

Fraud is the Moving Target, Not Corporate Securities Attorneys: The Market Relevance of Firing Before Being Fired Upon and Not Being “Shocked, Shocked” That Fraud is Going On

A Response to Marc Steinberg

Marianne M. Jennings*

I. INTRODUCTION

It is only surprising that investors, creditors, and other private claimants are targeting lawyers for recovery of their corporate fraud losses because it took decades of scandals for these private claimants to realize the potential in this untapped resource.¹ Given the massive corporate collapses of the past five years as well as the congressional demands built into Sarbanes-Oxley (SOX), the Securities and Exchange Commission’s (SEC) longstanding restraint in pursuing inside and outside corporate counsel has perhaps been shamed into submission.² Enron’s former outside counsel, Vinson & Elkins, recently settled class action suits brought against it for \$30 million; this settlement has raised concerns in the legal community.³ With 100 companies now under scru-

* Professor of Legal and Ethical Studies, W.P. Carey School of Business, Arizona State University. Author of *THE SEVEN SIGNS OF ETHICAL COLLAPSE: HOW TO SPOT MORAL MELTDOWNS IN ORGANIZATIONS BEFORE IT’S TOO LATE* (2006).

1. Sheri Qualters, *The Next Backdating Target May Be Firms*, NAT’L L. J., July 31, 2006, at 1, 17.

2. The SEC promulgated rules that provide specific direction for legal counsel (both internal and outside) when a client is about to issue a materially false financial report, such as a 10K or 10Q. See Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6296 (Feb. 6, 2003) (adding Part 205, or “Final Attorney Rules,” to Title 17 of the Code of Federal Regulations). Outside counsel for companies (who assist in the preparation of 10Ks and 10Qs) also have up-the-ladder reporting requirements. If the company has a “qualified legal compliance committee” (QLCC), the rules require outside counsel to report material issues to that QLCC. If the company does not have a QLCC, then outside counsel must report “forthwith” the evidence of the impending material violation to either “the issuer’s chief legal officer [CLO] . . . or to both the issuer’s [CLO] and its [CEO].” 17 C.F.R. § 205.3(b)(1) (2003). The CLO, whether uncovering the information himself or herself or learning of it through other employees, compliance program reporting systems or outside counsel, must then conduct an investigation to determine whether the allegation raised about the potential securities violation has a foundation in fact. If the CLO does not report the matter to the audit committee, then outside counsel is obligated to do so. The SEC stopped short of requiring outside counsel to make a “noisy withdrawal” or disavow the financial statements when the client company and/or CLO have taken no steps to remedy what outside counsel feels is a material issue. See *id.*

3. There are more details on the Vinson & Elkins role in Enron’s behaviors and collapse in

tiny for the backdating of options awarded to investigators, shareholders have made it clear that they believe outside counsel was aware of their clients' backdating practices.⁴ This revelation of option skullduggery has resulted in restatements for the periods of backdating.⁵ Indeed, the termination of general counsel at several of the companies now under scrutiny for backdating seems to indicate a level of participation, including even the drafting of the stock option plans for executives.⁶ The criminal trials of executives and bankers who were bystanders in corporate fraud have resulted in questions about the wisdom of this deference to counsel, which may be the last bastion of corporate immunity.⁷ The recent decision in *Simpson v. AOL Time Warner, Inc.*⁸ demonstrates further chipping away at the immunity of third parties who are bystanders and more when, to paraphrase the popular phrase, "fraud happens."⁹

Part II. See *infra* notes 41-45 and accompanying text.

4. Qualters, *supra* note 1, at 17.

5. *Id.*

6. For example, the general legal counsel and corporate secretary, William F. Sorin, of Comverse, resigned in May 2006, and federal charges are expected in the case. In May 2006, Comverse's board uncovered instances in which options "grant dates did not match," and the board discovered that there was an options re-pricing program. Corporate governance watchdog groups had raised the issue prior to the investigation and the backdating is believed to go back to 2001. Julie Creswell & David Dash, *Charges Expected on Options*, N.Y. TIMES, Aug. 4, 2006, at C1, C2. Three former executives with Brocade Communications have been charged (not including legal counsel), the first criminal charges in the options cases. Edward Iwata, *Ex-Brocade Execs Charged in Stock Case: Federal Officials Looking into Options Issues*, USA TODAY, July 21, 2006, at 1B.

7. See Kurt Eichenwald & David Barboza, *Enron Criminal Investigation Is Said to Expand to Bankers*, N.Y. TIMES, June 26, 2002, at A1. Daniel H. Bayly, formerly the head of investment banking at Merrill Lynch was convicted of conspiracy to defraud investors for his role in arranging for the purchase of three Nigerian barges from Enron. Bayly was sentenced to 30 months in prison and has indicated that the Nigerian barge deal consisted of a five-minute phone conversation. The verdicts, without exception, were later reversed. *United States v. Brown*, 459 F.3d 509 (5th Cir. 2006). The government called the agreement a wink-and-nod one in which those involved (including three others) were aware that there was no risk transferred to Merrill and that the transaction was one used to simply bolster Enron earnings. Referred to as "over-reaching" by prosecutors, the charges and verdict have been, according to prosecutors, a signal that professionals cannot look the other way when they understand the intent and purpose of a transaction. Landon Thomas, Jr., *Deals and Consequences*, N.Y. TIMES, Nov. 20, 2005, at 31. Three British bankers were also charged with criminal fraud for their involvement with South Hampton L.P., a partnership with Andrew Fastow, Enron's former CFO, as a principal. Kurt Eichenwald, *3 British Bankers Are Accused of Fraud in Offshoot of Enron Case*, N.Y. TIMES, June 28, 2002, at C14. The dust-up there continues as extradition issues are tackled. In addition to the criminal charges, there are the civil settlements by bankers. Citigroup paid \$2 billion to settle with Enron investors. Julie Creswell, *Citigroup Agrees To Pay \$2 Billion in Enron Scandal*, N.Y. TIMES, June 11, 2005, at A1.

8. 452 F.3d 1040 (9th Cir. 2006).

9. The court noted:

We conclude that conduct by a defendant that had the principal purpose and effect of creating a false appearance in deceptive transactions as part of a scheme to defraud is conduct that uses or employs a deceptive device within the meaning of § 10(b). . . . Finally, a plaintiff may be presumed to have relied on this scheme to defraud if a misrepresentation, which necessarily resulted from the scheme and the defendant's conduct therein, was disseminated into an efficient market and was reflected in the market price.

Id. at 1052. The basic scheme was described by the court as follows:

Plaintiff alleges that Homestore entered into a series of sham transactions with various Third Party Vendors for some product or service that Homestore did not need. The Third Party Vendors would then contract with AOL for advertising on Homestore's website and AOL would give this money back to Homestore under their advertising reseller agreement. Both the Third Party Vendors and AOL would keep a portion of the money as a commis-

In that case, the court permitted the plaintiffs to amend their complaints in order to include outside vendors as defendants in their Section 10(b) litigation for the outside vendors' roles in the overstatement of their buyer's (Homestore's) revenue.¹⁰

Lawyers who provide counsel to businesses and other organizations have operated within this civil, criminal, and regulatory hands-off land because of the following protections that have been built into the ethical rules: the asserted and theoretical need for client confidence, the highly technical definitions related to materiality and fraud, and the strong lobbying by the American Bar Association (ABA) and other professional groups.¹¹ The resulting ethical rules and statutory and regulatory standards have curbed the need for the development of definitive pre-fraud responsibilities and non-codified ethical accountability on the part of corporate counsel.¹² Corporate counsel and their professional and oversight bodies have operated with tunnel vision regarding their roles vis-à-vis business organizations and other corporate structures (such as nonprofits). This tunnel vision springs from an over-reliance on complex definitions, technical rules, and a fundamental misunderstanding of the unique role of the lawyer in the business and organizational contexts. Tragically, the effect of the legal immunity and professional constraints is the creation of amoral technicians who draft paperwork without disclosing pertinent background information, who conduct investigations and issue findings according to client-imposed limitations, and who feel comfortable with the rationalization that to do otherwise would force clients to be less than candid with them.

The professional and regulatory rules that govern the lawyer-client

sion.
Id. at 1044.

10. *See id.* at 1043.

11. For a complete history of the SOX rules passage and the ABA role, *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. LEGAL ETHICS* 35, 41-43 (2003).

12. The use of the term "corporate counsel" is intended to include all lawyers who provide counsel, both inside and outside counsel, to corporations (including securities-related matters), as well as lawyers for other types of entities, including nonprofit and charitable organizations. All of these have had their share of legal difficulties, mostly fraud; some embezzlement. *See, e.g., Arizona Law Firm Pays \$21 Million, Denies Role in Baptist Foundation Collapse*, 34 *SEC. REG. & L. REP.* (BNA) 802 (2002) (Baptist Foundation of Arizona and what amounted to a Ponzi scheme involving real estate investments); Steve Secklow, *Feeding the Frenzy: A New Era Consultant Lured Rich Donors Over Pancakes, Prayers*, *WALL ST. J.*, June 2, 1995, at A1 (New Era was a philanthropic foundation for nonprofit endowment investments that promised to double the amount invested, a concept that worked for those who entered at the beginning of what amounted to a Ponzi scheme); Karen W. Arenson, *Former United Way Chief Guilty of Theft of More Than \$600,000*, *N.Y. TIMES*, April 4, 1995, at A1 (Former United Way CEO, William Aramony and others were convicted of using the nonprofit as a till from which withdrawals could be made for hiring unqualified people, Concorde flights, Florida condos and all else associated with the high life at the expense of donors and without the board's knowledge). These examples illustrate, as this article will explain, that lawyers for organizations and business entities, corporate and otherwise, face similar challenges in grappling with conduct, decisions, individual roles in such, and the tall order of gaining effective communication and information within them.

relationship read as if attorneys are in situations in which they are counseling Michael Corleone on his planned murder of Fredo.¹³ True enough, Michael's lawyer should speak up at the point of Michael's planned execution of Fredo, in both the interests of Fredo's life as well as in honoring the professional responsibility rules that require counsel to put the big kibosh on planned crimes. However, despite the awkwardness and impact on client retention, being Michael's lawyer at the point of the announced Fredo plan means an ultimatum presented to Michael that includes withdrawal, noise and all. But the greater concern—one that is lost in the great “to disclose or not to disclose debate”—is that legal ethics experts and lawyers fail to realize that they are in that position because they have turned a blind eye to all the developments and conduct that led to the plans for Fredo's demise. This is surely the ultimate rejection of the brother's keeper concept. The question is not “to disclose or not to disclose;” the question is, “how did you get into this position of forced disclosure in the first place?” Fraud has many steps along the path to full-blown Ponzi scheme, yet the rules address the lawyer's conduct at the point of fraud, noisy withdrawal, and all-but-the-weapon-aimed-point in Fredo's death.¹⁴ And, those rules are piously grounded in the nobility of effective representation.

Lawyers who serve as corporate counsel play a role differing from the role conceived in the drafting of the ethical standards of the ABA. Indeed, even in the rules that specifically address corporate counsel issues there is a superficial understanding of the evolution of fraud and financial reporting. Corporate counsel is not a criminal defense lawyer simply confronting a client who has stated, “I am going to kill Fredo.” Corporate counsel does not have the luxury of such defining mens rea moments. Executive meetings do not find VPs and CEOs declaring, “Fraud. That's the way to make money in business. There's our strategic plan.” Indeed, corporate counsel does not even enjoy the luxury of a

13. THE GODFATHER II (Paramount Pictures 1974). The script was written by Mario Puzo and Francis Ford Coppola, who also directed the film that would win the Academy Award for best picture that year. Michael learned that Fredo set him and his family up for a real battering with bullets and, just like any other enemy, must be destroyed. But, he does keep his enemy closer than his friends as he indicates his plan to Consigliere/lawyer/adopted brother Tom Hagen with, “I don't want anything to happen to him [Fredo] while my mother's alive,” and to Fredo himself with, “I know it was you, Fredo -- you broke my heart -- you broke my heart,” and “Fredo you're nothing to me now[,] you're not a brother, you're not a friend, I don't want to know you or what you do.” The Godfather Part II Transcript, <http://www.jgeoff.com/godfather/gf2/transcript/gf2transcript.html>. (last visited September 29, 2006).

