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# CORPORATE LAWYERS AS GATEKEEPERS\*

Stephen M. Bainbridge

## INTRODUCTION

The capital markets for corporate securities suffer from an inherent information asymmetry. Investors demand credible information both at the time of the original purchase from the issuer and on an on-going basis so as to support a liquid secondary trading market. In theory, corporations will provide such information. In practice, of course, some will choose fraud, and various market failures will cause even honestly run firms to disclose inaccurate or incomplete information. Investors will demand to be compensated for bearing this risk via a higher rate of return.

As a way of both improving the quality of and bonding the credibility of its disclosures, so as to reduce its cost of capital, a company will hire various outsiders—such as an outside auditor and underwriters—to function as reputational intermediaries. Because the gatekeeper's business depends on its reputation for honesty, probity, and accuracy, it will not ruin that reputation to aid one client to cheat. These outsiders thereby function as gatekeepers, policing access to the capital markets.

Until passage of the Sarbanes-Oxley Act (SOX), lawyers rejected the idea that they were gatekeepers. The corporate bar long insisted that it owed no duties to anyone other than the managers and boards of directors of its clients. The idea that lawyers might have obligations to shareholders, the investing public, or other capital market participants was abhorrent to the bar. Lawyers were advocates, confidants, and advisors, not auditors.<sup>1</sup>

In fact, however, lawyers often play a reputational intermediary role not dissimilar to that of an auditor. A very high profile general counsel or law firm partner, for example, can give a client in trouble the benefit of the lawyer's reputation for probity and upstanding ethics.

Usually, of course, counsel play a more behind-the-scenes role, but it is still a gate-keeping role. Specifically, transactional counsel and in-house lawyers are well positioned to intervene by blocking the effectiveness of a defective registration statement or prevent the consummation of a transaction, to cite but two examples.<sup>2</sup>

Unfortunately, lawyers have all too often failed to be effective gatekeepers. In litigation arising out of the 1980s savings and loan crisis, for example, Judge Stanley Sporkin famously asked:

Where were these professionals, a number of whom are now asserting their rights under the Fifth Amendment, when these clearly improper transactions were being consummated? Why didn't any of them speak up or disassociate themselves from the transactions? Where also were the outside accountants and attorneys when these transactions were effectuated? What is difficult to understand is that with all the professional talent involved (both accounting and legal), why at least one professional would not have blown the whistle to stop the overreaching that took place in this case.<sup>3</sup>

A decade later, the same questions were asked of lawyers who worked for firms like Enron.

At Enron itself, for example, there was "an absence of forceful and effective oversight [of the company's disclosures] by . . . in-house counsel, and objective and critical professional advice by outside counsel at Vinson & Elkins,"<sup>4</sup> along with senior management and the auditors. The report expressly criticized Vinson & Elkins, which the investigators argued "should have brought a stronger, more objective and more critical voice to the disclosure process."<sup>5</sup>

An internal investigation at WorldCom likewise faulted, among others, the firm's lawyers for allowing a pervasive "breakdown in ... the company's corporate-governance structure."<sup>6</sup> An internal investigation criticized WorldCom's general counsel because his legal department was not properly structured "to maximize its effectiveness as a control structure upon which the Board could depend."<sup>7</sup>

As Senator John Edwards aptly summarized the problem, when companies break the law, "you can be sure that part of the problem is that the lawyers ... are not doing their jobs."<sup>8</sup> Edwards successfully persuaded Congress that "corporate lawyers should not be left to regulate themselves [any] more than accountants should be left to regulate themselves."<sup>9</sup> SOX therefore required the Securities and Exchange Commission (SEC) to adopt new ethics rules bringing the corporate lawyer – client relationship into the federal regulatory sphere.

Despite SOX's many strictures in this and other areas, however, a new and even more devastating financial crisis came in 2008 when the subprime mortgage market's troubles nearly brought the entire banking system to its knees. Once again, questions are being asked about the role that lawyers played in this crisis. A reassessment of SOX's legal ethics rules thus is in order.

