ENRON—WHERE WERE THE LAWYERS?

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INTRODUCTION

Sweeping securities law and corporate governance reforms enacted by Congress during the summer of 2002 and subsequent initiatives by the Securities and Exchange Commission (the SEC) make attorneys more responsible for thwarting corporate wrongdoing. However, the new rules and proposals raise difficult and challenging questions, and may change the landscape of attorney–client relationships for the corporate lawyer.

I. WHERE WERE THE LAWYERS?

In the wake of Enron, WorldCom, Tyco, and other recently disclosed corporate scandals, a question is often asked—"where were the lawyers?" Make no mistake, the lawyers were there, and the lawyers were asleep at the switch. Prominent law firms, in particular Houston's Vinson & Elkins L.L.P., are now being sued in several Enron shareholder derivative suits and class actions.[1] The suits against Vinson & Elkins allege that the law firm, which had to have been aware of various—now questionable—Enron transactions, including personal involvement of individual Enron officers and employees, participated in Enron's fraud by structuring, negotiating, and giving advice with respect to these transactions, as well as drafting documents and preparing SEC disclosure filings.[2] Yet, the lawyers did nothing to stop these transactions or even insist on proper disclosure.[3] Among their defenses, the lawyers assert that because the company's officers and its accountants concluded that certain transactions, such as special purpose entities and other off-the-books operations, did not have to be reflected on Enron's financial statements, the lawyers had no reason to

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1. *See, e.g.*, *In re* Enron Corp. Securities, Derivative and ERISA Litigation, 235 F. Supp. 2d 549 (S.D. Tex. 2002).

2. *Id.* at 565.

3. *Id.* at 705. On December 20, 2002, U.S. District Court Judge Melinda Harmon refused to dismiss Vinson & Elkins from the case, holding that "in light of its alleged voluntary, essential, material and deep involvement . . . Vinson & Elkins was not merely a drafter, but essentially a co-author of the documents it created for public consumption concealing its own and other participants' actions." *Id.* This ruling is now on appeal. *Enron Defendants Ask 5th Circuit to Dismiss Case*, 8 ANDREWS SEC. LITIG. &REG. REP. 3 (Mar. 12, 2003), *available at* WL 8 No. 21 ANSLRR 3.

press the issues of propriety, public disclosure, and whether failure to disclose was a violation of securities laws.[4] In short, they assert they had no reason and no obligation to challenge their client.

Yet the lawyers could have acted before matters got out of hand. They could have looked to learn what was really happening and warned corporate leadership about what they had found.[5] If the facts and circumstances of transactions with no substantial business purpose "suggest that their sole function is to give the balance sheet a false boost," legal questions are raised that do not evaporate because accountants and corporate managers are also making judgments.[6] Shortly after the Enron debacle came to light, the American Bar Association Task Force on Corporate Responsibility published a comment worth noting. It wrote:

> [I]t is a clear failure of corporate responsibility when outside directors, auditors, and lawyers, who have important roles in our system of independent checks on the corporation's management, fail to avert or even discover—and sometimes actually condone or contribute toward the creation of—the grossest of financial manipulations and fraud.[7]

It is in this context that Congress reacted to the question—"where were the lawyers?"

II. SECURITIES LAW REFORM

As part of its sweeping securities law reform legislation, in the form of the Sarbanes–Oxley Act of 2002 (the Act), Congress directed the SEC to adopt regulations pertaining to the conduct of corporate lawyers by January 26, 2003.[8] Section 307 of the Act[9] mandated that the SEC issue rules

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4. *Id at* 704–05.

5. *See Financial Collapse of Enron Corp.: Hearing Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce*, 107th Cong. 7 (2002) (prepared statement of Rep. W.J. Tauzin, Chairman, House Comm. on Energy and Commerce), *available at* http://energycommerce.house.gov (last visited Apr. 13, 2003).

6. Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, 58 BUS. LAW. 143, 167 (2002).

7. James H. Cheek et al., *Preliminary Report of the American Bar Association Task Force on Corporate Responsibility: July 16, 2002*, 58 BUS. LAW. 189, 192 (2002), *available at* http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf (last visited Apr. 13, 2003).

8. Sarbanes–Oxley Act of 2002, 15 U.S.C.A. §§ 7201–7266, 78o-6, 78d-3, 18 U.S.C.A. §§ 1348–1350, 1519–1520, 1514A (West Supp. 2003). This legislation was passed almost unanimously by Congress and signed into law by President Bush on July 30, 2002.