14. Professor Steinberg makes reference to Judge Sporkin's comment that asked where the lawyers were as all the fraud was progressing in the savings and loan industry. See Marc I. Steinberg, *The Corporate/Securities Attorney as a “Moving Target” - Client Fraud Dilemmas*, 46 WASHBURN L.J. 1, 2 n.6 (2006). In this series of scandals, a member of Congress used more colorful language. Representative Edward J. Markey (D., Mass) accused Mr. Skilling of using “the Sergeant Schultz defense of ‘I see nothing, I hear nothing.’” Stephen Labaton & Richard A. Oppel Jr., *Enron's Many Strands: The Overview; Testimony of Enron Executives is Contradictory*, N.Y. TIMES, Feb. 8, 2002, at A1, C4.

one-on-one conversation with the perpetrator. The perpetrators of organizational fraud must have accomplices, and one of the accomplices may be saying, "Under FASB, we are well within the guidelines." Discernment is the greater part of valor when it comes to the role of corporate counsel. If a lawyer has reached the point of debating, "To blow the whistle or not to blow the whistle," there are two conclusions. One is that the lawyer has missed signals of evolving fraud along the way. Another is that the lawyer turned a blind eye to those obvious signals. Many of the case discussions in the next segment verify that the blind eye is a phenomenon in legal representation in corporate securities law. If the first conclusion applies, the resolution is training for corporate counsel in discernment, detection, and even in financial accounting. If the second conclusion on turning a blind eye applies, then corporate counsel deserves the culpability. As discussed in Part III, free markets cannot perform their discerning functions well when there is immunity from consequences. Part II of this article explores the evolution of fraud in several organizations as well as in the cases cited by Professor Steinberg in which lawyers enjoyed immunity. The explorations also provide a type of training tool for spotting fraud as the common factors in the cases emerge. Part III explores the flaws in the reasoning in both the law and ethical principles in granting counsel immunity from third party liability. Part IV provides suggestions for both the liability standards as well as what will be necessary for the development of lawyerly moral compasses and individual certitude in drawing lines for clients as a fraud evolves.

The bird's eye view, sans tunnel vision, of all of the immunity, duty, and angst-ridden discussions on whistle-blowing is that those in the role of corporate counsel want rules that allow them to continue as corporate counsel until a definitive moment. If they behave according to rules at that definitive moment, regardless of what has happened up to that point, they expect and enjoy protection from civil or criminal liability. But the greater issue is a question of ethics, not in the sense of professional rules ethics, but rather in the sense of moral obligation. The result of all the technical focus and hand-wringing over disclosure is that the one area that should be explored in great depth remains unexplored. The applicable rules and regulations carry the presumption that the lawyer is "shocked, shocked," that fraud is going on in an organization.¹⁵

15. CASABLANCA (Warner Brothers 1942). The quote is part of an exchange in the film in which the local police raid Rick Lazlo's place to "round up the usual suspects":

Captain Renault: I'm shocked, shocked to find that gambling is going on in here!

[*a croupier hands Renault a pile of money*]

Croupier: Your winnings, sir.

Captain Renault: [*sotto voce*] Oh, thank you very much.

Memorable Quotes from Casablanca (1942), <http://www.imdb.com/title/tt0034583/quotes> (last visited Oct. 21, 2006).

Effort is better spent in exploring why corporate counsel are shocked; not when and why corporate counsel should have liability.

Fraud evolves. Rather than protection and immunity, corporate counsel need two skills: (1) the ability to spot fraud as it is cooking; and (2) the ethical gumption to walk away unless the corporate client resolves an issue in an ethical manner or abandons a line of conduct that takes it down fraud's path (although not quite yet at its door). Professor Steinberg offers a brilliantly detailed, accurate, and technical discussion of the role of counsel at the *mens rea* moment.¹⁶ But, his proposed resolution yet again redirects lawyers away from solutions. Indeed, his suggestion of seeking a second opinion helps us avoid the two-part training with, in essence, "Let's get two lawyers in on the situation so that both of us can enjoy a sense of comfort until the breaking point."

Because of the unique role lawyers who serve as corporate counsel play, the issue that should be explored is not the hyper-technicality of when a fraud is a fraud and when to disclose a fraud and to whom, but rather, how can a lawyer serving as corporate counsel work to prevent the evolution of fraud? The bulk of the debate centers on the steps lawyers should take once an organization is in fraud territory. The second opinion proposal would bring more lawyers along for the ride but does not solve the problems inherent in serving as corporate counsel. Further, professional organizations and individual lawyers fail to grasp that the drive to seek immunity in corporate fraud cases only increases negative public perception of the profession. Fretting over being a moving target is reactionary, not visionary. Corporate counsel has a unique role to play in steering organizations down paths of honor. Fraud cannot be curbed when some of its players are immune from the buffetings of the market.

II. THE EVOLUTION OF CORPORATE FRAUD

With apologies to Tolstoy, all corporate frauds are alike.¹⁷ The types of fraud may vary. Fraud can result from embezzlement, abuse of financial reporting and audit standards, or just insider trading. While the types of frauds may differ, all frauds play out in the same way in organizations. There are common key elements in the evolution of a corporate fraud: (1) they do not generally begin as frauds; (2) the initial decisions can seem aggressive, but innocuous; (3) there are underlying reasons for the aggressive reporting and decision-making (either a highly successful organization that does not want to lose momentum or

16. See Steinberg, *supra* note 14.

17. LEO TOLSTOY, ANNA KARENINA 3 (Constance Garnett trans., Doubleday & Co. 1946) (1877). "[H]appy families are all alike; every unhappy family is unhappy in its own way." *Id.*

substantial benefits for those involved in the evolving fraud); (4) the initial decision evolves into many additional seemingly innocuous decisions that “pile on;” and (5) the fraud is not a surprise to those working within the organization.¹⁸ Several illustrations from some of the legendary frauds of business history illustrate how common the threads are. Each of these company-specific discussions highlights what should have been obvious. These examples illustrate that the conundrum of “to disclose or not to disclose” is a contrived situation resulting from inaction. The failure to offer counsel, strategic advice, and redirection—the essence of the role corporate counsel should be playing—played a role in the evolving frauds.

A. *Enron*

There is a long road between creating one Special Purpose Entity (SPE) off-the-books that conceals some debt exposure and issuing financial reports that reflect \$100 million in earnings when there is actually a \$21 million loss, not to mention \$1 billion in liabilities.¹⁹ Enron took its first step on the path to financial fraud through the initial decision to utilize FASB 125 in a manner that no one disputes was technically within the rule.²⁰

Arthur Andersen auditor David Duncan was concerned when Andrew Fastow first proposed an off-the-book entity.²¹ The issue of Fas-

18. Not a surprise, but most hung on to their stock because of a belief that their superiors could still pull it all off. Fraud may be fraud, but if we sail through it with a high stock price, “What, me worry?”

19. According to the testimony of its former head, David W. Delainey, Enron Energy Services, despite its phenomenal financial reports was, in reality, a “basket case.” Peter Elkind & Bethany McLean, *The Luckiest People in Houston: Why You Haven't—and Won't—See Some of Enron's Most Colorful Characters Anywhere Near This Trial*, FORTUNE, April 17, 2006, at 59.

20. FASB 125 (which no longer exists except in reformed and modified form as FASB 140), governs the consolidation of financial statements with regard to special purpose entities (SPEs). The rule provides that until the company owns 50% or more of the voting shares, consolidation reporting with the parent is not required. The problem was that Enron was advancing the funds for the remaining 51% of ownership so that other investors were only actually investing about 5% of the total funds needed for the entities and the remaining amount consisted of pledges from other off-the-book entities that were secured by Enron, although that security was not fully disclosed. Just understanding the layers of buy-backs, pledges, collateral, and security requires charts that Word cannot handle. For a full explanation of the structure see Marianne M. Jennings, *A Primer on Enron: Lessons From a Perfect Storm of Financial Reporting, Corporate Governance and Ethical Culture Failures*, 39 CAL. W. L. REV. 163 (2003).

21. *The Role of the Board of Directors in Enron's Collapse*, Rep. of the Permanent Subcomm. on Investigations of the S. Gov't Affairs Comm., S. REP. NO. 107-70 at 25-26 (2002) [hereinafter PSI Report]. Mr. Duncan emailed, on May 28, 1999, a message of inquiry about the Fastow proposal to Benjamin Neuhausen, a member of Andersen's Professional Standards Group in Chicago. Mr. Neuhausen responded, with some of the response in upper case letters for emphasis, “Setting aside the accounting, idea of a venture entity managed by CFO is terrible from a business point of view. Conflicts galore. Why would any director in his or her right mind ever approve such a scheme?” Mr. Duncan, wrote back to Mr. Neuhausen on June 1, 1999, “[O]n your point 1 (i.e., the whole thing is a bad idea), I really couldn't agree more. Rest assured that I have already communicated and it has been agreed to by Andy that CEO, General [Counsel], and Board discussion and approval will be a requirement, on our part, for acceptance of a venture similar to what we have been discussing.” *Id.*

tow's role was indeed taken to the board for approval because under Enron's code of ethics, there was both a general and a specific policy on conflicts of interest.²² The specific provisions that applied to the Fastow role were:

[N]o full-time officer or employee should: . . . Own an interest in . . . another entity which does business with . . . the Company, unless such ownership . . . has been previously disclosed in writing to the Chairman of the Board and Chief Executive Officer of Enron Corp., and such officer has determined that such interest or participation does not adversely affect the best interests of the Company.²³

Technically, under these rules, the CEO could waive the policy on conflicts. Apparently based on advice of counsel, the waiver for Fastow was a board agenda item (unanimously approved) at least three times.²⁴ The fraud at Enron was evolving, and not in a secretive way. It evolved in a manner that should have raised a few eyebrows of the experienced corporate counsel, whether in-house or outside.²⁵ The 1999 10-K, a document reviewed by in-house and outside counsel, contained the following disclosure under the mandatory, "related party transactions" discussion: "A senior officer of Enron is the managing member of LJM's general partner."²⁶ Further, the exhibits for two years of Enron's 10-Ks included a list of the off-the-book entities, all reviewed by both internal and external counsel.²⁷ As the off-the-book entities grew and the fraud with it, the flags became more obvious. Given the many flags, one of the questions that arose was the role of Enron's general counsel. Enron's general counsel during this time was James Derrick, and few of the post-collapse reports have offered a positive portrayal of his efforts.²⁸

22. The general conflicts principle provided:

Employees of Enron Corp., . . . are charged with conducting their business affairs in accordance with the highest ethical standards. An employee shall not conduct himself or herself in a manner which directly or indirectly would be detrimental to the best interests of the Company or in a manner which would bring to the employee financial gain separately derived as a direct consequence of his or her employment with the company.

Code of Ethics from Enron Management (July 2000), at 12 (on file with author).

23. *Id.* at 57.

24. See PSI Report, *supra* note 21, at 25. The board's approval was, as directors are quick to point out, a ratification of the CEO's actions, not a waiver of the code of ethics policy on conflicts. Actually, one board member argued that the board's action was an enforcement of the code of ethics, not a waiver because Fastow's actions could not be done without the approval. *Id.* at 25 n.49.

25. Indeed, at least one analyst raised a concern about the issues raised in the 10-K. John Olson, a research analyst, felt his questions about Enron were not answered adequately, and issued a warning, based on the information in the 10-K. Ken Lay complained about Mr. Olson to Olson's boss. *Houston's New Celebrity*, N.Y. TIMES, Jan. 21, 2002, at C8.

26. Jonathan Weil, *What Enron's Financial Reports Did - And Didn't - Reveal*, WALL STREET J., Nov. 5, 2001, at C1, C14 (discussing Enron's 1999 10-K).

27. By the time Enron collapsed, during the fall of 2001, it had over 3000 off-the-book entities, including 800 that were off-shore (with 771 in the Cayman Islands). The full list can be found in the 2000 10-K. See generally SEC Filings & Forms (EDGAR), <http://www.sec.gov/edgar.shtml> (last visited Oct. 21, 2006).

28. Indeed, Neal Batson's report for the bankruptcy court concludes that while Derrick and other lawyers at Enron may have factual and legal defenses, pursuing them for malpractice in their conduct related to the SPEs was appropriate. Final Report of Neal Batson, Court-Appointed Examiner, Appendix C: Role of Enron's Attorneys,

The bankruptcy report concluded that Derrick did little to investigate underlying legal issues when questions were presented to him and relied too much on the representations of others.²⁹ The report also concludes, regarding Derrick's presence at board meetings, "it appears that he rarely provided any legal advice to the board. Even when Derrick did advise the Enron Board . . . he failed to educate himself on the underlying facts or governing law."³⁰

There would be yet another defining moment prior to Enron's collapse that would involve legal counsel. Sherron Watkins, who eventually became one of *Time's* 2002 persons of the year for her role in bringing the financial situation of Enron to public light, was the newly appointed vice president for corporate development at Enron. As a former Andersen employee, she had some experience with accounting issues and financial reporting. In August 2001, in what would be the beginning of the final three months of Enron's highfalutin' existence, she discovered the large off-the-books structure.³¹ She began looking for another job because, as she would later explain, she believed the off-the-books SPEs to constitute "fuzzy" accounting and that either the company would collapse or she would be fired for her planned anonymous memo to raise the issues.³² The Watkins anonymous memo initially went to Kenneth Lay, then-chairman of Enron's board, and former CEO. Ms. Watkins did not send the memo to, or raise the same with, Jeffrey Skilling, Enron's then-CEO, or Andrew Fastow, its then-CFO, because, as she would later testify, "It would have been a job-terminating move."³³ When news of the memo spread like wildfire throughout the management ranks of the company, she did tell Mr. Lay that she was its author. Mr. Fastow reacted not with concern about the company's accounting practices or their public exposure but with concern that Ms. Watkins was seeking his job.³⁴ The late Mr. Lay asked Vinson & Elkins, Enron's outside counsel, to review the memo.³⁵ Vinson & Elkin's billings for Enron were \$30 million in 2001 and between \$35 and \$40 million in other years.³⁶ Vinson & Elkins investigated and

<http://www.enron.com/corp/por/pdfs/examinerfinal/NBFinalAppendixC1.pdf> [hereinafter Batson Report] (last visited Oct. 21, 2006).

