to mandate it.[7]

The denial of a duty to go outside in cases of egregiously harmful illegality is hard to square with plausible notions of professional duty. If the organizational client is being harmed, and disclosure would mitigate the harm, it arguably follows that disclosure is appropriate. The bar resists this conclusion on grounds of confidentiality. It argues that, as a general matter, clients will not consult lawyers without confidentiality safeguards, and that, since legal advice promotes compliance with law, this will be socially costly. But the argument is implausible. For one thing, corporate agents have incentives for consulting lawyers that do not depend on confidentiality. They face the prospect of increased exposure to liability for failing to do so: for example, loss of the "advice of counsel" defense to criminal charges or the "business judgment" defense to civil claims.

In addition, the logic of the argument suggests that the privilege should belong to the agent, when in fact it belongs to the organization, which can waive it when it finds it in the organizational interest to do so. Prosecutors routinely insist on such waiver as a condition of the settlement of criminal charges against the organization. And the privilege does not mitigate the duty of the corporate lawyer to insure that the organization discloses information she receives from managers that the organization is legally required to disclose (for example, under securities or litigation discovery rules), even when it is harmful to the manager personally. Given these facts, it has always been irrational for a corporate manager to make a disclosure to the organization's counsel that he would not have been willing to make in the absence of any confidentiality guarantee. Thus, the likely effect in terms of reduced disclosure to counsel, from requirements that increase disclosure by counsel, is trivial.

Even if their duties stop at the board, lawyers will still have to make judgments about when loyalty to the corporate client requires them to remonstrate with management or climb the ladder to the board. A key issue salient in recent scandals and still unresolved in important respects concerns the legitimacy of transactions that are motivated primarily by a desire to

7. W. Bradley Wendel, Professional Responsibility: Examples and Explanations 79-84 (2004).

achieve favorable accounting effects unrelated to economic effects. Many of the Enron deals seem plainly illegal, but managers continue to feel that they have many lawful options to engage in transactions that have no legitimate business purpose. In her article here, Sung Hui Kim accepts the premise that such deals are in the interests of shareholders, presumably because they will raise share price in the short term, and thus would be undertaken by a "faithful agent" if otherwise lawful.[8] But from another point of view, such manipulations ought to be regarded as prima facie violations of fiduciary duty because they are likely to compromise the corporation's reputation for fair and accurate financial reporting and because they distort key measures of managerial accountability to the shareholder electorate.[9] (In addition, while some shareholders of a particular corporation might receive a short-term benefit from accounting manipulation—as they might from outright fraud—all shareholders are better off in the long run if all corporations forgo it.)

II. WHO REGULATES? SELF (JUDICIAL)-REGULATION OR LAY REGULATION?

The Enron-inspired Sarbanes-Oxley Act is the first federal statute in the history of the republic to regulate lawyers directly and broadly. The second came only two years later, when Congress confirmed and extended the power of the Internal Revenue Service ("IRS") to regulate extensively the practice of tax lawyers.[10] Prior to these statutes, regulation of the legal profession was considered a matter for the states and in important respects a matter of "self-regulation."

Of course, the profession has never had formal power to regulate itself. Power at the state level has been lodged formally in the courts, but the courts have tended to acquiesce in the proposals of the bar associations, and every jurisdiction has some version of the American Bar Association model norms. Over the years, federal agencies have preempted some state rules to regulate the lawyers who practice before them, but these moves have tended to be narrow, and the agencies have often incorporated the profession's norms into their own regulations. The Sarbanes-Oxley rules are a much more dramatic step. They preempt a broad range of the bar's norms, and their enactment reflects an explicit legislative judgment that the bar's self-regulatory efforts have been inadequate.

It seems likely that the trend toward displacement of the states and the bar as the primary regulators of the profession will continue. The states have inadequate jurisdictional scope to deal with key problems in practice

8. Kim, *supra* note 6, at 983.

9. For argument and citations, see William H. Simon, *Earnings Management as a Professional Responsibility Problem: A Comment on Steven Schwarcz's "The Limits of Lawyering,"* 84 Texas L. Rev. (forthcoming Nov. 2005).