9. 15 U.S.C.A. § 7245 (West Supp. 2003).

prescribing "minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way" in the representation of public companies.[10] This mandate included a provision requiring attorneys to report evidence of material violations of securities laws, breach of fiduciary duty, or similar violations by the issuer or any officer, director, employee, or agent "up the corporate ladder" within the company to the chief legal officer or the chief executive officer.[11] If those officers do not respond appropriately to such evidence, the attorney is required to report the evidence to the audit committee of the board of directors, another committee of independent directors, or to the full board of directors.[12] As an alternative to up-the-ladder reporting, if the issuer has established a "qualified legal compliance committee," consisting of independent directors with authority to consider and investigate attorney reports of material violations, the attorney may report directly to this committee instead of officers and the board.[13]

The requirement of up-the-ladder reporting addresses the difficult question—"Who is the lawyer's client?" The rule mandated by Congress is a reminder that the corporate lawyer represents the corporate entity as a whole, not particular executives.[14] As such, the lawyer is required to make certain that, if necessary, the board of directors is apprised of managerial conduct that might result in violation of law or breach of duty.

This is underscored by the pointed remarks made by Senator John Edwards of North Carolina, a sponsor of Section 307, introducing this legislation on the Senate floor:

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10. *Id.* The regulation, as adopted by the SEC in its final rule, is broad in reaching all attorneys "appearing and practicing before the Commission." 17 C.F.R. § 205.2(a) (2003). It includes not only representing clients in matters or proceedings before the SEC, but also preparing and giving advice with respect to disclosure documents and advising on securities laws and SEC rules and regulations regarding documents to be filed or as to whether information is required to be filed. *Id.* Public companies cover all companies that file reports with the SEC or have a pending registration statement for an offering of securities. *Id.* § 205.2(h).

11. *Id.* § 205.3(b)(1). Reporting violations up the corporate ladder is not a new concept. In 1981, in an SEC administrative action, the SEC called for lawyers who became aware that a client was engaged in substantial and continuing failure to satisfy disclosure requirements of federal securities laws to take prompt steps to avoid or end the client's noncompliance. In the Matter of Carter and Johnson, SEC Release No. 34-17597, 1981 Fed. Sec. L. Rep. (CCH) ¶ 82,847 (Feb. 28, 1981). Those prompt steps might include notifying the client's board of directors or resignation from representation. *Id.* But, what the lawyer ultimately did was up to him. *Id.*

12. 17 C.F.R. § 205.3 (2003).

13. *Id.* § 205.3(c)(1). This alternative was provided in the SEC's final rules adopting up-the-ladder reporting. *Id.* § 205.3(c).

14. *See id.* § 205.3(a) (stating that an "attorney appearing and practicing before the Commission in the representation of an issuer owes his or her professional and ethical duties to the issuer as an organization").

> 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 [and approving and paying their fees]. So as a result, that is with whom they have a relationship. . . . The problem is that the CEO and the chief financial officer are not the client. Their responsibility and the client they have to advocate for—and which they have an ethical responsibility to advocate for—is, in fact, the corporation, not the CEO or the chief financial officer.
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> One of the most critical responsibilities that those lawyers have is, when they see something occurring or about to occur that violates the law, breaks the law, they must act as an advocate for the shareholders, for the company itself, for the investors. . . . They know the law and their responsibility is to do something about it if they see the law being broken or about to be broken.
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> This amendment [Section 307] is about making sure those lawyers, in addition to the accountants and executives in the company, don't violate the law and, in fact, more importantly, ensure that the law is being followed. . . . If you find out that the managers are breaking the law, you must tell them to stop. If they won't stop, you go to the board of directors, which represents the shareholders, and tell them what is going on.[15]

The final rule as adopted by the SEC echoes Senator Edwards' comments, expressly providing that the lawyer owes his or her professional and ethical duties to the issuer *as an organization.*[16] "That the attorney may work with and advise the issuer's officers, directors, or employees in the course of representing the issuer does not make such individuals the attorney's clients."[17] On January 29, 2003, the SEC adopted its final rules implementing the Congressional mandate for up-the-ladder reporting.[18] The rule became effective on August 5, 2003.[19]

Many commentators have questioned various provisions of the up-the-ladder reporting rule, and challenging questions still linger. For example:

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15. 148 CONG. REC. S6551–52 (daily ed. July 10, 2002) (statement of Sen. Edwards).

16. 17 C.F.R. § 205.3(a) (2003).

17. *Id.*

18. The Final Rule, Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6296 (Feb. 6, 2003) (proposed by SEC Jan. 29, 2003) (to be codified at 17 C.F.R. pt. 205), *available at* http://www.sec.gov/rules/final/33-8185.htm (last visited Apr. 13, 2003).