29. *Id.* at 11.

30. *Id.*

31. See Jodie Morse & Amanda Bower, *The Party Crasher*, TIME, Dec. 30, 2002, at 54-55.

32. See *id.*

33. John Schwartz, *Enron's Many Strands: The Week That Was; Explanations From One Former Enron Official, Silence From Another*, N.Y. TIMES, Feb. 17, 2002, at 32.

34. Rebecca Smith, *Fastow Memo Defends Enron Partnerships and Sees Criticism as Ploy to Get His Job*, WALL ST. J., Feb. 20, 2002, at A3.

35. Vinson & Elkins settled claims made against it related to its sign-off on fraudulent deals for \$30 million. *Vinson & Elkins To Pay Enron \$30M Settlement*, NAT'L L. J., June 5, 2006, at 3.

36. Gary McWilliams & John R. Emshwiller, *Executives on Trial: Skilling Testimony May Come Today*, WALL ST. J., April 6, 2006, at C3; see also Reed Abelson, *Enron Board Comes Under a Storm of Criticism*, N.Y. TIMES, Dec. 16, 2001, at 34.

reported, “the facts disclosed through our preliminary investigation do not, in our judgment, warrant a further widespread investigation by independent counsel and auditors.”³⁷ This report was issued after Ms. Watkins had written a memo outlining exactly what was being done in terms of the Raptor partnerships. She had done her homework on the accounting and the LLPs and had even discussed the issues with Enron’s risk manager. On one document that described the Raptor transactions, something that Vinson & Elkins would have had access to, Ms. Watkins wrote by hand, “There it is! That is the smoking gun. You cannot do this!”³⁸ Ms. Watkins later testified, “My understanding as an accountant is that a company can never use its own stock to generate a gain or avoid a loss on its income statement.”³⁹

Max Hendricks III, a partner at Vinson & Elkins, testified at the Lay, Skilling criminal trial and indicated that the firm’s investigation consisted of nothing more than asking executives in the company whether Ms. Watkins’s allegations had any truth.⁴⁰ The firm did not contact any of the employees Ms. Watkins had named in the memo as feeling pressure to not raise issues about Enron’s accounting practices, financial reports, and financial condition.⁴¹ Mr. Hendrick testified that he “didn’t believe it was part of his ‘charge.’”⁴² The report indicated that Enron accounting was “creative and aggressive,” but that there was no “reason to believe it [was] inappropriate from a technical standpoint.”⁴³ As to Watkins’s allegations that there were side agreements on Enron’s responsibilities for the off-the-book transactions, Vinson & Elkins accepted Fastow’s adamant denials of such deals without further verification or discussions with the parties that would have been involved in the discussions on Enron’s ultimate liability. Further, Vinson & Elkins accepted the denial after learning from David Duncan that if the allegations were true, such guarantees would alter fundamentally and materially the Enron financial statements and bring into question Enron’s viability as an ongoing entity.⁴⁴ Despite this limited investiga-

37. Peter Behr & April Witt, *Concerns Grow Amid Conflicts; Officials Seek to Limit Probe, Fallout of Deals*, WASH. POST, July 30, 2002, at A1; see also Steve Liesman, Jonathan Weil & Scot Paltrow, *Enron Crisis Puts Spotlight on FASB*, WALL ST. J., Jan. 18, 2002, at C1; McWilliams & Emshwiller, *supra* note 36.

38. Morse & Bower, *supra* note 31.

39. Tom Hamburger, *Enron Official Tells of ‘Arrogant’ Culture*, WALL ST. J., Jan. 17, 2002, at A3-4; see also Marianne M. Jennings, *The Disconnect Between and Among Legal Ethics, Business Ethics, Law, and Virtue: Learning Not to Make Ethics So Complex*, 1 U. ST. THOMAS L.J. 995, 998-1005 (2004).

40. McWilliams & Emshwiller, *supra* note 36.

41. Letter from Max Hendricks, III, Partner, Vinson & Elkins, L.L.P., to James Derrick, Jr., General Counsel, Enron (Oct. 15, 2001) [hereinafter V & E Letter] (on file with author). The full scope of Vinson & Elkins review is evident in its letter regarding the investigation into the Watkins’s memo. *Id.*

42. McWilliams & Emshwiller, *supra* note 36.

43. V & E Letter, *supra* note 41.

44. *Id.*

tion and the bizarre conclusions on the accounting practices, Vinson & Elkins would issue a clean bill of health that Enron executives would use to quell the growing rebellion among critics and investors about the health of the company and its accounting practices.⁴⁵ Indeed, the only concerns Vinson & Elkins expressed were: (1) Arthur Andersen would need additional reassurance on the oral guarantees; (2) Ms. Watkins should be told that they found no substance to her allegations; and (3) all the Raptor transactions had “[p]otential [b]ad [c]osmetics . . . if subjected to a Wall Street Journal exposé or class action lawsuit.”⁴⁶

Following both the Watkins memo as well as the Vinson & Elkins report, Mr. Lay asked the firm to offer advice on how Ms. Watkins might be terminated.⁴⁷ The signals were not of siren level, but a respected professional who was a senior officer had raised legitimate accounting questions and now was a target for termination. James Derrick did not familiarize himself with the content of the Watkins memo or follow up with an internal, albeit limited, inquiry on the concerns it raised.⁴⁸ Even if Ms. Watkins’s concerns were not well-founded, the practice of terminating those who raise good-faith concerns has not been counted among corporate best practices since the days of Charles Keating and the savings and loan collapses.⁴⁹ Indeed, part of Ms. Watkins’s advice to Mr. Lay was that he fire Vinson & Elkins for being complicit with Fastow in the structuring of all of the off-the-book entities and transactions.⁵⁰ Ms. Watkins’s assumption was that Mr. Lay had been duped by Skilling, Fastow, and Vinson & Elkins.⁵¹

45. *Id.* Few are aware that Enron used another law firm, Andrews & Kurth, for many of the FASB 125/140 off-the-book transactions between 1998 and 2001. The bankruptcy report also recommends pursuit of the firm for malpractice. Specifically, the Batson Report concludes that Andrews & Kurth knew that Enron had no intention of transferring control of assets that were the basis for the sales transactions between and among the various entities and Enron. Batson Report, *supra* note 28.

46. V & E Letter, *supra* note 41. Securities fraud has been called many things, but “bad cosmetics” is a new and colorful one. Mr. Hendrick was the signatory on the letter. There are those who argue that Vinson & Elkins’ conclusion was inevitable because the direction from James Derrick was that Vinson & Elkins was not to conduct discovery and not to question Andersen’s underlying decisions and assumptions. So constrained, Vinson & Elkins concluded that they found nothing. See Sung Hui Kim, *The Banality of Fraud: Re-situating the Inside Counsel as Gatekeeper*, 74 *FORDHAM L. REV.* 983 (2005). However, that argument presumes that Vinson & Elkins was acting in a vacuum. Given its previous questions and concerns (*see supra* text accompanying note 45), it had to ignore individual partner concerns about the same issues Watkins was raising.

47. Jeff Franks, *Whistle-Blower Says Lay Did Little to Save Enron*, Reuters, March 16, 2006, available at <http://www.tiscali.co.uk/news/newswire.php/news/reuters/2006/03/16/business/whistle-blower-says-lay-did-little-to-save-enron.html>. Ms. Watkins was right on Fastow and Skilling, in terms of termination potential, but did not see Lay’s reaction coming.

48. Batson Report, *supra* note 28.

49. For more discussion on the lessons from these frauds, see *infra* notes 170-178 and accompanying text.

50. Greg Farrell, *Watkins Set To Take the Stand Today: Former Exec Wrote Famous Enron Memo*, USA TODAY, March 15, 2006, at 3B.

51. Ironically, Ms. Watkins was not a bad legal theorist. Had Lay dumped Skilling, Fastow, and Vinson & Elkins, he would not have been criminally culpable. His convictions, now set aside, related to conduct after the Watkins memo, not for any transactions prior to that time. Indeed, it could be

With regard to the actual knowledge of problematic operations at Enron, the following factors were present. None of them prompted internal or external counsel to raise concerns with the board, let alone regulators: (1) accounting practices were so risky that the external auditor was presenting physical depictions of risk in chart form to the board; (2) an executive level officer was serving as a principal in an off-the-book entity and was earning fees for doing business with the company; (3) the board was waiving repeatedly the company's ethics code;⁵² (4) the company was creating off-the-book entities at a rate of over 1000 per year; (5) the financial state and ratios of the company defied logic; (6) key executives were leaving the company and selling their stock with the explanation of family time; (7) the law firm was asked to investigate the allegations of a key executive and then asked for advice on her termination; and (8) lawyers within the firm were expressing concerns, doubts, and wry humor about the accounting, financial, and general dealings of Enron.⁵³ One lawyer even used the term "fraud" in expressing his concerns about company structure, deals, and the conduct of an officer.

With just these eight factors (and there were more signals), lawyers were aware of serious questions about the financial practices, reporting, and condition of the company. Yet no action was taken, and with the exception of the Vinson & Elkins settlement, they all have walked away from the Enron collapse. Perhaps these eight factors did not point to a specific crime. Perhaps the information presented here does not offer proof of the elements of fraud. Yet, professionals, including lawyers, did not provide the appropriate counsel for a company that was, at a minimum, operating at the very edge of legal and accounting propriety. If Vinson & Elkins had counseled Lay, even at the late point of the Watkins memo, about the concerns felt by more than one partner, perhaps the Enron history would have been rewritten.

What this history of Enron establishes is that in a fraud of this

argued that Enron's general counsel could have pulled the company back from the brink with the same advice and a coming-clean.

52. Technically, board members in hindsight want to describe what was done; they were, in fact, allowing a senior officer to pilot and profit from entities doing business with the company (and not always in forthright or real transactions).

53. Joseph C. Dilg, the partner in charge of the Enron account, received a demand for paperwork on a large series of transactions on Christmas Eve 1997. Dilg sent an e-mail (now public as a result of discovery in the investor suits) to the lawyers and staff to buck up under all the work, a take-off on "Twas the Night Before Christmas." However, the e-mail reveals a certain level of knowledge about the inherently suspicious Enron accounting. Herewith, an excerpt from the Dilg poem that indicates a wry and cynical awareness of the phony nature of Enron's financials or at least an awareness that mark-to-market accounting makes financial statements fairly meaningless:

No sooner than you could say 'mark-to-market'

Our client's year end financials began to sparkle.

Michael Orey, *Enron's Last Mystery*, BUS. WK., June 12, 2006, at 28. All the litigation and post-collapse analysis have revealed that Enron often booked the full revenues from a 20-year contract in one year. *Id.* at 30.

magnitude there are many points of intervention. When these optimum moments are lost, the result is the inevitable march to fraud. Both internal and external counsel were in possession of information, which, if disclosed and while not perhaps yet criminal, would have fundamentally altered the investment decisions of existing and potential Enron shareholders.

B. WorldCom

While Enron offers us the greatest detail in terms of the evolution of fraud, there are other companies with histories that reveal how consistent the common traits of evolving fraud are. In every fraud there is a similar list of signals and critical intervention points. Once the signals have arisen, inaction on the part of both in-house and external counsel is a form of complicity that is earning a position of civil and, perhaps, criminal liability.⁵⁴

The Enron fraud had a grounding in legality and was, in a twisted and convoluted way, a clever fraud that began as a matter of accounting and legal interpretation. WorldCom had no grounding in accounting or legal interpretation. The executives and employees at WorldCom were desperate souls resorting to desperate measures. WorldCom was a fraud that was labeled unsophisticated by both members of the audit profession and academicians.⁵⁵

From 1989, when WorldCom first went public, to 2000, when its final merger proposal was rejected by the Justice Department, WorldCom (begun as LDDS), grew from a four-person small-town telephone company that was formed over coffee at a diner to an international company with 61,800 employees and revenues of \$35.18 billion.⁵⁶ WorldCom was a company built by mergers. However, when its last merger was blocked because of antitrust concerns, WorldCom, like all the companies discussed here, hit a wall. The flexibility of merger accounting had granted WorldCom wide latitude in its accounting, and somehow that wide latitude always worked in its favor. Its phenomenal double-digit returns and growth fueled a share price that created millionaires among the rank-and-file employees at headquarters in Hattiesburg, Mississippi and a billionaire in Bernie Ebbers, its CEO. With-

54. See Marianne M. Jennings, *Restoring Ethical Gumption in the Corporation: A Federalist Paper on Corporate Governance – Restoration of Active Virtue in the Corporate Structure to Curb the “Yeehaw Culture” in Organizations*, 3 WYO. L. REV. 387 (2003).

55. See generally Jonathon D. Glater & Kurt Eichenwald, *Turmoil at WorldCom: The Accounting: Audit Lapse at WorldCom Puzzles Some Professionals*, N.Y. TIMES, June 28, 2002, at C1.

56. See Barnaby J. Feder, *An Abrupt Departure is Seen as a Harbinger; Leadership Shake-up Could Spread as WorldCom and its Rivals Regroup*, N.Y. TIMES, May 1, 2002, at C1. The company went public on NASDAQ and would complete sixty-five mergers during the period between 1989 and 2002.

out the benefit of continuous merger and acquisition accounting flexibility, WorldCom could no longer continue the double-digit revenue growth it had been delivering. Flat or reduced earnings meant that the share price, upon which so many loans, to Ebbers in particular, hung in the balance, would drop.