The relationship between corporate lawyers and corporate management presents two distinct sets of principal-agent problems. The first arises out of the information asymmetry between full-time managers and independent members of the board of directors who devote but a small portion of their time and effort to the firm. The former inherently have better access to firm information than do the latter. That asymmetry became even more acute, however, with the post-SOX emphasis on having a board whose majority consists of outsiders so insulated from management as to satisfy the demanding definition of independence. The post-reform board therefore must find new ways of unbiased and independent information.

Corporate counsel could be an important source of such information. Because the management-attorney relationship tends to dominate the attorney's relationship with the firm however, lawyers have strong incentives to help management control the flow of information to the board of directors. As Enron Bankruptcy Examiner Neal Batson observed, for example:

One explanation for the attorneys' failure may be that they lost sight of the fact that the corporation was their client. It appears that some of these attorneys considered the officers to be their clients when, in fact, the attorneys owed duties to Enron.<sup>10</sup>

Indeed, as Senator Edwards noted, counsel often develop a de facto loyalty to management that trumps their de jure duties:

We have seen corporate lawyers sometimes forget who their client is. What happens is their day-to-day conduct is with the CEO or the chief financial officer because those are the individuals responsible for hiring them. So as a result, that is with whom they have a relationship. When they go to lunch with their client, the corporation, they are usually going to lunch with the CEO or the chief financial officer. When they get phone calls, they are usually returning calls to the CEO or the chief financial officer.<sup>11</sup>

This problem is especially pronounced for in-house counsel. Technically, of course, they work for the entity, but, in practice, counsel naturally tend to view their management supervisors as their employer.<sup>12</sup>

The second principal-agent problem arises because attorneys may be tempted to turn a blind eye to managerial misconduct or even to facilitate such misconduct. As to in-house general counsel, even if formally appointed by the board of directors, their tenure normally depends on their relationship with the CEO. As for outside

legal counsel, they must please their clients in order to retain their business and to attract the business of future clients. This pressure is especially strong given the large number of capable firms and attorneys available for hire: law firms are something of a fungible good.

In particular, counsel are subject to strong pressure to be a team player. In *The Terrible Truth About Lawyers*, Mark McCormack, founder of the International Management Group, a major sports and entertainment agency, wrote that “it’s the lawyers who: (1) gum up the works; (2) get people mad at each other; (3) make business procedures much more expensive than they need to be; and (4) now and then deep-six what had seemed a perfectly workable arrangement.”<sup>13</sup> McCormack further observed that, “when lawyers try to horn in on the business aspects of a deal, the practical result is usually confusion and wasted time.”<sup>14</sup> He concluded that often “the best way to deal with lawyers is not to deal with them at all.”<sup>15</sup>

Because these attitudes are widely shared in the business community, there is much pressure—especially on in-house counsel—to get out of the way. In turn, lawyers want to be seen as team players. Unfortunately, the incentive to be a team player has led some counsel to bless highly suspect management decisions.

As Enron examiner Batson observed, for example, Enron’s “attorneys saw their role in very narrow terms, as an implementer, not a counselor. That is, rather than conscientiously raising known issues for further analysis by a more senior officer or the Enron Board or refusing to participate in transactions that raised such issues, these lawyers seemed to focus only on how to address a narrow question or simply to implement a decision (or document a transaction).”<sup>16</sup>

To be clear, the point is not that lawyers are pervasively co-opted or immoral. The point is only that lawyers have both economic incentives and cognitive biases that systematically incline them to at least shut their eyes to instances of client misconduct.<sup>17</sup>

## II. SOX § 307

When the Senate took up SOX, Senator Edwards proposed a floor amendment, subsequently enacted as § 307 of the Act, requiring the SEC to:

[I]ssue rules ... setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule (1) requiring an attorney 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 counsel or the chief executive officer of the company (or the equivalent thereof); and (2) if the counsel or officer does not appropriately respond to the evidence ... requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed ... by the issuer, or to the board of directors.<sup>18</sup>

It gives lawyers a very “simple” obligation: “You report the violation. If the violation isn’t addressed properly, then you go to the board.”<sup>19</sup>

In compliance with § 307, the SEC, in January 2003, promulgated the “Part 205” attorney conduct regulation.<sup>20</sup> The core of the new rules is a version of the up-the-ladder reporting requirement envisioned by Senator Edwards.<sup>21</sup>