19. *Id.*

when does the attorney "become aware of evidence" of a material violation, which is the triggering standard provided in the final rule? Who determines "materiality?" Does the rule suggest that the attorney must make an independent investigation of management actions that were not revealed to the attorney?[20] Though these questions exist, most commentators agree that the objective of the rule is sound and even necessary to further corporate responsibility.

The SEC, however, in its original proposals for up-the-ladder reporting, surprised and somewhat alarmed the corporate bar, as well as many corporate issuers, in going well beyond the Congressional mandates of Section 307 of the Act.[21] The SEC would also require attorneys under certain circumstances to withdraw from representation of an issuer, to notify the SEC that they have done so, and to disaffirm documents filed or submitted to the SEC on behalf of the issuer.[22] This requirement has become known as "noisy withdrawal." The proposal would require attorneys to withdraw from representing the issuer, based on "professional considerations," if they have reported evidence of a material violation pursuant to up-the-ladder rules and have not received an appropriate response to their report, and reasonably believe that a violation is ongoing or about to occur and is likely to result in substantial injury to the financial interest or property of the issuer or investors.[23] After withdrawing, the attorney would be required to give written notice to the SEC and promptly disaffirm any opinion or document filed with the SEC that the attorney prepared or assisted in preparing that the attorney reasonably believes may be materially false or misleading.[24]

As an alternative proposal, the SEC would require the issuer (rather than the attorney) to report to the SEC, and to disclose publicly, an attorney's notice of withdrawal.[25] Importantly, in either case, the SEC would be advised that the attorney has withdrawn from representation for

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20. For example, hundreds of millions of dollars in loans to senior management of Tyco were not disclosed. John Freeman, *Lawyers and Corporate Disgrace*, S.C. LAW (Jan. 2003), WL 14-JAN SCLAW 9.

21. *Compare* 15 U.S.C.A. § 7245 (West Supp. 2003), *with* The Proposed Rule, Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6324 (Feb. 6, 2003) (proposed by SEC Jan. 29, 2003) (to be codified at 17 C.F.R. pts. 205, 240, and 249), *available at* http://www.sec.gov/rules/proposed/33-8186.htm (last visited Apr. 13, 2003).

22. The Proposed Rule, Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6324, 6326 (Feb. 6, 2003) (proposed by SEC Jan. 29, 2003) (to be codified at 17 C.F.R. pts. 205, 240, and 249), *available at* http://www.sec.gov/rules/proposed/33-8186.htm (last visited Apr. 13, 2003).

23. *Id.*

24. *Id.*

25. *Id.* at 6329.

"professional considerations."[26] A significant exception to the requirement of "noisy withdrawal" is provided with respect to issuers that have formed a qualified legal compliance committee to consider and investigate attorney reports of material violations.[27] In such cases, the attorney is not required to resign from representation following a report to such committee, leaving any further action to the committee.[28]

III. CONCERNS ABOUT "NOISY WITHDRAWAL"

Probably more than any other provision of the Act, the focus on lawyers has triggered intensive debate and lobbying from lawyers, including legal scholars and distinguished members of the legal profession, as well as corporate issuers. After its initial proposals, the SEC received a flood of letters commenting on and challenging the SEC's initiatives, particularly "noisy withdrawal." Some have challenged the SEC's authority to require "noisy withdrawal," and a repeated concern voiced by commentators is that the proposals will severely alter the traditional attorney–client relationship, to the detriment of lawyers, issuers, and the public.[29] As a result of this strong reaction and pressure from both lawyers and issuer clients, the SEC has deferred action on "noisy withdrawal" and has solicited additional comments.[30]

The strongly voiced concerns about the effect of "noisy withdrawal" on attorney–client relationships are well founded and should be heeded. The American Bar Association, in its Comment letter to the SEC, said that the provision for "noisy withdrawal" would "risk destroying the trust and confidence many issuers have up to now placed in their legal counsel, creating divided loyalties and driving a wedge into the attorney–client relationship."[31] Many commentators feel that the requirement of a "noisy

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26. *Id.* at 6326.

27. *Id.*; *see also supra* note 13 and accompanying text.

28. 17 C.F.R. § 205.3(c) (2003). This poses an interesting decision for the lawyer whether or not to recommend to his client to establish a qualified legal compliance committee, if for no other reason than to take the lawyer off the hook from having to resign.

29. *E.g.*, Eleven Persons or Law Firms, Comments on Proposed Rules Relating to Implementation of Standards of Professional Conduct for Attorneys, Release No. 33-8150, 34-46868 (Dec. 23, 2002), *available at* http://www.sec.gov/rules/proposed/s74502/jagrundfest1.htm (last visited Apr. 13, 2003) (noting that the proposed rules "cut to the core of the attorney–client relationship and propose a massive restructuring of traditional notions of professional responsibility").