It was clear that executives in the company had crossed a line from the first entries designed to keep earnings at their record-high levels during the acquisition era. Buford Yates, director of general accounting at WorldCom prior to its bankruptcy, sent an email to David Myers, WorldCom's controller in July 2000 in which Yates expressed doubts about the internal company accounting proposal for changing the operating expense of purchased wire capacity to a capital expense: "I might be narrow-minded, but I can't see a logical path for capitalizing excess capacity."⁵⁷ Both men then communicated with WorldCom's then-CFO, Scott Sullivan, with Mr. Yates sending an email that read, "David [Myers] and I have reviewed and discussed your logic of capitalizing excess capacity and can find no support within the current accounting guidelines that would allow for this accounting treatment."⁵⁸ Later, following federal investigations which resulted in the indictment of both Mr. Myers and Mr. Yates, Mr. Myers admitted, "this approach had no basis in accounting principles."⁵⁹

Perhaps legal counsel was not aware of this accounting shift. Nevertheless, they would have had the benefit of other clear signals. In 2001, WorldCom employees who had filed a class action suit against the company provided affidavits indicating that WorldCom was "understating costs, hiding bad debt, backdating contracts to book orders earlier than accounting rules allow."⁶⁰ The 113-page suit was filed in federal district court by employees who drew a precise picture of the financial shenanigans. The suit was filed over a year before WorldCom's financial collapse.⁶¹ The board was aware of the suit. When the suit was dismissed, so were its allegations. Neither the board nor legal counsel investigated the veracity of the sworn allegations. While many of us are sensitive to the nuisance costs of frivolous securities litigation, this suit was distinct because it was brought by employee shareholders and also because of the specificity in the affidavits about the accounting and financial reporting practices of WorldCom. This was not a suit based on

57. Kevin Maney, Andrew Backover & Paul Davidson, *Prosecutors Target WorldCom's Ex-CFO*, USA TODAY, August 29, 2002, at 1B, 2B.

58. *Id.* at 2B.

59. Kurt Eichenwald, *2 Ex-Officials at WorldCom Are Charged in Huge Fraud*, N.Y. TIMES, Aug. 2, 2002, at A1, C5.

60. Neil Weinberg, *Asleep at the Switch*, FORBES, July 22, 2002, at 38.

61. *Id.* The complaint had attached 100 interviews with former WorldCom employees, striking in their detail. *Id.* Some examples included receivables that were over seven years old and significant delays in paying suppliers in order to increase net profit figures. *See id.*

the ubiquitous theory of “the share price dropped and someone has to be responsible.”⁶² “The truth is that this never was an industry which made phenomenal returns. People forgot this was foremost a utility business.”⁶³

WorldCom’s numbers, like Enron’s, defied market possibilities: WorldCom’s revenues went from \$950 million in 1992 to \$4.5 billion by 1996.⁶⁴ Operating income rose 132% from 1997 to 1998. Sales increased to \$800 billion and the price of WorldCom’s stock rose 137%.⁶⁵ In 1999, WorldCom’s increase in net income was 217%.⁶⁶

WorldCom made its first announcement regarding earnings restatements on June 25, 2002. With Andersen fired as auditor and KPMG as its new auditor, WorldCom announced that it had overstated cash flow by \$3.9 billion for 2001 and the first quarter of 2002 by booking ordinary expenses as capital expenditures.⁶⁷ The sheer magnitude of the restatement stunned the markets because Enron’s fraud had been topped, in both size and chutzpah.

The WorldCom situation finds the following traits in the run-up to the fraud: (1) accounting practices were so risky that the controller and head of accounting were confronting the CFO with their concerns that nothing in the accounting rules permitted the company’s course of action; (2) an executive-level officer (CEO Ebbers) had personal loans of \$75 million from the company as well as a \$100 million loan guarantee from WorldCom, all approved by the board;⁶⁸ (3) the board was waiving procedural requirements for those loans;⁶⁹ (4) the company was merging at a rate of 20 companies per year; (5) the financial state and ratios of the company defied logic; and (6) employees had filed lawsuits with affidavits detailing accounting improprieties. Once again, as with Enron, some clear signals were building and emerging long before the company hit the fraud wall.

62. *See id.*

63. Henny Sender, *WorldCom Discovers It Has Few Friends*, WALL ST. J., June 28, 2002, at C1, C3.

64. The numbers were computed using “Selected Financial Data” as called out in each of the company’s annual reports. The annual reports were formerly available at the WorldCom website (<http://www.worldcom.com>).

65. WORLDCOM INC., ANNUAL REPORT (1998).

66. WORLDCOM INC., ANNUAL REPORT (1999).

67. Andrew Backover, Thor Valdmanis, Matt Krantz & Michelle Kessler, *WorldCom Finds Accounting Fraud*, USA TODAY, June 26, 2002, at 1B.

68. Andrew Backover, *Questions on Ebbers Loans May Aid Probes*, USA TODAY, Nov. 6, 2002, at 3B.

69. *See generally* Kurt Eichenwald, *Corporate Loans Used Personally, Report Discloses*, N.Y. TIMES, Nov. 5, 2002, at C1. Worse, the loans were classified as advances to cover margin calls, an arguable business purpose to protect the share price, but they were used to cover Ebbers’ personal expenses. *See id.*

C. Fannie Mae

Fannie Mae was a company driven to earnings targets through a compensation system tied to those results. The report of the Office of Compliance of the Office of the Federal Housing Enterprise Oversight (OFHEO) on the financial reports, compensation systems, and accounting practices of Fannie Mae is more chilling than any of the accounts of the other companies noted here because not only were these missteps committed after Freddie Mac, a sister agency, had been reined in for similar practices, but also after the collapses of the other companies noted here.⁷⁰ In fact, Franklin Raines, the former CEO of Fannie Mae who was ousted by the board when the revelations of earnings manipulation emerged, testified at Congressional hearings on Sarbanes-Oxley, expressing his outrage and disappointment at the behavior of executives at companies such as Enron.⁷¹ Judge Sporkin, of “where were the lawyers?” fame, who worked with OFHEO on the Fannie Mae report said of the company’s operations, “More than any other case I’ve seen, it’s all there.”⁷² The restatements for the company would total a staggering \$12 billion.⁷³

Like the other companies, Fannie Mae had a phenomenal run in terms of financial performance. For more than a decade, Fannie Mae achieved consistent, double-digit growth in earnings.⁷⁴ In that same decade, Fannie Mae’s mortgage portfolio grew by five times to \$895 billion.⁷⁵ From 2001 to 2004, its profits totaled \$24 billion.⁷⁶ And before news of the accounting misdeeds became public, Fannie Mae’s shares were trading at over \$80.⁷⁷

Fannie Mae, like Enron, used SPEs in a questionable manner,

70. Freddie Mac executives had been accused of obstructing its accounting inquiry in 2003. Elliot Blair Smith, *Freddie Mac Debate Deepens*, USA TODAY, June 25, 2003, at 3B.

71. Ironically, Mr. Raines was head of the Corporate Governance Task Force of the Business Roundtable and appeared on behalf of that organization. He offered, “We understand why the American people are stunned and outraged by the failure of corporate leadership and governance at Enron. It is wholly irresponsible and unacceptable for corporate leaders to say they did not know—or suggest it was not their duty to know—about the operations and activities of their company, particularly when it comes to risks that threaten the fundamental viability of their company.” Another excerpt was: “The success of the American free enterprise system obtains from the merger of corporate responsibility with individual responsibility, and The Business Roundtable believes that responsibility starts at the top.” *Corporate and Auditing Accounting: Hearing Before H. Comm. on Fin. Servs.*, 107th Cong. (2002) (statements by Franklin D. Raines Chairman, Corporate Governance Task Force of The Business Roundtable), available at <http://www.businessroundtable.org/newsroom/document.aspx?qs=5676BF807822B0F1ADC4E9167F75A70478154>.

72. Paula Dwyer, Amy Borrus, & Mara Der Hovanesian, *Fannie Mae: What’s the Damage?*, BUS. WK., Oct. 11, 2004, at 44.

73. *Id.*

74. James R. Hagerty & John D. McKinnon, *Fannie Mae Board Agrees to Changes It Long Resisted*, WALL ST. J., Sept. 28, 2004, at A1.

75. *Id.*

76. Alex Berenson, *Shake-up at Fannie Mae: The Outlook; No Real Disruption Seen for Big Lender or Mortgage Market*, N.Y. TIMES, December 17, 2004, at C1.

77. See Dwyer, Borrus, & Der Hovanesian, *supra* note 72.

smoothed earnings through decisions on the recording of interest costs, and used questionable discretion in determining the accounting treatment for buying and selling its mortgage assets. The accounting practices of Fannie Mae were so aggressive that when Raines, lawyers, and others met with the SEC to discuss the agency's demand for a restatement, the SEC told Raines that Fannie Mae's financial reports were inaccurate "in material respects."⁷⁸ When pressed for specifics, Donald Nicolaisen, head of SEC's accounting division, held up a piece of paper that represented the four corners of what was permissible under Generally Accepted Accounting Principles (GAAP) and told Raines, "[Y]ou weren't even on the page."⁷⁹

When Raines and Fannie Mae CFO, J. Timothy Howard, were removed by the board, Daniel H. Mudd, the former chief operating officer during the time frame in which the accounting issues arose, was appointed CEO.⁸⁰ When congressional hearings were held following the OFHEO report, Mudd testified that he was "as shocked as anyone" about the accounting scandals at the company at which he had served as a senior officer.⁸¹ He added, "I was shocked and stunned," when Senator Chuck Hagel confronted Mudd with, "I'm astounded that you would stay with this institution."⁸²

However, a study of the company shows that no one should have been shocked because, as Judge Sporkin observed, this was not a close call. Fannie Mae's accounting policies were not even within gray areas. For example, its policies on amortization, a critical area in accounting for a company buying and holding mortgage loans, were developed by the chief financial officer with no input from the controller function of the company. The result was that Fannie Mae's amortization policies were not in compliance with GAAP.⁸³ Its computer model would shorten the amortization of the life of a loan in order to peak earnings performance with higher yields. Fascinatingly, the amortization policies were developed because of a mantra within the company of "no more

78. Bethany McLean, *The Fall of Fannie Mae*, FORTUNE, January 24, 2005, at 122.

79. *Id.*

80. Stephen Labaton, *Chief Is Ousted At Fannie Mae Under Pressure*, N.Y. TIMES, Dec. 22, 2004, at A1.

81. David S. Hilzenrath & Annys Shin, *Senators Grill Fannie Mae Chief; Mudd Tells Panel He Was "Shocked" by Accounting Problems*, WASH. POST, June 16, 2006, at D2.

82. *Fannie Mae Execs Face Intense Questioning From Senators*, USA TODAY, June 16, 2006, at 4B.

83. Fannie Mae's "Purchase Premium and Discount Amortization Policy," its internal policies on accounting and financial reporting on its loan portfolio, did not comply with GAAP. OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT, OFFICE OF COMPLIANCE, REPORT OF FINDINGS TO DATE SPECIAL EXAMINATION OF FANNIE MAE, at vii, 149 (2004) [hereinafter OFHEO INTERIM REPORT]. The final report was issued in February 2006 with no new surprises or altered conclusions beyond what appeared in this interim report. See Greg Farrell, *No New Problems In Report On Fannie*, USA TODAY, Feb. 24, 2006, at 1B.

surprises.”⁸⁴ What was referred to as “arbitrary volatility” became the justification for the amortization models. “Arbitrary volatility” turned out to be a difficult-to-grasp concept for those outside Fannie Mae.⁸⁵

In November 2003, a full year before Fannie Mae’s issues would become public, Roger Barnes, an employee in the Controller’s Office at the company, left Fannie Mae because of his frustrations in the lack of response from the Office of Auditing. He had provided a detailed concern about the company’s accounting policy that internal auditing did not investigate in an appropriate manner, as OFHEO later concluded.⁸⁶ No one at Fannie Mae would heed Barnes’ warnings about the flaws in Fannie Mae’s computer models for amortization. Worse, in one instance, Mr. Barnes notified the head of the Office of Auditing that at least one on-top adjustment had been made in order to make Fannie Mae’s results meet those that had been forecasted.⁸⁷ When those in charge of the Office of Auditing investigation into the Barnes allegation did not get the information that they needed for looking into the specific adjustments Barnes had alleged as being made intentionally, the investigation was dropped.⁸⁸ Many of the officers at Fannie Mae disclosed in

84. In 2003, Jonathan Boyles, at that time Fannie Mae’s Senior Vice President for Financial Standards, wrote in an internal memo that Fannie Mae’s interpretation of FASB rules came from management’s desire to minimize earnings volatility. OFHEO INTERIM REPORT, *supra* note 83, at v. All of the executives appeared to miss the issue. That volatility in their line of work existed was never in dispute. What none of the executives seemed to grasp is that they needed to live with the volatility, not manipulate it out of existence.