#### A. SEC Implementation

The initial jurisdictional question is whether a lawyer is “appearing and practicing before the Commission in the representation of an issuer.”<sup>22</sup> Only lawyers doing so are subject to the SEC’s ethics standards. Unfortunately, the definition of “appearing and practicing” is both sweeping and quite vague:

#### 1. Preliminary Matters: Jurisdiction and Preemption

Appearing and practicing before the Commission: (1) Means: ... Providing advice in respect of the United States securities laws or the Commission’s rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document ....<sup>23</sup>

To be sure, the adopting release states “an attorney’s preparation of a document (such as a contract) which he or she never intended or had notice would be submitted to the Commission, or incorporated into a document submitted to the Commission, but which subsequently is submitted to the Commission as an exhibit to or in connection with a filing, does not constitute ‘appearing and practicing’ before the Commission.”<sup>24</sup> Yet, many non-securities lawyers may know that their documents will be so filed and thus will find themselves “appearing and practicing” before the Commission despite having had no intention of doing so.

The Part 205 regulations recognize that the attorney “represents the issuer as an entity rather than the officers.”<sup>25</sup> As originally proposed, Part 205.3 further provided that an attorney “shall act in the best interest of the issuer and its shareholders.”<sup>26</sup> As finally adopted, however, the relevant rule provides only that “[a]n attorney appearing and practicing before the Commission in the representation of an issuer owes

#### 2. The Issuer as Client

his or her professional and ethical duties to the issuer as an organization.”<sup>27</sup> As UCLA law professor Sung Hui Kim notes, the final rules thus “fail to address the situational pressures” that lead counsel to treat the firm’s managers as their real client.<sup>28</sup>

### 3. Up-the-Ladder Reporting

Former ABA Model Rule 1.13 acknowledged the potential need for an attorney to report on suspected wrongdoing within the organization, but it also limited the ability of an attorney to do so effectively. The language of the Rule was discretionary rather than prescriptive, allowing an attorney to use his judgment about whether or not to proceed with reporting evidence of misconduct to the board of directors or even to high-level corporate officers. In contrast, Part 205 uses the prescriptive word “shall” to describe an attorney’s duty. In pertinent part, the rule provides:

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 by 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 to both the issuer’s chief legal officer and its chief executive officer (or the equivalents thereof) forthwith.<sup>29</sup>

As a result, an attorney will not have the luxury of using his own judgment about whether or not to report wrongdoing once the statutory level of evidence is triggered. As Senator Edwards anticipated, counsel must report up within the chain of command.<sup>30</sup>

The initial obligation of a lawyer who “becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer” is to report such evidence to the issuer’s chief legal or executive officer.<sup>31</sup> Subject to a slew of exceptions and alternatives, unless the lawyer “reasonably believes that [that officer] has provided an appropriate response within a reasonable time, the attorney shall report the evidence of a material violation to” the audit committee of the board of directors.<sup>32</sup>

### B. Assessment

The market for legal services gives management a set of carrots by which to align the interests of corporate counsel with their own. SOX did not attempt to change those incentives. Instead, it gave the SEC a set of sticks by which to enlist corporate counsel in preventing fraud and empowering boards of directors. The goal is laudable. But will it work?

#### 1. Relying on Self-Policing Lawyers

In adopting the final rules, the SEC abandoned an initial effort to “exclude the subjective element” from the concept of “reasonable belief.”<sup>33</sup> An attorney who receives what he “reasonably believes is an appropriate and timely response” from management, for example, “need do nothing more.”<sup>34</sup> As a result, the decision to report up the ladder is largely in the hands of the lawyer.



A related problem, having the same effect, is that several key provisions are expressly permissive rather than mandatory. For example, § 205.3(b) characterizes reporting to the board as a “last resort” rather than requiring automatic disclosure of all evidence of wrongdoing to the board. In practice, only a fraction of reports, therefore, will ever make it past the CEO or CLO to the board.<sup>35</sup>