30. The Proposed Rule, Implementation of Standards of Professional Conduct, 68 Fed. Reg. 6324, 6325 (Feb. 6, 2003) (proposed by SEC Jan. 29, 2003) (to be codified at 17 C.F.R. pts. 205, 240, and 249), *available at* http://www.sec.gov/rules/proposed/33-8186.htm (last visited Apr. 13, 2003). The comment period ended on April 7, 2003. *Id.*

31. American Bar Association, Comments on Proposed Rules Relating to Implementation of Standards of Professional Conduct for Attorneys, Release No. 33-8150, 34-46868 (Dec. 18, 2002),

withdrawal" by outside counsel would have a chilling effect upon the willingness of inside counsel and the corporation's business leaders to engage and confide in their legal advisors, particularly at the time when outside legal advice may be most needed.[32] And, if clients are afraid to confide candidly and completely in their counsel and instead proceed without legal advice, it will be the public who will be harmed.[33] Significantly, it is feared that any "noisy withdrawal" for "professional considerations" will likely trigger a prompt visit by the SEC to the client's doorstep. Even the possibility of such result may effectively force a client to acquiesce in following the lawyer's advice even if in good faith it strongly disagrees with such advice and the advice may even be wrong or at least debatable.[34] Instead of viewing lawyers as confidential and trusted advisers, clients may begin to view their counsel as agents of the SEC.[35] This raises the question: Will "noisy withdrawal" effectively turn lawyers into whistleblowers against their clients, impinging on the attorney–client privilege, which traditionally has been left to state professional responsibility and ethics laws? Nevertheless, despite these objections, it is expected that some form of "noisy withdrawal" will make it into the final rules.[36]

CONCLUSION

Lawyers, unlike accountants, are perceived as advocates, who are supposed to support and fight for their clients, not blow the whistle on them. That view is correct, but it is also part of the problem. Lawyers cannot confuse their role as advocates in litigation or adversary negotiations with "the need of corporate clients for independent, objective legal advice" to the corporate entity in the course of corporate decision making.[37] Reporting evidence of violations of law and breach of fiduciary duty by

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available at http://www.sec.gov/rules/proposed/s74502/apcarlton1.htm (last visited Apr. 13, 2003).

32. International Paper Company, Comments on Proposed Rules Relating to Implementation of Standards of Professional Conduct for Attorneys, Release No. 33-8150, 34-46868, *available at* http://www.sec.gov/rules/proposed/s74502/jpmelican1.htm (last visited Apr. 13, 2003).

33. 77 Law Firms, Comments on Proposed Rules Relating to Implementation of Standards of Professional Conduct for Attorneys, Release No. 33-8150, 34-46868 (Dec. 18, 2002), *available at* http://www.sec.gov/rules/proposed/s74502/77lawfirms1.htm (last visited Apr. 13, 2003).

34. *Id.*

35. Sullivan & Cromwell, Comments on Proposed Rules Relating to Implementation of Standards of Professional Conduct for Attorneys, Release No. 33-8150; 34-46868 (Dec. 18, 2002), *available at* http://www.sec.gov/rules/proposed/s74502/sullivanc1.htm (last visited Apr. 13, 2003).

36. Douglas McCollom, *Speak No Evil*, THE DEAL, Feb. 17, 2003, at 18. "Practitioners and regulators alike would tell you there are still important principles at stake. They're both right." *Id.*

37. Cramton, *supra* note 6, at 173.

management to the board of directors and requiring an appropriate response fulfills this need.

The new up-the-ladder rules and "noisy withdrawal" rule proposals raise many difficult questions and indeed may change the landscape of attorney–client relationships. Would these rules have prevented or minimized the kind of wrongdoing alleged in the shareholder cases against Enron and its outside counsel? Vinson & Elkins has argued that it only drafted documents. As such, it had only a minimal role in its client's allegedly fraudulent transactions.[38] Minimal role or not, if the SEC's proposed rules were then in place, Vinson & Elkins would have been required to advise Enron's board of directors as soon as it got wind of the fraud[39] and, if remedial action was not taken, it would have had to publicly resign[40]—even from its largest client.

38. *In re* Enron Corp. Securities, Derivative and ERISA Litigation, 235 F. Supp. 2d 549, 704 (S.D. Tex. 2002).

39. Competent lawyers in the exercise of reasonable care generally will get at least a hint of wrongdoing at some point in the transaction.

40. Francis A. McMorris, *The World According to Sarbanes–Oxley*, THE DEAL, Feb. 17, 2003, at 12–13.