85. That those in the organization understood that the accounting was “iffy” is reflected in an interview excerpt included in the OFHEO Interim Report with Janet Pennewell, the Vice President of Resource & Planning, with the interview taking place on June 15, 2004. The investigator asked, “What is arbitrary volatility in earnings?” Ms. Pennewell responded,

Arbitrary volatility, in our view, was introduced when—I can give you an example of what would cause, in our view, arbitrary volatility. If your constant effective yield was dramatically different between one quarter and the next quarter because of an arbitrary decision you had or view—changing your view of long-term interest rates that caused a dramatic change in the constant effective yield that you were reporting, you could therefore be in a position where you might be booking 300 million of income in one quarter and 200 million of expense in the next quarter, introduced merely by what your assumption about future interest rates was. And to us that was arbitrary volatility because it really just literally because of your view, your expectation of interest rates and the way that you were modeling your premium and discount constant effective yield, you would introduce something into your financial statements that, again, wasn’t very reflective of how you really expect that mortgage to perform over its entire expected life, and was not very representative of the fundamental financial performance of the company.

Id. at 6. The operative words in the quote are “to us,” or, in other words, “in our views on accounting and what it should be.” Another problem in the Fannie Mae unique volatility theory was that Fannie Mae had fixed-rate mortgages in its portfolio. Thus, how the market trekked about on interest rates was irrelevant for a good portion of its portfolio. Also, no one was really sure how and who came up with the policy once OFHEO investigators showed up with questions, to wit, from Mr. Tim Howard, then CFO of Fannie, “I’m not sure who recommended it.” *Id.*

86. *Id.* at iv.

87. Known as an intentional act in the world of investigation, no one followed through on Mr. Barnes’ concern even though the minutes of their August 2003 meeting with him reflected the fact that he was raising an issue of a questionable adjustment made for the purposes of meeting earnings targets. *Id.* at 75.

88. See generally *id.* at 78-79. OFHEO concluded from this and other factors that there was a lack of diligence in Fannie Mae for pursuing issues brought to its attention by employees, an irony given Raines’ role as the head of governance reforms at the Business Roundtable.

interviews that they were aware of the Barnes allegation of an intentional act related to financial reporting, but none followed up on the issue or required an investigation.⁸⁹ Barnes turned out to be correct but was not vindicated until the OFHEO report concluded he was correct, something that did not occur until Barnes left Fannie Mae.⁹⁰ Fannie Mae settled with Barnes before any suit for wrongful termination was filed. In 2002, at about the same time Barnes was raising his concerns internally, the *Wall Street Journal* began raising credible (and certainly predictive given what the OFHEO eventually discovered) questions about Fannie Mae's accounting practices.⁹¹

The final OFHEO report noted that Fannie Mae's current CEO, Daniel Mudd, listened in 2003 as employees expressed concerns about the company's accounting policies. However, Mr. Mudd took no steps to follow up on either the questions or concerns that the employees had raised in the meeting that also subsequently turned out to accurately reflect the financial reporting missteps and misdeeds at Fannie Mae.⁹² In a search of the OFHEO Interim Report for the word "counsel" or "general counsel," the only time the term appears is during the summer of 2004 when OFHEO was conducting its investigation into what had happened at Fannie Mae. The attorneys were hands-on in phone conferences as well as in the sessions in which Fannie Mae employees are questioned. The special report done for Fannie Mae's board indicates that the Legal Department at Fannie Mae was aware of the Barnes allegation, but it deferred to internal auditing for making any decisions about the merits of the allegations, a flawed decision in that the group was not qualified to make a determination on the technical and policy elements raised in the Barnes allegation. The report also indicates that lawyers for the company had an obligation to follow through on the allegations.⁹³

Fannie Mae paid a \$125 million fine to OFHEO for its accounting improprieties.⁹⁴ As part of that settlement, Fannie Mae's board agreed to new officers, new systems of internal control, and the presence of outside consultants to monitor the company's progress. The agency concluded that it would take years for Fannie Mae to work through all

89. *See id.* at 78. However, the OFHEO investigation reveals inconsistencies in the Office of Auditing's take on the Barnes allegation. *See generally id.* at 76.

90. At the time Barnes raised his concern, Fannie Mae had an Ethics and Compliance Office, but it was housed within the company's litigation division and was headed by a lawyer whose primary responsibility was defending the company against allegations and suits by employees. PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP, REPORT TO THE SPECIAL REVIEW COMMITTEE OF THE BOARD OF DIRECTORS OF FANNIE MAE, (2006) [hereinafter BOARD REPORT].

91. *See generally Systemic Political Risk*, WALL ST. J., Sept. 30, 2005, at A10.

92. Eric Dash, *Regulators Denounce Fannie Mae*, N.Y. TIMES, MAY 24, 2006, at C1. Mr. Mudd said, "I absolutely wish I had handled it differently." *Id.*

93. BOARD REPORT, *supra* note 90, at 28.

94. Edward Iwata, *Celebrated CEO Faces Critics*, USA TODAY, Oct. 6, 2004, at 1B, 2B.

of the accounting issues and corrective actions needed to prevent similar accounting missteps in the future.⁹⁵ Fannie Mae settled charges of accounting issues with the SEC for \$400 million.⁹⁶ Investigations into the role of other third parties and their relationships to Fannie Mae and “actions and inactions” with them are pending.⁹⁷ Former head of the SEC Harvey Pitt commented, “When a company has engaged in wrongful conduct, the inquiry [inevitably turns to] who knew about it, who could have prevented it, who facilitated it.”⁹⁸

The pattern holds strong: (1) Fannie Mae’s earnings defied economic realities; (2) employees and regulators were raising red flags about accounting practices that subsequently proved to be true, but no action was taken; (3) there was a failure to conduct investigations into allegations raised; and (4) the company’s growth had been so strong that it had become iconic and virtually unchallenged internally or externally.

D. HealthSouth

HealthSouth, a chain of hospitals and rehabilitation centers, like the other companies examined here, enjoyed phenomenal success. From 1987 through 1997, HealthSouth’s stock rose at a rate of 31% per year.⁹⁹ The stock had gone from \$1 per share at the time of its Initial Public Offering in 1986 to \$31 per share in 1998.¹⁰⁰ In April 1998, HealthSouth CEO Richard Scrushy told analysts that HealthSouth had matched or beat earnings estimates for forty-seven quarters in a row.¹⁰¹ Consistent with the WorldCom and Tyco themes and resulting accounting flexibility, HealthSouth became a billion dollar company through acquisitions.

At a more blatant, perhaps flamboyant level than witnessed in the discussion of other companies that were revealed to be frauds, CEO Scrushy sent all the signals of the captain of a ship of fraud. He held Monday morning meetings with his executives that were glibly referred to around the company as the “Monday-morning beatings.”¹⁰² The purpose of the meetings was to ensure that the company was meeting the numbers it had pledged and analysts’ expectations. If they did not, it

95. *Fannie Mae Overhaul May Take Years*, N.Y. TIMES, June 16, 2006, at C3.

96. Elliot Blair Smith, *Fannie Mae To Pay \$400 Million Fine; Report Mainly Blames Ex-CEO, CFO for Tricky Accounting*, USA TODAY, May 24, 2006, at 1B.

97. Dawn Kopecki & Mara Der Hovanesian, *It Looks Like Fannie Had Some Help; Major Players on the Street May Be Tied to the Fiasco at the Mortgage Giant*, BUS. WK., June 12, 2006, at 36.

98. *Id.*

99. John Helyar, *Insatiable King Richard*, FORTUNE, July 7, 2003, at 76, 82.

100. Reed Abelson & Milt Freudenheim, *The Scrushy Mix: Strict and So Lenient*, N.Y. TIMES, April 20, 2003, at BU1, 12.

101. *Id.*

102. *Id.*

2006]

Fraud is the Moving Target

47

was common knowledge throughout the company that Mr. Scruschy's instructions to the officers in the meetings were, "Go figure it out."¹⁰³ At one meeting he announced a new company policy, "I want each one of the [divisional] presidents to e-mail all of their people who miss their budget. I don't care whether it's by a dollar."¹⁰⁴ One HealthSouth officer would later offer this explanation of the company culture, "The corporate culture created the fraud, and the fraud created the corporate culture."¹⁰⁵

HealthSouth's officer team was young with a high turnover rate. For example, the vice president of reimbursements for the company—a critical position because of the importance of compliance in terms of bills submission under Medicare rules as well as the associated financial reporting issues regarding the revenues associated with reimbursement—was given to a twenty-seven-year-old with no regulatory experience in Medicare reimbursements.¹⁰⁶ The company burned through five CFOs in a five-year period and the final CFO prior to the collapse was just twenty-eight years old when Mr. Scruschy chose him for the ascent to that second-in-command position.¹⁰⁷ Their bonuses and salaries grew at exponential rates, particularly the longer they stayed.¹⁰⁸

If HealthSouth's board of directors seemed to have a tin ear to all the developments with staff, litigation, and restatements, it was perhaps because the board was a study in conflicts of interest. One director had earned \$250,000 per year on a consulting contract with HealthSouth for a seven-year period, while another director had a joint investment venture with Mr. Scruschy on a \$395,000 investment property. Another director was awarded a \$5.6 million contract for his company to "install glass at a hospital being built by HealthSouth." MedCenterDirect, a hospital supply company run online and which did business with HealthSouth, was owned by Mr. Scruschy, six directors, and one of those directors' wives. The audit committee and the compensation committee had consisted of the same three directors since 1986; two of the directors had served on the board for eighteen years, and in 1996, eight of the fourteen board members were also company officers. One director received a \$425,000 donation to his charity from HealthSouth just prior to going on the Board.¹⁰⁹ A corporate governance expert has said the con-

103. Helyar, *supra* note 99, at 84.

104. *Id.* at 86.

105. *Id.* at 84.

106. This information was gleaned from a review of HealthSouth's 10-Ks from 1994 through the present. See generally SEC Filings & Forms (EDGAR), <http://www.sec.gov/edgar.shtml>.

107. *Id.*

108. *Id.*

109. Joann S. Lublin & Ann Carrns, *Directors Had Lucrative Links At HealthSouth*, WALL ST. J., April 11, 2003, at B1, B3.

duct of the HealthSouth board could amount to “gross negligence.”¹¹⁰ One Delaware judge noted that the directors who had financial and philanthropic ties to company officials during the era of fraud are “suspected of malfeasance.”¹¹¹ HealthSouth also had an extensive loan program for executives in order to enhance equity ownership. The key executives owed significant amounts of money to the company that they borrowed in order to exercise their stock options.¹¹²

Perhaps more so than WorldCom, there were some very public events, including litigation involving HealthSouth that should have piqued interest and investigations because they were clear indicators that there was trouble afoot. One such incident occurred in September 1998, when Scrushy and other executives, including the company’s CFO, began selling off their shares of HealthSouth.¹¹³ Following these large sales, the company announced a reduction in forecasted earnings because, as Scrushy explained, there had been a change in Medicare rules. There was indeed a change in Medicare rules, but the reduction in forecasted earnings should have been \$20 to \$30 million, not the \$175 million HealthSouth announced at that time.¹¹⁴

Also in the same time frame, the employees at HealthSouth, just as at the other companies discussed, began to face realizations about their company and began to voice their frustrations. HealthSouth was involved in a whistle-blower lawsuit that alleged Medicare fraud and, as a result, brought a defamation suit against a former employee who had accused HealthSouth of admitting Medicare patients that its facilities were not equipped to handle. Kimberly Landry, the former employee who was sued for defamation by the company, had posted her concerns on the Internet. HealthSouth pursued the defamation suit until after the financial collapse. When that occurred and there was a change in both leadership and the board, the company withdrew the suit.

HealthSouth profits were restated in 2002 and 2003 to reflect \$2.5 billion less in earnings for periods dating back to 1994, with \$1.1 billion occurring during 1997 and 1998. The stock was trading on pink sheets at \$0.165 per share in mid-April 2003, from a \$31 high in 1998.¹¹⁵ HealthSouth’s total restatement of earnings for 2000 and 2001, not released until 2005, would total \$1 billion. The company paid \$350 million to law-

110. *Id.*

111. *Id.*

112. *See generally* SEC Filings & Forms (EDGAR), <http://www.sec.gov/edgar.shtml> (see disclosures in proxy statements for 1995-2002).

113. These trades are now under investigation by the FBI. Milt Freudenheim, *F.B.I. is Investigating HealthSouth Trades*, N.Y. TIMES, Feb. 7, 2003, at C1.

114. This large reduction in earnings is the subject of an SEC investigation because, the theory goes, the reduction was overstated to cover up other evolving reporting issues. Abelson & Freudenheim, *supra* note 100, at BU1, 12.

115. *See generally id.*

2006]

Fraud is the Moving Target

49

yers and auditors for the completion of its Chapter 11 restructuring, \$200 million to settle civil charges with the SEC, and another \$347.7 million to settle Medicare fraud charges with the federal government.¹¹⁶

Fifteen of HealthSouth's executives entered guilty pleas to various federal charges. Five of HealthSouth's former CFOs testified against Mr. Scrushy at his criminal trial for the government. Only one CFO had no culpability. He left the company because of his concerns about the financial reporting. His going-away cake read, "Eat ____." Mr. Scrushy was acquitted of all thirty-six federal felony charges related to the HealthSouth collapse in June 2005, following long (twenty-one days) and intense deliberations by a jury that seemed to have doubts even after that verdict was returned. The jury's hesitation, whatever its origins, offers support for the thesis of this discussion—that fraud, while not easily established in a legal sense, has a long line of signals in its development and still results in substantial harm to those who allow it to progress in the name of "Who knew?"