10. *See* Mark Ely et al., *The Tax Shelter Rules Come Full Circle: An Analysis of the Tax Shelter Provisions in the American Jobs Creation Act of 2004*, BNA Tax Management Weekly Report, Dec. 27, 2004, http://www.bnatax.com/tm/wr_taxshelterly.htm.

that are increasingly multistate and multinational. Moreover, the track record of self-regulation is not impressive. As Jonathan Macey argues, the bar has often succumbed in its regulatory efforts to monopolistic self-interest at the expense of public values.[11] And as Geoffrey Miller suggests, recent changes in the economic circumstances of practice may require more extensive regulatory standards and enforcement than the bar would prefer.[12] Increasing competition, lawyer mobility, and the attenuation of client relations have weakened the force of informal social and reputational pressures that previously supplemented formal public regulation.

III. WHAT EXPERTISE?: DISCIPLINARY VERSUS INTERDISCIPLINARY PERSPECTIVES

The shift in regulatory authority from the bar and the states to federal administrative agencies also involves a shift from uniform regulation across the profession to regulation differentiated by practice contexts.[13] The SEC promulgates norms for lawyers in the securities context, the IRS for lawyers in tax practice, and the Office of Thrift Supervision for lawyers representing banks. This trend involves fragmentation within the profession, but it also potentially involves integration across professions within the relevant practice contexts.

Regulation across professions within a given practice setting would parallel the evolving configuration of skills, tasks, and, in some respects, the sense of professional identity. Increasingly, professionals work in interdisciplinary teams. The composition and attitudes of these teams is defined by the nature of the problems they work on. In some areas, we can see a tendency of people to think of their work, less in terms of the discipline in which they have been credentialed, and more in terms of the problems they work on. For example, observers of drug courts have noted that the lawyer roles there are not strongly distinguished from the roles of probation officers, judges, and medical people. No doubt each group is connected to one or more traditional professional associations, but all of them also meet together in the National Association of Drug Court Professionals.[14]

Enron provides a striking illustration of the stakes in configuring the boundaries of expertise. Both lawyers and accountants failed in their gatekeeping responsibilities, and Milton Regan's account suggests that part of the problem in each case was an implausibly narrow conception of

11. Jonathan Macey, *Occupation Code 541110: Lawyers, Self-Regulation, and the Idea of a Profession*, 74 Fordham L. Rev. 1079 (2005).

12. Geoffrey Miller, *From Club to Market: The Evolving Role of Business Lawyers*, 74 Fordham L. Rev. 1105 (2005).

13. *See generally* David Wilkins, *Making Context Count: Regulating Lawyers After Kaye, Scholer*, 66 S. Cal. L. Rev. 1147 (1993).

14. Michael C. Dorf & Charles F. Sabel, *Drug Treatment Courts and Emergent Experimentalist Government*, 53 Vand. L. Rev. 831, 859-65 (2000).

responsibility.[15] The accountants asked for legal opinions as authority for many improper transactions, especially the ones involving "special purpose entities" facilitating off-balance-sheet financing. The lawyers issued the opinions, even in the face of doubts that the opinions had the significance under the relevant accounting standards that the auditors attributed to them. In the wake of the collapse, the accountants now assert that they relied on the lawyers; the lawyers insist that they have no responsibility for accounting matters. But the distinction between legal and accounting issues is difficult to draw. Some of the criteria under the relevant accounting standard are legal, and the standard explicitly calls for a legal judgment on a central issue. If, as appears, this is a matter that is best resolved by interdisciplinary judgment, any effort to compartmentalize responsibility between professions is bound to be arbitrary, and to the extent it encourages efforts to exploit ambiguity to escape responsibility, counterproductive. Effective practice in this area will require lawyers and accountants each to be familiar with the elements of the others' discipline that bear on the problems they work on together.

Lawyers are wary of explicit multidisciplinary practice. Key segments of the bar are threatened by the idea of lawyers practicing in the same firms as other professionals, and have so far managed to prohibit it in most jurisdictions. They would no doubt resist efforts to impose uniform practice norms on the members of different professions working in the same practice areas. The ideology of confidentiality plays a strong role in this area. The bar has succeeded in achieving stronger confidentiality protections than competing professions for lawyers' consultations with clients. (Accountants, bankers, and business consultants are sometimes asked to leave the boardroom when lawyers discuss sensitive issues with directors, for fear of jeopardizing the attorney-client privilege.)