Much the same problem is presented by the purportedly objective standard requiring a lawyer to report “evidence” of misconduct. After an attorney reports evidence of a material violation to management,<sup>36</sup> the manager shall “cause such inquiry into the evidence of a material violation as he or she reasonably believes is appropriate to determine whether the material violation described in the report has occurred ....”<sup>37</sup> The discretionary standard by which lawyers are to determine whether there is evidence a violation has occurred—namely, whether a “prudent attorney” would think it was “reasonably likely” that a material violation had occurred<sup>38</sup>—allows for professional concerns and other conflicts of interest to skew the lawyer’s assessment, minimizing the chances that the potential violation would be reported to management, let alone to the board. Because of the two-tiered reporting system in which disclosure to the board is contemplated only after management inaction, the corporate managers may often look at evidence presented by a concerned attorney, “reasonably” determine that in fact no violation has occurred (notwithstanding ever-present conflicts of interest), and dismiss the whole matter without any knowledge by the board. The attorney would have complied with his statutory obligation to report up the ladder, yet the board’s monitoring function would have been eviscerated.

In addition, research in behavioral economics suggests certain basic cognitive biases that are likely to discourage lawyers from detecting or acting upon management misconduct. Behavioral economists have identified a number of well-documented cognitive errors relevant to the problem in hand. One is the overconfidence bias, which has been defined as “the belief that good things are more likely than average to happen to us and bad things are less likely than average to happen to us.”<sup>39</sup> If a lawyer is subject to this bias, his judgment will be skewed against believing that his clients are bad people committing fraud. A closely related bias is the confirmatory bias, which is defined as the tendency for actors to interpret information in ways that serve their self-interest or preconceived notions. Lawyers who made the decision to associate with a particular firm, therefore, are less likely to recognize management misconduct, because evidence thereof would be inconsistent both with the lawyer’s self-interest in maintaining a relationship with the co-worker and the lawyer’s self-image as someone who identifies and associates with honest people. Taken together, these systematic, decision-making biases generate a type of “cognitive conservatism” that makes a lawyer “likely to dismiss as unimportant or aberrational the first few negative bits of information that she receives regarding the client or situation.”<sup>40</sup>

## 2. The Lawyer Who Cried Wolf

As we saw in the preceding section, the reliance on self-policing may lead to under-reporting. Given the uncertainty about the scope of the rules and the potentially severe sanctions for guessing wrong, however, it seems equally plausible—and equally problematic—that lawyers may err in the other direction. First, invoking the up-the-ladder reporting right to report evidence about possible wrongdoing allows attorneys to cover themselves. When lawyers routinely use reporting up the ladder as a “CYA” mechanism, however, their conduct changes the signaling effect of disclosure. If reporting up the ladder occurs frequently, it will become a routine procedure that does not necessarily indicate real doubt by the attorney about the propriety of the managers’ actions. Indeed, so as to preserve their relationship with management, lawyers may try to take the sting out of disclosing possible misconduct within an organization by de-stigmatizing the practice. Once reporting up the ladder loses its sting, however, the impact of the disclosure is lessened. In such an environment, senior management and the board will not take accusations as seriously as they should.

## 3. Structural Concerns in the Market for Legal Services

The roles played by Vinson & Elkins as Enron’s principal outside counsel can be separated into three distinct categories: first, the aggressive structuring of the controversial special purpose entity transactions used in Enron’s accounting scam; second, drafting Enron’s disclosure documents; and third, conducting an internal investigation of a whistleblower’s allegations.<sup>41</sup> The latter category is a relatively rare undertaking that differs significantly from the far more common transactional work of the first two types. Oddly, however, SOX § 307 and the Part 205 regulations seem better designed to deal with the third context than with either of the first two. It is only in the third context, for example, that lawyers deliberately set out to look for evidence of wrongdoing.

In transactional work, § 307 issues may arise in one of three main ways:

First, counsel may be aware of aggressive or risky conduct by management but is unaware of fraud or other illegality. Vinson & Elkins, for example, most likely “knew of aggressive and risky transactions and reporting decisions [by Enron’s management] but did not have actual knowledge of illegal conduct.”<sup>42</sup> Section 307 does not require counsel to report evidence of uninformed, excessively aggressive, or unethical conduct to the board; however, counsel only must report evidence of fraud and breaches of fiduciary duty. Because much (probably most) of the board’s monitoring function involves preventing (or at least supervising) overly aggressive management, § 307 thus fails to address the basic information asymmetry between management and the board.

Second, counsel may have actively participated in—or at least facilitated—actual fraud. In these cases, the lawyer also is unlikely to report up the ladder, albeit for the different reason that he now has something to hide.