The following list, similar to that of the other companies, emerges as this history of another fraud is examined: (1) there was litigation against the company that centered on employee concerns about the financial viability of the company; (2) there was a high turnover rate among the executive team, particularly in the CFO position; (3) those working on financial reports for the company were concerned about the numbers and the compliance officer had an employee concern that focused, in a knowledgeable way, on what was wrong with the company's accounting; (4) there was a high level of interconnectedness and self-dealing among and between board members; (5) HealthSouth had phenomenal financial performance despite a rocky incident of restatement of financials and a questionable explanation; (6) the culture within the company, as evidenced by a defamation suit against a former employee, was one of fear, born of an autocratic CEO who had surrounded himself with security; and (7) financial performance had been phenomenal and pledges were made to continue the results and levels of performance forward.

E. Tyco

Tyco was another company schooled in the way of sleight-of-hand accounting exercised through the phenomenon of acquiring companies at an alarming rate. Tyco made 700 acquisitions between 1998 and 2001 for about \$8 billion, and Tyco never disclosed the acquisitions to the

116. This information can be found in the 1,600-page report filed by the company on June 27, 2005. This Form 10-K, was a report consolidating 2002 and 2003 and was the first the company filed since 2001. *See generally* SEC Filings & Forms (EDGAR), <http://www.sec.gov/edgar>.

public.¹¹⁷

As at WorldCom, Enron, and HealthSouth, there were litigation rumbblings long before the company's collapse. When Tyco took over U.S. Surgical in 1998, there was litigation between the two companies. Documents that have emerged in the case include memoranda between Tyco financial executives in which they discuss methods whereby U.S. Surgical could slow growth in between the time Tyco announced its acquisition and when the actual transfers were made. The executives referred to the process they developed as "financial engineering." The lawsuit was brought by shareholders of Progressive Angioplasty Systems, Inc., a company that U.S. Surgical had acquired prior to its own acquisition by Tyco. The shareholders' fairly credible allegation was that Progressive had experienced slower growth during the period in which the alleged "financial engineering" is said to have occurred. The memos worked. Just prior to the closure of the deal, U.S. Surgical took a one-time hit of \$322 million in miscellaneous charges.¹¹⁸ Tyco settled the suit with the shareholders for a \$40 million payment, but the parties in the case all signed a confidentiality agreement and no one will disclose the terms of the settlement, other than the amount. Following Tyco's collapse, the SEC reopened its inquiry into the Tyco/U.S. Surgical matter and was focusing on whether Tyco withheld data in their earlier inquiries and whether the \$40 million was hush money for the "financial engineering."¹¹⁹ The common thread is once again a lawsuit that raises serious allegations about the company's financial practices. However, through settlement, dismissal, and otherwise, the suits went away. Nevertheless, the credibility problems underlying the litigation did not. Nor did legal counsel for the companies require further investigation on matters raised in the suits. In fact, Mark Belnick, an attorney who would later become general counsel for Tyco, received \$2 million in compensation for settling the U.S. Surgical matter.¹²⁰

The financial performance here was as mind-boggling as those of the other companies. From 1992 through 1999, Tyco's stock price grew fifteen-fold.¹²¹ Tyco's earnings grew by about 25% each year during

117. Mark Maremont, John Hechinger, & Gregory Zuckerman, *Tyco Worries Send Stock Prices Lower Again—Tyco Plan to Tap its Credit Lines Spooks Investors*, WALL ST. J., Feb. 5, 2002, at C1.

118. See generally Laurie P. Cohen & Mark Maremont, *Secret Payment by Tyco Is Target of Investigation*, WALL ST. J., Sept. 30, 2002, at A3. Mr. Mark Belnick, Tyco's general counsel, see *infra* note 116 and accompanying text for more information about Mr. Belnick and his role in Tyco, received a \$2 million bonus for wrapping up the earlier SEC investigation without any action being taken. Laurie P. Cohen, *SEC Asks Tyco If It Withheld Data in Earlier Inquiry*, WALL ST. J., Nov. 25, 2002, at C1.

119. Cohen, *supra* note 118, at C1.

120. *Id.*

121. Alex Berenson, *Ex-Tyco Chief, a Big Risk Taker, Now Confronts the Legal System*, N.Y. TIMES, June 10, 2002, at C1.

Kozlowski's era,¹²² and during 1999, Tyco's stock price rose 65%.¹²³ Tyco spent \$50 billion on acquisitions in nine years,¹²⁴ and the company's debt-to-equity ratio nearly doubled from 25% to 47% in one year (2001). These are the components of a "How is this possible?" question, along the lines of Enron, WorldCom, and HealthSouth. Within the company, and perhaps more importantly, among counsel, there were warnings about the creativity of the company's accounting. The warnings from the company's outside legal counsel went unheeded. A May 25, 2000 email from William McLucas of Wilmer Cutler to Belnick, then general counsel for Tyco, contains clear warnings about the questionable accounting treatments as well as the pressure those preparing the financial reports were experiencing:

We have found issues that will likely interest the SEC. . . . [C]reativeness . . . is employed in hitting the forecasts There is also a bad letter from the Sigma people just before the acquisition confirming that they were asked to hold product shipment just before the closing¹²⁵

The lawyer concluded that Tyco's financial reports smelled of "something funny."¹²⁶

When Tyco's outside legal counsel raised concerns about payments Tyco was making to Mr. Kozlowski's then-mistress and advised that they be disclosed in SEC documents, employees in Tyco refused to make the disclosures and continued making the payments.¹²⁷ The email from partner Lewis Liman at Wilmer Cutler sent March 23, 2000, to Tyco's general counsel, Mark Belnick, read, "There are payments to a woman whom the folks in finance describe to be Dennis's girlfriend. I do not know Dennis's situation, but this is an embarrassing fact."¹²⁸

There are seven factors that should have been signals to legal counsel: (1) accounting practices were so risky that outside legal counsel was warning internal legal counsel that if the company's books were examined by a competent accountant, the practices would look questionable; (2) all executive-level officers had personal loans from the company through a Key Employee Loan Program (KELP);¹²⁹ (3) the board was

122. See *The Top 25 Managers of the Year*, BUS. WK. ONLINE, Jan. 14, 2002, http://www.businessweek.com/magazine/toc/02_02/B3765magazine.htm.

123. See *The Top 25 Executives of the Year*, BUS. WK. ONLINE, Jan. 11, 1999, <http://www.businessweek.com/1999/02/b3611001.htm>.

124. See *Top 25 Managers*, *supra* note 122.

125. Laurie P. Cohen & Mark Maremont, *E-Mails Show Tyco's Lawyers Had Concerns*, WALL ST. J., DEC. 27, 2002, at C1.

126. Mark Maremont & Laurie P. Cohen, *Tyco Probe Expands to Include Auditor PricewaterhouseCoopers*, WALL ST. J., Sept. 30, 2002, at A1.

127. Cohen & Maremont, *supra* note 125.

128. *Id.*

129. "Under the program, Mr. Kozlowski improperly borrowed approximately \$61,690,628 in non-qualifying relocation loans to purchase real estate and other properties, Mr. Swartz borrowed approximately \$33,097,925, and Mr. Belnick borrowed approximately \$14,635,597." This information can be found in the company's 8-K for September 17, 2002. See generally SEC Filings & Forms (EDGAR), <http://www.sec.gov/edgar.shtml>.

waiving procedural requirements for doing business with directors;¹³⁰ (4) the company was merging at a rate of twenty companies per year; (5) the financial state and ratios of the company defied logic—between 1991 and 2001, CEO Dennis Kozlowski took Tyco from \$3 billion in annual sales to \$36 billion in 2001 by paying \$60 billion for over 200 acquisitions;¹³¹ (6) a company acquired by Tyco had its shareholders file suit against Tyco for accounting improprieties and the resulting impact on the value of their investments; and, (7) outside legal counsel were raising questions brought to them from finance area employees in the company about payments to the CEO's mistress.

F. *The Steinberg Cases*

Professor Steinberg, in discussing the limitations of liability and responsibility of corporate counsel, cited a number of cases in which fraud was the order of the day.¹³² Professor Steinberg is, of course, correct in his assessment that courts are loathe to find attorney liability to third parties for their corporate work because there is no such duty under federal securities law, absent a duty to disclose the client's conduct. Nonetheless, understanding what the lawyers and clients were doing in the cases offers insight into the externalities that immunity introduces into a free market system as well as, and perhaps more importantly, the moral detachment that springs from that immunity. In short, the irony of reviewing cases that found in favor of corporate counsel is the realization of how far the profession has drifted.

1. *Fortson v. Winstead, McGuire, Sechrest & Minick*

In this case, Hall Financial Real Estate Group (HFG) formed the Hall City Centre Limited Partnership (City Centre Partnership) to acquire and operate a commercial office tower in St. Petersburg, Florida.¹³³ HFG retained the law firm of Winstead, McGuire, Sechrest & Minick (Winstead) to render an opinion concerning certain tax aspects of the City Centre Partnership. HFG sold securities in the City Centre

130. See generally Laurie P. Cohen & Mark Maremont, *Tyco Ex-Director Pleads Guilty*, WALL ST. J., Dec. 18, 2002, at C1.

131. Daniel Eisenberg, *Dennis the Menace*, TIME, June 17, 2002, at 46; see also Mark Maremont, et al., *Tainted Chief: Kozlowski Quits Under a Cloud, Worsening Worries About Tyco*, WALL ST. J., June 4, 2002, at A1, A10.

132. Not included in this discussion of the Steinberg cases are those that focused only on auditors such as *Windon Third Oil & Gas Drilling P'ship v. Fed. Deposit Ins. Corp.*, 805 F.2d 342 (10th Cir. 1986). The disciplinary actions are also excluded because the focus of this discussion is on liability to third parties, a discussion that centers on market forces. Regulatory actions are taken when market forces have not taken hold or have proved inadequate because of fraud, the very issue that is explored in Parts III and IV.

133. 961 F.2d 469 (4th Cir. 1992). This case is cited for the proposition that there must be a duty on the part of counsel to disclose client's conduct before there can be liability of law firm/counsel to third parties.

2006]

Fraud is the Moving Target

53

Partnership through a Private Placement Memorandum (PPM), in reliance on an exemption from the registration requirements of the federal securities laws. The PPM, which was drafted and approved by in-house counsel at HFG, disclosed the details of the financing of the City Centre development, reviewed the financial status of the general partners, and identified the risks involved in the investment. It also included a tax opinion letter prepared by Winstead. Dreams turned to dust, and within four years, the investment was not as promised. The limited partners (appellants), unable to recover from the brain trust behind the defunct deal, turned to Winstead. In dismissing the suit, the court said: “Winstead surely knew that the limited partners would rely on its tax opinion, but appellants have not challenged the accuracy or completeness of that opinion. Appellants’ real complaint is with the adequacy of HFG’s financial disclosure.”¹³⁴

Note the presence of the following factors, as were also present in *Enron et al.*, which have become an increasingly obvious theme: participation of outside counsel in a limited role; reliance on work of others without verification of work; no opinion expressed as to the viability of the investment, the financial viability of the client, or the trustworthiness of the client; limitations are disclosed; if the plaintiffs in the case had full information about the offeror they would not have invested; and, the court relied on regulations and the ABA ethics standards in dismissing the failure of outside counsel to delve more deeply into the client’s condition and propensities:

The attorney “does not have the responsibility to ‘audit’ the affairs of his client or to assume, without reasonable cause, that a client’s statement of the facts cannot be relied upon.” The Treasury regulations include similar language: “[A] practitioner need not conduct an audit or independent verification of the asserted facts, or assume that a client’s statement of the facts cannot be relied upon, unless he/she has reason to believe that any relevant facts asserted to him/her are untrue.”¹³⁵

2. *Schatz v. Rosenberg*

On December 31, 1986, MER Enterprises (MER) purchased two companies, VAMCO and ABC, from Ivan and Joanne Schatz, and the Schatzes received \$1.5 million in promissory notes from MER, which were personally guaranteed by its owner, Mark E. Rosenberg.¹³⁶ The Schatzes received a letter on March 31, 1986 and an update letter delivered at closing on December 31, 1986, which indicated that Rosenberg’s

134. *Id.* at 471.

135. *Id.* at 474 (quoting ABA Comm. on Ethics and Prof’l Responsibility, Formal Op. 346 (1982) (discussing tax law opinions in tax shelter investment offerings)) (alteration in original) (citations omitted).

136. 943 F.2d 485, 487-88 (4th Cir.1991).

net worth exceeded \$7 million. “These financial documents contained several misrepresentations obscuring the fact that” Rosenberg’s financial empire had crumbled between April and December of 1986.¹³⁷ “Rosenberg’s largest business, Yale Sportswear Corporation (“Yale”), filed for bankruptcy in September 1987, and Rosenberg filed for personal bankruptcy thereafter. The law firm of Weinberg & Green represented Rosenberg and his entities throughout this period.”¹³⁸ The Schatzes

never received payment on their promissory notes and lost an additional \$150,000 when they made a ‘bridge loan’ to BBC, the company which was formed when VAMCO and ABC merged with the Back Center, Inc. (“BCI”), another of Rosenberg’s companies. To add insult to injury, Rosenberg paid Weinberg & Green’s legal fees for the transaction out of VAMCO and ABC’s cash reserves. Rosenberg siphoned off operating capital from VAMCO and ABC to prop up Yale. By the time Rosenberg and Yale filed for bankruptcy, VAMCO and ABC were essentially worthless.¹³⁹

Unfortunately, the Schatzes had surrendered their controlling interests in the businesses.