This is a great marketing advantage for lawyers, but as I suggested above, the social benefits of attorney-client confidentiality are unproven and the benefits to corporate clients are vastly exaggerated. A little-noticed cost of confidentiality is that it undermines accountability, not only of clients, but of the lawyers themselves. Confidentiality prevents review and assessment of the quality of much legal advice. The loss of confidentiality is not an inadvertent by-product of the interdisciplinary team model, but a consequence of its core commitment to transparency and professional accountability. This model is designed to force professionals to be as clear and articulate as possible to each other about their judgments, both to force reflection and to facilitate cross-disciplinary peer review.[16] Regan's Enron story is a prime example of the costs of disciplinary parochialism and

15. Milton C. Regan, Jr., *Teaching Enron*, 74 Fordham L. Rev. 1139 (2005).

16. Dorf and Sabel foresee the emergence of "a new conception of a profession, consisting of a loosely defined subject matter, a set of core skills, generalized partnering disciplines, and a commitment to making reasonably explicit (as opposed to tacit) the corrigible principles that enable practitioners to succeed." Dorf & Sabel, *supra* note 14, at 864.

associated confidentiality norms in inhibiting both reflection and accountability.

IV. HOW MUCH PUBLIC RESPONSIBILITY? LETTER OR SPIRIT OF THE LAW?

Enron-style transactions designed solely to achieve misleadingly favorable accounting results and aggressive tax shelters have in common that they are designed to conform to the literal terms of the applicable law while flouting its underlying values. These transactions have no business purposes. They are undertaken solely to achieve benefits for the clients (or, in the Enron case, the managers) that the lawyers, were they to make a judgment on the matter, would probably concede were inconsistent with the spirit of the law.

Of course, there is a good deal of dispute about whether these transactions comply even with the letter of the law. But the lawyers argue that they do and, more importantly, that compliance with its letter is all that the law requires. Thus, for example, Vinson & Elkins has defended its work for Enron by arguing that lawyers have a duty to exploit "loopholes" in the law, and it has found many defenders.[17]

Every lawyer recognizes public responsibilities to respect the law, but the profession has long been ambivalent or divided over the competing conceptions of legal fidelity based, respectively, on letter and spirit. In the post-Enron era, the formalist letter-of-the-law position seems to be harder to defend.

First, the law itself is increasingly demanding respect for its spirit as well as its letter. Although the issue remains contested, judges and regulators seem increasingly inclined to interpret the law purposively and they refuse to recognize literal compliance as justification for conduct that knowingly and flagrantly thwarts clear underlying purposes.

Second, both the dignity of the bar and its status and privileges depend on the idea that lawyering serves public values. The premise of the attorney-client evidentiary privilege, for example, is that confidentiality encourages people to consult lawyers, and that it is socially desirable for people to do so. But the formalistic conception of legal responsibility undermines the latter claim. If the compliance that lawyers encourage means nothing more than conformity to the law's literal terms, if legal advice is as likely to facilitate evasion as vindication of the law's underlying purposes, then there is no reason to think that there is any social interest in encouraging consultation with lawyers.

For these reasons, the ability to relate the client's circumstances to the law's underlying purposes has long been viewed as an essential lawyering skill. But the Enron-type scandals show how readily it can be jeopardized by narrow conceptions of responsibility. Milton Regan's detailed account of the Enron "special purpose entity" transactions nicely dramatizes this

17. Patti Waldmeir, *Don't Blame the Lawyers for Enron*, Fin. Times, Feb. 21, 2002, at 14.

point. By immersing us in the details of the transaction, Regan is able to convey some sense of how the lawyers, viewing the transaction piece by piece and taking account only of the literal terms of the applicable norms, might have concluded that they were legitimate. But any lawyer who asked what was the purpose of a transaction and compared that purpose to the underlying purpose of the relevant laws would have found it much more difficult to conclude that what they were doing was acceptable.

The Enron board's Finance Committee was told that the transaction was a "hedge" that "[d]oes not transfer economic risk but transfers P & L [income statement profit and loss] volatility."[18] Of course, a hedge that does not transfer economic risk is an absurdity. And a transaction that transfers P & L volatility without affecting economic risk sounds like a synonym for fraud. Such an answer should have been at least a blazing red flag for the lawyers. Regan's account suggests that they may never have asked the kinds of questions that would have elicited it. Such misguided restraint seems less likely in the post-Enron era.

CONCLUSION

The articles in this collection provide a roadmap to the controversies over the role of the business lawyer in what is likely to prove a watershed period in the history of the profession.

18. Special Investigative Committee of the Board of Directors of Enron Corp., Report of Investigation (Feb. 1, 2002), at 157.