Third, counsel may have grounds for suspicion—but no direct evidence—of fraud or other illegality. In theory, this category presents the best case for an up-the-ladder reporting requirement to successfully aid the board in overseeing management. In practice, however, it is likely to be very rare. Corporate managers are highly unlikely to seek legal assistance with outright fraud, as opposed to conduct that merely pushes the edge of the envelope. In the post-SOX § 307 environment, managers are even more likely to conceal any hint of impropriety from counsel.<sup>43</sup>

As many commentators on the Part 205 regulations complained, the rules may have a chilling effect on attorney–client communication.<sup>44</sup> Even corporate managers not engaged in actual misconduct will not welcome the investigation that an attorney’s reporting up would engender, especially where there is a possibility that counsel will go over their heads. Managers therefore may withhold information from counsel, so as to withhold it from the board, especially when the managers are knowingly pursuing an aggressive course of conduct. Indeed, in many of the recent corporate scandals, the misconduct was committed by a small group of senior managers who took considerable pains to conceal their actions from outside advisors, such as legal counsel.<sup>45</sup> Many commentators complained that § 307 will diminish the quality of the attorney’s representation of the client because counsel will lack unfettered access to information.<sup>46</sup> More pertinent for our purposes, however, the likelihood that an attorney will encounter evidence of misconduct also is reduced.<sup>47</sup>

#### 4. Impact on Lawyer–Client Communication

Counsel, therefore, is most likely to come across evidence of misconduct when conducting an affirmative investigation, such as when performing due diligence in connection with the issuance of securities. Yet, it may be doubted that due diligence often turns up direct evidence of misconduct. In the first place, even a full-fledged accounting audit is not a true forensic audit designed to uncover wrongdoing, but rather only a sampling audit that may entirely miss the problem.<sup>48</sup> In the second place, due diligence is time-consuming. It is therefore expensive. It therefore tends to be done by young associates. As a result, much client misconduct will go undetected by outside counsel because the lawyers with the most direct exposure to the raw data frequently lack experience. In the third place, due diligence is currently limited to issuances of securities. Routine disclosures and other matters constituting “appearing and practicing” before the SEC traditionally have not triggered a due diligence investigation.

Dotcom era frauds typically involved cooking the books so as to raise—or at least support—the firm’s stock price so that the managers could profit from their stock options. The problem is that generally accepted accounting principles (GAAP) provide substantial flexibility, which permits the phenomenon of earnings management by which corporate managers manipulate financial data so that operating results

#### 5. Will Lawyers Know It When They See It?

conform with forecasts. Even trained corporate lawyers often lack the mathematical skills and accounting knowledge to tell the difference between earnings management allowed by GAAP and illegal financial chicanery. In Enron itself, for example, “Enron and its accountants were (in many cases) making exquisitely fine judgment calls.”<sup>49</sup> Few lawyers likely have the expertise necessary to second-guess such judgments. As Professor Lawrence Cunningham observed, “an important lesson from Enron is the danger that prevailing professional cultures create a crack between law and accounting that resolute fraud artists exploit.”<sup>50</sup>

### III. WHAT COULD HAVE BEEN DONE

The SEC was quite reticent in exercising its authority under § 307. Consistent with the spirit of SOX, the SEC might have been even more aggressive in pressing lawyers to communicate with the board of directors. The SEC might have required, for example, that the audit committee and/or the board meet periodically with the general counsel outside the presence of other managers and inside directors.

The SEC might have required the counsel to report possible violations to the board even if the chief legal or executive officer undertook a reasonable response to the violation. After all, it is the board of directors that has a responsibility to assure that “appropriate information and reporting systems are established by management” and that “appropriate information will come to its attention in a timely manner as a matter of ordinary operations.”<sup>51</sup>

A more radical solution would be an enhanced due diligence obligation, which would effectively transform securities lawyers into auditors. A legal audit of the firm in connection with major transactions and/or the preparation of significant disclosure documents would increase the likelihood that counsel would become aware of evidence of client misconduct, which could then be reported up the ladder. Indeed, SOX had already moved in this direction by imposing a new obligation for the chief executive officer and chief and financial officers to certify disclosure documents.<sup>52</sup> Given the amount of client misconduct that went undetected by accounting audits and legal due diligence, however, it may be doubted whether the benefits of such a radical solution would outweigh the costs.