With Rosenberg judgment-proof, the Schatzes turned to Weinberg & Green and filed suit against the firm for, among other things, violation of securities laws. The basis of the suit was the firm’s sullen and mute posture on the condition of its client even as the transactions and payments progressed. The court concluded that there was no liability under securities laws because, as Professor Steinberg noted, the courts require some fiduciary duty as a basis for liability and there was none between Weinberg & Green and the Schatzes. Further, there must be some representation by Weinberg & Green, something that was never alleged nor occurred.¹⁴⁰

The twist in the case is that the Schatzes’ lawyer made an anonymous request to the Maryland State Bar for an ethics opinion using the facts of his case. The Maryland State Bar issued an opinion concluding, “that a law firm in Weinberg & Green’s position had an ethical duty to either withdraw from representation or disclose the misrepresentations to the third person.”¹⁴¹ But, the court noted correctly, the ethical ruling did not create a legal duty to disclose. The critical elements of this case were: Weinberg & Green “papered the deal” or merely “act[ed] as a scrivener;”¹⁴² Weinberg & Green was paid for its efforts; no opinion expressed on financial viability of client; no action taken to correct misrep-

137. *Id.*

138. *Id.*

139. *Id.*

140. *See generally id.* (analyzing duty of law firm to disclose financial condition of their client).

141. *Id.* at 492.

142. *Id.* at 495.

2006]

Fraud is the Moving Target

55

resentations despite acute awareness of client's status; Weinberg & Green relied on Rosenberg for information; the court was troubled by the conduct of the lawyers;¹⁴³ and if the plaintiffs had access to the information the lawyers had, they would not have made the investment.

3. *Abell v. Potomac Ins. Co.*

In this case, investors had purchased bonds issued by the Westside Rehabilitation Center (Westside).¹⁴⁴ The market for rehabilitation patients was apparently not what had been anticipated, and Westside defaulted on the bonds. The investors brought suit against both Joe Fryar, Westside's developer, and Wright, Lindsey & Jennings (WLJ), the law firm representing the bond issue's underwriters. Westside had no money (the bonds were to fund the case and Westside would operate with an inflow of Medicaid reimbursements), had a board of directors that never met, and was pretty much the alter ego of Joe Fryar.¹⁴⁵

Fryar hired Booz, Allen & Hamilton (Booz Allen) to do a feasibility study for Westside. With integrity unmatched in this discussion and a toss of future Fryar revenues to the wind, Booz Allen issued its report in 1979 that concluded the project was not financially feasible. For all its trouble, Booz Allen was threatened with suit by Fryar, so it signed a settlement stating that its conclusions on Westside were for physical rehabilitation and might not be applicable if Fryar changed Westside's clientele to the mentally handicapped and emotionally disturbed who were, according to Fryar, offering greater financial returns. The bond offering proceeded once all the glitches and certifications were ironed out between and among local and state authorities. The fact that Fryar owned the property that would be purchased by Westside for the rehabilitation facility was not disclosed in the bond materials, nor was the fact that Fryar would enjoy a 50% return on his investment once he sold the property to Westside, which he would do and thus get the cash from the bond offering.¹⁴⁶

WLJ did not disclose the Fryar ownership nor the Booz Allen report in its due diligence review of the project for the underwriter, although partners at WLJ were aware of both. When the project unraveled, as Booz Allen had predicted, the bondholders sought recovery from WLJ and others using different theories. The court held that WLJ was not liable under federal securities laws because it was not a seller

143. Professor Steinberg highlighted the judicial angst here by quoting that segment of the opinion that concludes that while we may need reform in terms of lawyer conduct in these situations, it cannot come through the securities laws. See Steinberg, *supra* note 14, at 2 n.6.

144. 858 F.2d 1104 (5th Cir. 1988).

145. See *id.*

146. See *id.* at 1111-13.

within the statutory definition for purposes of a Section 12 claim. For purposes of the 10b-5 fraud claims, WLJ did not deny that information was omitted and perhaps misleading. Its defense was that the information that was omitted or misleading was immaterial and therefore could not be the basis of a claim against it. The firm's argument was quite strong because when full details were disclosed a year later, the investors did not react, and the bond price remained stable.¹⁴⁷ Despite the jury concluding otherwise, the court reversed the verdict.¹⁴⁸

The key elements of the case were: the law firm was aware that its client had concealed his role in dealing with the company on the major asset (the property for the center); the law firm was aware of a premier management consulting study that indicated financial success was not viable; the law firm disclosed neither of the above until after the investors had purchased the bonds; and the center, as predicted, did not generate sufficient funds to pay interest, let alone repay the bonds.¹⁴⁹

4. Barker v. Henderson, Franklin, Starnes & Holt

This case represents one that pushes the envelope in terms of lawyer duty and immunity.¹⁵⁰ The plaintiffs in this suit were investors who had purchased bonds between 1974 and 1976 from the Michigan Baptist Foundation (Foundation). The bonds were used as financing for a retirement village in Florida. The combination of the elderly living in a Florida village with a charitable foundation funding it all represents a tripartite of fraud's best havens. Having lost all of their investment when the project went under, the bondholders brought suit against both the law firm, Henderson, Franklin, Starnes & Holt (HFSH), and the accounting firm. William Graddy, a partner in HFSH, gave advice to the Foundation from the project's inception. Julian Clarkson, another HFSH partner, was also a director of the Trustee (the Lee County Bank that served as Trustee for the bonds) and chairman of its trust committee. Graddy and other attorneys at HFSH assisted the Foundation in organizing the project, drawing up its bylaws, and negotiating the purchase of the land. Fred Edenfield, a partner in the accounting firm, also

147. The court described the letter as follows:

That letter, designed to calm investors' fears, disclosed the \$2.4-million profit Fryar and All American collectively had made from selling land to Westside. It also revealed that Fryar used the money generated from this land transaction, not money originally his own, to secure his personal bonds backing the project. Finally, the letter reported the negative assessment which Booz, Allen had made of Fryar's 1983 Westside plans.

Id. at 1116 n.11.

148. *Id.* at 1117, 1128.

149. There is another factor in the case. Fryar was a major piece of work. One of the issues on appeal was what to do with his requested reversal when part of the reason for the appeal was his tampering with one of the jurors. Trust Booz Allen when it comes to spotting problems. *See id.* at 1143-47.

150. 797 F.2d 490 (7th Cir. 1986).

2006]

Fraud is the Moving Target

57

“gave advice to the Foundation at the outset of the project. Edenfield and Graddy were good friends.”¹⁵¹

“Graddy and Edenfield were among the incorporating directors of the Foundation, although they were immediately replaced by the permanent directors.”¹⁵² Graddy recruited Lee County Bank as trustee and prepared the trust indenture.

The indenture, although legally sufficient, did not contain controls sufficient to prevent the losses that ensued. . . . Graddy and Edenfield reviewed a draft of the proposed selling document in 1971. . . . Edenfield reviewed a draft projection in 1973, the same year Graddy reviewed a draft letter of solicitation. Neither asked the Foundation to make substantial changes.¹⁵³

Like all good Ponzi schemes, the project was undercapitalized and dependent upon new bonds sales to keep it going. Graddy was aware of other similar projects and the high failure rate. In 1976, Graddy attended meetings in which a Lee County bank officer discussed his concerns about the continuing viability of the project. The Trustee withdrew in October 1976.¹⁵⁴

In addition, “Graddy knew that some of the directors of the Foundation had purchased an option on land in which the Foundation was interested and later sold their interest to the Foundation in exchange for some of the Foundation’s bonds.”¹⁵⁵ This self-dealing could have (and probably should have, though no court or regulator ever challenged the exemption or the charitable status of the Foundation) endangered the Foundation’s exemption from the registration requirement. The bonds were sold unregistered.¹⁵⁶

The bondholders alleged that the paperwork did not disclose the risks involved. In fact, Judge Easterbrook simply assumes that there were omissions in the selling materials. The bondholders also alleged that HFSH knew of the Foundation’s continuing need for solicitation of funds but did not “blow the whistle,” and that HFSH induced the Trustee to continue to lend support for what was a failing project. However, HFSH’s name was not on any of the selling documents after 1974, and, at Graddy’s insistence, two other law firms reviewed the materials. HFSH billed the Foundation \$125 in 1974 and had no billings for the Foundation after that. Graddy told the Foundation board that his law firm had no securities expertise. HFSH had no representative on the Foundation board. Judge Easterbrook stated the “blow the whistle” standard clearly and succinctly:

151. *Id.* at 492.

152. *Id.*

153. *Id.* at 493.

154. *Id.*

155. *Id.*

156. *Id.* at 492.

When the nature of the offense is a failure to “blow the whistle,” the defendant must have a duty to blow the whistle. And this duty does not come from § 10(b) or Rule 10b-5; if it did the inquiry would be circular. The duty must come from a fiduciary relation outside securities law.¹⁵⁷

The court further noted that “[n]either lawyers nor accountants are required to tattle on their clients in the absence of some duty to disclose.”¹⁵⁸

Judge Easterbrook noted through a detailed listing that HFSH did not “feather their nests” from the project, a factor that weighed heavily in his conclusion that there was no duty.¹⁵⁹ The common factors are: a risky project; continuing flow of information about problems with the project; those involved in the project have expressed concerns; underlying issues of undisclosed conflicts of interest; and new investors unaware of the level of risk.

5. *Lycan v. Walters*

In what should be used as an instructive case for investors of “here’s a bad investment” warning signals, this motion-for-summary-judgment case involves investments in a venture capital foray into the acquisition of a bankrupt battery company.¹⁶⁰ The investors were a group of farmers, one of whom was a sickly widow.¹⁶¹ The seeds for the investment were planted when one of the venture capitalists, Gary Walters of Prime Corporation, seeking to acquire Prime Battery from bankruptcy, and his accountant, Azeem Meo, made a presentation to a group of farmers. Showing wisdom and restraint, the non-sickly farmers (one of whom was the son of the widow) made the jaunt from Illinois to Indiana to see Prime Battery and talk with the lawyer, one Douglas R. Brown, who had been hired by Prime Corporation to get Prime Battery’s assets out of bankruptcy. Brown met with the farmers’ delegation (the widow could not make the trip), and the delegation also viewed the battery company. Brown’s statements to the group (not disputed by Brown and indeed later established by affidavit as truthful), included the following: (1) when the farmers expressed concern that a bankruptcy could drag on for years, Brown responded “that the bankruptcy was ninety-five per cent complete and that there was no problem at all with

157. *Id.* at 496.

158. *Id.* at 497.

159. *Id.*

160. 904 F. Supp. 884 (S.D. Ind. 1995).

161. It is one of those unwritten rules of securities laws that sophisticated investors become widows and orphans when investments go south. Here was an investment with a sickly widow from the outset, perhaps a foreshadowing. Louie DePalma, the cab dispatcher on the television series “Taxi,” who was named as television’s greatest comic character, had three rules for life: “Never eat in the same restaurants, fly on the same plane, or invest in the same things as losers.”

finishing it up;”¹⁶² (2) “Brown also told them that the beautiful part about a bankruptcy is that the assets have been ‘cleansed;”¹⁶³ and (3) when asked by the farmers why he (Brown) did not invest, “Brown replied that his father was a small town judge and that he did not have the capital to make that kind of investment.”¹⁶⁴

The farmer group invested a total of \$337,000 in the venture, receiving shares of stock in Prime Corporation for their funds.¹⁶⁵ After they had invested their funds, the lawyer handling the financing for Prime, Mark E. Maddox, concluded that the farmers’ group did not qualify as accredited investors for purposes of an exempt transaction and that the transaction needed to be rescinded. Somehow the rescission and refund did not occur before the bankruptcy blew up, and the assets never made it out of bankruptcy. Indeed, there was little chance that those assets ever would make it out, given the state of Prime Battery and the list of Prime Battery creditors. It is uncontroverted that neither Maddox nor Brown disclosed to the farmers the risk or problems in the venture. Nevertheless, the court concluded neither had a duty to disclose such to them, employing the same analysis used in other cases.¹⁶⁶ What makes this case more compelling than the other Steinberg cases is that one of the farmers had actually written a \$2,000 check to Maddox, thus leading to a great deal of discovery and questioning about Maddox’s role.¹⁶⁷ Nonetheless, the court concluded that the check was written as a payment on behalf of Prime Corporation and not in the capacity of Maddox as her lawyer.¹⁶⁸ Still, the farmers testified to their belief that Maddox would look out for their best interests.¹⁶⁹ The evidence included ten phone conversations Maddox had with the farmers. The key elements here are: a problematic transaction that kept devolving into more difficulties; a naïve group of investors who misunderstood the role of the lawyers; and representations that, while 100% correct in a technical sense, caused the investors to be misled (e.g., it was correct that the bankruptcy was 95% complete—the omission was that the 5% represents the fall-apart point).