To be sure, these ideas push the edge of the envelope insofar as the SEC’s regulatory authority is concerned. Although § 307 only explicitly mandated an up-the-ladder reporting requirement, the statutory reference to “minimum standards of professional conduct” sweeps far more broadly and could easily encompass additional, more extensive obligations. The SEC thus doubtless has wider authority than it has chosen to exercise to date.<sup>53</sup>

At the end of the day, § 307 — warts and all — was necessary to break the organized bar’s resistance to legal ethics reforms intended to reduce the managerialist bias of the rules of professional conduct. Corporate counsel work for the board, not management. Only by threatening lawyers who fail to report up-the-ladder with discipline could the balance of power be shifted in favor of directors relative to managers.

In practice, firms should still be able to ensure that the client gets the full benefit of transactional lawyering services by developing a best practice approach to dealing with possible material violations. In consultation with the audit committee, the general counsel and principal outside counsel should develop a written policy for identifying and reporting violations. The board members, CEO, and CFO should be briefed on their legal obligations with respect to reports, but also encouraged to view a report as a potential win-win situation rather than a zero-sum or adversarial game. Up-the-ladder reporting can give the firm an opportunity to cut off potential violations before they mature into a legal or public relations nightmare, but only if counsel and managers are willing to trust one another.



- \* This essay is an abridged version of Stephen M. Bainbridge's *CORPORATE GOVERNANCE AFTER THE FINANCIAL CRISIS*, Oxford University Press (2011).
1. See John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403, 1405 (2002) (noting prevailing view that an issuer's lawyer is a "transaction engineer, rather than [a] reputational intermediary").
  2. SEC v. Nat'l Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978), provides a well-known example of how transactional lawyers failed as gatekeepers. National Student Marketing was to be acquired by Interstate National Corporation in a merger. The merger agreement conditioned the parties' obligation to close on an exchange of opinion letters from each corporation's attorneys and "cold comfort letters" from each corporation's accountants. At the closing, National Student Marketing's lawyers became aware of serious problems with their client's financial statements. The problems were sufficiently severe that National Student Marketing's auditors refused to issue a clean cold comfort letter. Despite knowing of both the auditor's concerns and the underlying problems, counsel nevertheless issued the necessary opinion letter and failed otherwise to object to the closing going forward. Whether the lawyers should have blown the whistle on their client remains a matter of debate. At a minimum, however, National Student Marketing's lawyers could and should have closed the gate, preventing the merger from being consummated, by withholding their opinion letters and advising their clients to hold off until the accounting concerns could be addressed.
  3. Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901, 920 (D.D.C. 1990).
  4. William C. Powers, Jr., et al., Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp. 17 (Feb. 1, 2002), *available at* <http://news.findlaw.com/hdocs/docs/enron/sicreport/>.
  5. *Id.* at 26.
  6. Rebecca Blumenstein & Susan Pulliam, *WorldCom Fraud was Widespread*, WALL ST. J., June 10, 2003, at A3.
  7. Rebecca Blumenstein & Jesse Drucker, *MCI's Treasurer; Counsel to Resign After Disclosure*, WALL ST. J., June 11, 2003, at A3, A12.
  8. 148 CONG. REC. 12519 (2002) (statement of Sen. John Edwards).
  9. *Id.*
  10. See Thomas G. Bost, *Corporate Lawyers After the Big Quake: The Conceptual Fault Line in the Professional Duty of Confidentiality*, 1 J. BUS. ENTREPRENEURSHIP & L. 335, 347 (2008) (quoting Batson).
  11. 148 CONG. REC. 12519 (2002) (statement of Sen. John Edwards).
  12. Hierarchical pressures are especially pronounced if the managers with whom counsel work with closely have the power to fire them. After all, inside counsel are necessarily economically dependent on a single client. If they get fired, they lose their income, their insurance and other benefits, and their basic livelihood. It is especially difficult for in-house counsel to remain independent of management when a large chunk of their compensation comes in the form of incentive stock

options or restricted stock grants in shares of their employer or when a big chunk of their savings is squirreled away in a 401(k) stuffed with that employer's stock. Indeed, at that point, counsel become subject to the same pressures as any other manager to keep the stock price up, to make sure the company hits its numbers, to puff up good news and downplay bad news. In other words, the in house counsel inherently is subject to a conflict of interest created by dual roles as gatekeeper and as a business person with an interest in the financial success and longevity of the entity.

13. MARK H. McCORMACK, *THE TERRIBLE TRUTH ABOUT LAWYERS* 14–15 (1987).
14. *Id.* at 87.
15. *Id.* at 15.
16. Thomas G. Bost, *The Lawyer as Truth-Teller: Lessons From Enron*, 32 PEPP. L. REV. 505, 514 (2005) (quoting Batson).
17. As my friend and UCLA School of Law colleague Sung Hui Kim noted in an important contribution to the literature, conventional wisdom assumes that lawyers who participate in or otherwise facilitate corporate fraud have “consciously and deliberately chose[n] the path of greed and depravity.” Sung Hui Kim, *The Banality of Fraud: Re-situating the Inside Counsel as Gatekeeper*, 74 FORDHAM L. REV. 983, 991 (2005). As an alternative to this “venality hypothesis,” Kim advances a “banality hypothesis.” *Id.* at 992. According to the latter, inside counsel who behave unethically do so not because they are venal but because their situation causes them to be conformist and obedient. Kim supports her argument by drawing on research from several related disciplines—which might variously be described as behavioral economics, experimental economics, experimental psychology, and sociology—to provide a detailed “ethical ecology” of the environment within which inside counsel operate. *Id.* at 1001. This ethical environment has three critical characteristics: (1) the inside counsel is conceptualized by both himself and others as an employee; (2) employees are professionalized to view themselves as agents whose conduct should be aligned to the interests of the principal; and (3) they are expected to be team players. While arguing that the inside counsel’s situation “makes unethical behavior, at least in the form of acquiescence, likely,” Kim acknowledges that one might expect “smart professional[s]” to nevertheless exercise their moral autonomy and take an “ethical stand.” *Id.* at 1026. In response, Kim deploys theories about systematic biases from cognitive psychology to argue that such professionals are often able to blind themselves to the ethical problem at hand.
18. Sarbanes-Oxley Act of 2002 § 307, 15 U.S.C. § 7245 (2006).
19. 148 CONG. REC. 12519 (2002) (statement of Sen. John Edwards).
20. Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8185, Exchange Act Release No. 47,276, Investment Company Act Release No. 25,919, 68 Fed. Reg. 6296 (Feb. 6, 2003), *available at* <http://www.sec.gov/rules/final/33-8185.htm> [hereinafter Securities Act Release No. 8185].
21. 17 C.F.R. § 205.3(d)(2) (2011). In promulgating the Part 205 regulations, the SEC postponed action with regard to mandatory noisy withdrawals. The original proposal obligated an attorney whose internal complaints did not receive an adequate mitigating response by the issuer to resign from the corporation and to file a notification with the



SEC explaining the basis for such resignation. This noisy withdrawal rule met with substantial criticism from the bar. As adopted, Part 205 permits, but does not require, an attorney to disclose confidential client information to the SEC under specified conditions, most notably where necessary to prevent “injury to the financial interest or property of the issuer or investors.” *Id.*

22. 17 C.F.R. § 205.1 (2011).
23. 17 C.F.R. § 205.2(a)(1)(iii) (2011).
24. Securities Act Release No. 8185, *supra* note 20.
25. Press Release No. 2002-158, SEC, SEC Proposes Rules to Implement Sarbanes-Oxley Act Provisions Concerning Standards of Professional Conduct for Attorneys (Nov. 6, 2002), *available at* <http://sec.gov/news/press/2002-158.htm>.
26. Securities Act Release No. 8185, *supra* note 20.
27. 17 C.F.R. § 205.3(a) (2011).
28. Kim, *supra* note 17, at 1034.
29. 17 C.F.R. § 205.3(b)(1) (2011).
30. As discussed below, Part 205 facially preempts inconsistent state rules of legal ethics. *See infra* note 53.
31. § 205.3(b)(1).
32. 17 C.F.R. § 205.3(b)(3) (2011).
33. Securities Act Release No. 8185, *supra* note 20.
34. 17 C.F.R. § 205.3(b)(8) (2011).
35. To be sure, § 205.3(b)(4) allows attorneys to bypass management and go directly to the board to report misconduct if it would be futile to report to the CEO or CLO. The problem with that provision may be best illustrated by an example. Suppose attorney Anne suspects wrongdoing by the CEO. Knowing full-well that reporting the CEO’s wrongdoing to the CEO and/or the CLO would be pointless, but considering that the “futility provision” is only discretionary, Anne may choose to talk to the CEO and CLO rather than go over their heads to the Board for fear of alienating those individuals. If there is any risk that Anne is mistaken about the wrongdoing, going over the heads of the CEO and CLO will permanently poison her relationship with them. If Anne opts to first speak to the CEO or CLO, and they give Anne her statutorily mandated assurance that the problem is being investigated and reasonably resolved, Anne has fulfilled her duties. Yet, the CEO and CLO may be allowed to continue their misconduct.
36. The standard is (confusingly) defined as “credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.” 17 C.F.R. § 205.2(c) (2011).
37. 17 C.F.R. § 205.3(b)(2) (2011).
38. § 205.2(c).
39. Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CAL. L. REV. 1051, 1091 (2000).
40. Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry Into Lawyers’ Responsibility for Clients’ Frauds*, 46 VAND. L. REV. 75, 101 (1993).

41. See generally Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons?*, 48 VILL. L. REV. 1097 (2003).
42. *Id.* at 1115.
43. In addition, lawyers will very rarely perceive their own situation to fall within the third scenario. As former Delaware Chancellor Allen aptly noted, albeit in a rather different context, “human nature may incline even one acting in subjective good faith to rationalize as right that which is merely personally beneficial.” *City Capital Assocs. v. Interco Inc.*, 551 A.2d 787, 796 (Del. Ch. 1988). It typically is personally beneficial for lawyers to refrain from antagonizing the corporate managers who hire and fire them. Hence, absent the proverbial smoking gun, we can expect lawyers to turn a blind eye to indicia of misconduct by those managers. Section 307 does too little to change those incentives.
44. See Securities Act Release No. 8185, *supra* note 20 (summarizing commentators’ views).
45. See, e.g., Mark Maremont, *Rite Aid Case Gives First View of Wave of Fraud on Trial*, WALL ST. J., June 10, 2003, at A1 (describing the “great lengths” to which defendants went in order to “hide their tracks”).
46. See Securities Act Release No. 8185, *supra* note 20 (summarizing commentators’ views).
47. If counsel cannot be bypassed, management may seek to intimidate them. The Enron abuses long went undetected, in part, because Enron management “either overruled or intimidated” subordinates. Steven L. Schwarcz, *Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures*, 70 U. CIN. L. REV. 1309, 1317 (2002). In-house counsel may be particularly vulnerable to such pressures.
48. Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 31 (2002).
49. Schwarcz, *supra* note 47, at 1313.
50. Lawrence A. Cunningham, *Sharing Accounting’s Burden: Business Lawyers in Enron’s Dark Shadows*, 57 BUS. LAW. 1421, 1422 (2002). In the selective disclosure context, the SEC acknowledges that: “In many cases, an issuer’s chief financial officer or investor relations officer may have a keener awareness than company counsel of the significance of information to investors.” Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: Motorola, Inc., Exchange Act Release No. 46,898 (Nov. 25, 2002), *available at* <http://www.sec.gov/litigation/investreport/34-46898.htm>. In my view, the qualifiers “many” and “may” were unnecessary.
51. *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 969–70 (Del. Ch. 1996).
52. Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C. § 7241 (2006).
53. Such radical reforms also would have conflicted with legal ethics rules of many states. The Part 205 regulations facially preempt state rules of professional conduct, however. 17 C.F.R. §§ 205.6(b)–(c) (2011). Accordingly, where there is conflict between a state’s rules and Part 205, the latter prevails, unless the state imposes a more stringent obligation upon its attorneys that is consistent with Part 205. Attorneys who comply with the Regulation’s procedures in good faith will be immune from liability for violating state ethics rules that conflict. As a result, the organized bar likely would be pressured to square its rules with those promulgated by the SEC.