6. Bernstein v. Portland Sav. and Loan Ass’n

This case is unique in that there is dissent related to the lawyer’s

162. *Lycan*, 904 F.Supp. at 893.

163. *Id.*

164. *Id.*

165. *Id.* at 891.

166. *Id.* at 905.

167. *Id.* at 895.

168. *Id.* at 905.

169. *Id.* at 908.

conduct as a basis for recovery.¹⁷⁰ In this case, the fraud begins when Portland Savings & Loan (Portland) chose the brokerage firm of Legel, Braswell Government Securities (Legel Braswell) as its broker.

In May 1978, the Federal Home Loan Bank Board [(FHLBB)] notified Portland it wished to discuss Portland's financial position at the end of the month. Days before Portland officials traveled to Little Rock to meet with FHLBB officials, Portland's president gave approximately \$1.36 million in Government National Mortgage Association (GNMA) bonds to Legel Braswell for safekeeping in exchange for cash.¹⁷¹

Under these types of arrangements, brokers "would enter a safekeeping agreement and either simply hold onto the bonds or hold them as collateral for a loan."¹⁷² Legel Braswell's attorney, Sidney Bernstein, either drafted or approved the written safekeeping agreement or the transaction itself. Without Portland's knowledge or approval, "Legel Braswell then reregistered the bonds into its name and pledged them as collateral for a loan from Blyth, Eastman, Dillon & Co., Inc. to Legel Braswell."¹⁷³

Within a week of these events, Portland was in trouble with Texas regulators and was required to stop all trading in speculative securities. In early November, Portland officials met with Bernstein and Legel Braswell's principals, stressed the seriousness of Legel Braswell's position, and pressed for rescission. Portland threatened

legal action such as going to the Texas Attorney General, the Securities Exchange Commission, the Justice Department, or others. Any of these actions would have, at minimum, severely impaired Legel Braswell's ability to trade securities. The Legel Braswell representatives went off by themselves to discuss the matter. When they returned, Bernstein stated that Legel Braswell agreed to rescission. Legel Braswell gave Portland a \$100,000 check as a good-faith deposit on the agreement because of Legel Braswell being in a cash pinch.¹⁷⁴

This was the very thing that led to the pledge of the securities in the first place. There was no rescission agreement reached.

The parties met several times in November of 1978, yet no rescission agreement was reached¹⁷⁵ Ultimately, "Legel Braswell agreed to pay Portland \$1,336,000 (the amount Portland proposed) [and they proposed] yet another rescission agreement with additional collateral."¹⁷⁶ Portland officials did not respond to Bernstein but met with their board to request permission to file suit against Legel Braswell; however, be-

170. 850 S.W.2d 694 (Tex. App. 1993).

171. *Id.* at 698. For those of you unschooled in the history of great financial debacles, the FHLBB was checking up on Portland to be sure it had sufficient cash to cover its loans. It would later turn out that there were scandals brewing in this industry.

172. *Id.*

173. *Id.*

174. *Id.*

175. *Id.* at 698-99.

176. *Id.* at 699.

fore Portland could file its suit, Legel Braswell filed for Chapter 11 bankruptcy that was later converted to a Chapter 7 bankruptcy.

In reversing a jury verdict against Bernstein's estate, the court held, as Professor Steinberg noted, that the Fredo principle applies in Texas. Lawyers are only required to disclose confidential information that results in death or substantial bodily harm. Fraud is annoying, stressful, and can greatly reduce the assets and cash flow, but it does not fall into the Texas exemption.¹⁷⁷ However, there is a passage in the dissenting judge's opinion that breaks rank on all the Steinberg cases:

[W]e apply the standard law of frauds to this case. All that is required is an assertion of fact made recklessly or with knowledge of its falsity with the intent that the other party will rely. Bernstein could not know whether Legel and Braswell would make Portland whole, yet Bernstein made that representation to Portland with the intent to deceive and induce action.¹⁷⁸

If nothing else, the judge's qualification is a note of caution to lawyers on representations about clients' future behaviors. Recapping the key points: the client was teetering near bankruptcy; the lawyer who had drafted the pledge agreement that was illegal was now working on a rescission understanding the precarious financial position; the lawyer did not understand the "keep-safe" nature of the original securities transaction before drafting the agreement; and the timing on the part of the third-party deprived it of any hope for recovering its rightful property.

7. Meyerhofer v. Empire Fire & Marine Ins. Co.

Empire Fire and Marine Insurance Company (Empire) made a public offering of 500,000 shares of its stock, pursuant to an SEC registration.¹⁷⁹ "The stock was offered at \$16 a share. Empire's attorney on the issue was the firm of Sitomer, Sitomer & Porges [(Sitomer)]. Stuart Charles Goldberg was an attorney in the firm and had done some work on the issue."¹⁸⁰ Within six months the stock price dropped from \$16 to \$7, thus precipitating large investor losses and resulting litigation against Empire and Sitomer. Goldberg

had rather specialized experience in the securities field and had published various books and treatises on related subjects. He became associated with the Sitomer firm in November 1971. While there Goldberg worked on phases of various registration statements including Empire, although another associate was responsible for the Empire registration statement and prospectus. However, Goldberg expressed concern over what he re-

177. Apparently, the death of the lawyer for the defendant does not count as grounds for disclosure. Mr. Bernstein passed away before the litigation got rolling, and his estate litigated the case through his personal representative. Duty-to-disclose cases survive death.

178. *Id.* at 714.

179. 497 F.2d 1190 (2d Cir. 1974).

180. *Id.* at 1192.

garded as excessive fees, the nondisclosure or inadequate disclosure thereof, and the extent to which they might include a 'finder's fee,' both as to Empire and other issues.¹⁸¹

Nonetheless, the Empire paperwork and issue went through. However, the excessive fee issue weighed heavily on Goldberg's mind, and he resigned from the Sitomer firm about seven months after the Empire registration. Goldberg would later become involved in litigation over his relationship with and disclosures to the law firm representing the plaintiffs in their suit against Empire and Sitomer.

As it turned out, Goldberg was probably right about the excessive fees issue. The key element in this case, for purposes of the discussion following on lawyer responsibilities and liabilities, is whether Goldberg waited too long in taking action. The court concluded that Goldberg's affidavit after the fact and after leaving the firm did not violate the ethics rules on client confidences.¹⁸²

III. THE FLAWS IN THE REASONING AGAINST ATTORNEY LIABILITY TO THIRD PARTIES

We debate the issue of the role of corporate counsel as if we are grappling with a serious societal issue of mere babes in the woods who unwittingly serve or fall victim to the diabolical. To continue the metaphor, the historical review in the first part of this article reveals that counsel does not enjoy such detached innocence and may be furnishing the disguises for the wolves that lie in wait. Our debate does not acknowledge the reality of the intricate, involved, and knowledgeable positions of the corporate counsel in the very cases that have fueled the debate. The debate bemoans the future of the lawyer-client privilege. Client confidentiality, we argue, hangs in the balance. The debate is ill-focused on a symptom. "To tell or not to tell" debates find us ignoring the root causes and perhaps admitting that there is a void in our understanding of the role of counsel in organizations (micro systems). The effect of that lack of understanding is that these organizations, particularly for-profit corporations, have an effect on the economic systems in which they operate (macro systems). The strained construction of the privilege protections may actually serve as a deterrent to market efficiencies. Focusing on the fraud once it has erupted and the role of counsel at that horse-out-of-the-barn point deprives the profession of an opportunity to define a helpful role counsel could play for companies (in the sense of fraud prevention).

There are two flawed assumptions made by those who favor immu-

181. *Id.* at 1193.

182. *Id.* at 1195. The lesson may be that the lawyer can disclose when plaintiffs' securities litigation hangs in the balance, not just for run-of-the-mill fraud.

nity for legal counsel without regard for third party claims and losses resulting from organizational frauds. The first flawed assumption is that counsel is limited in available information and can only function according to provided instruction and direction. Inherent in this assumption is a second assumption that counsel is the helpless, powerless victims of diabolical moguls who hold Svengali-like powers over counsel. The second flawed assumption is that without counsel's ability to keep client confidences close to the vest, clients will not confide in counsel, thereby resulting in more and more corporate frauds.

A. Flawed Assumption One: Counsel Is Limited in Information

The discussions of the lawyer-client relationship in the corporate securities settings carry the presumption that counsel cannot know everything.¹⁸³ For the privilege and immunity arguments against disclosure to apply, there must be an underlying assumption that the lawyer can know only what the client discloses. In a legal world that seeks to justify nondisclosure, this picture of the organizational client's relationship with the lawyer is idyllic but inaccurate. In no case reviewed in Part I did diabolical clients exclude lawyers from information loops. Indeed, in the cases of Enron and Tyco, the lawyers themselves were circulating memos about the critical issues that were flags. In the cases of World-Com, HealthSouth, and Fannie Mae, employees, either through litigation or reports to the compliance division, raised flags that turned out to be accurate concerns about their companies and their operations. In each of the cases, the information was there for the plucking; the fraud in the air was low-hanging fruit for anyone willing to at least pass through the orchard for a check.

In addition, there is no case in which any conduct, financial reporting, or loans to officers was concealed from counsel. To the contrary, the managers of these organizations appear to have disclosed all aspects of their programs and operations because of their own assumptions that (1) their counsel would go along with their proposed courses of action; and (2) that the privilege would afford them confidentiality on the facts behind their courses of actions that resulted in losses to investors and others. The detailed discussions of both the high-profile collapses as

183. For example, in a discussion of the nebulous notion of "who is the client?," one scholar makes the following observation:

In organizations, though, especially as they grow larger and more complex, information flow, responsibility, the ability to make decisions based on accurate information, and the ability to monitor future consequences all become more diffuse and harder to pin down. The 'highest authority' may be so far removed from actual operations and significant information that it has very little practical choice but to make decisions based on information provided by others.

Mark Aultman, *Legal Ethics Rules and Corporations: What's "Client" Got To Do With It?*, 33 *CAP. U. L. REV.* 49, 50 (2004) (footnote omitted).

well as the cases cited by Professor Steinberg that have involved third parties seeking recovery from lawyers belie this assumption. Lawyers in all of the cases were in positions of full information. With WorldCom, Tyco, and HealthSouth, there were claims that, while subsequently settled or dismissed, raised questions about the companies' accounting practices. In the cases of Enron's and Tyco's legal teams, it took affirmative neglect to support the claim of ignorance. In the case of Fannie Mae, legal counsel was fully aware of a competent and technically-expert employee's allegations, and yet it did not follow through on even the internal investigation of the allegation. In addition, Fannie Mae had the curse and benefit of regulators who were raising questions about the company's accounting three years before their allegations would be verified as completely accurate in both their facts and seriousness.

With the benefit of hindsight, the argument can be made that those living through the evolution of fraud may not have understood what they were witnessing. For the sake of argument, we can grant that it is possible that counsel in the business case histories reviewed here may not have fully appreciated or understood either the quality or significance of bits and pieces of information wafting their way. If they did not, however, the case for upholding the privilege and allowing lawyers to remain silent despite what they have witnessed or even allowed is not made by the assertion of counsel's ignorance. The case that is made, however, is one for better training on the part of lawyers who assume these roles as counsel for corporations. In short, if they did not know, there was a deficiency in training, not a lack of disclosure on the parts of their clients.

None of the Steinberg cases suffers from nuanced information. In the Steinberg cases, legal counsel had actual knowledge of issues that affected third parties and said and did nothing. Rather than the picture of counsel being forlorn fifth wheels in these organizations, they were dynamic participants. Following a policy of "If I don't ask about evil, I won't have to tell," was hardly the intent of the rules designed to preserve client confidentiality. Fraud, even in its embryonic stages, is rarely nuanced.

In both the large-company frauds and the Steinberg cases there is an unintended consequence of the privilege that allows legal counsel to stand idly by until the conduct ripens into either full fraud or bankruptcy; this point almost always results when the fraud comes up as a topic of discussion. The purpose of the lengthy introductory section was to establish how clear the evolving frauds and resulting damages were. Given the magnitude of the losses and the eyewitness role of counsel in the frauds, the new question, at a minimum, should be whether from a public policy perspective the legal profession should continue its passive

role in these settings. Preventable harm has long been a foundation of legal liability, in everything from medical malpractice to product liability. This fascinatingly self-serving exception for the legal profession runs contra to its role as champions of those who have been harmed by companies and professionals. The dismissal of the flawed assumption now permits the debate to move in the direction of harm and public policy and away from the shelter of being an inactive participant in the deeds of others.

The duty to speak up on physical crimes comes at the time of the stated intention. But the verbal affirmation may not be sufficiently clear to alert counsel. There would, however, be nothing wrong with halting arson by disclosing the purchase of fourteen gallons of gasoline. No good can come from having that much gasoline about. Nor can any good come from the decision to lessen the volatility of earnings, spin the company debt off the books, or just move revenues around subsidiaries until we get the numbers we like. Arson involves physical lead-up acts that, when coupled with obtuse phrases, paint a picture of a soon-to-be-set blaze. Financial fraud also involves lead-ups that can be curbed, but only through the involvement of aggressive legal counsel. We need not dwell on specific frauds or company litigation to understand the extent of counsel involvement in the lead-ups to critical legal issues that affect earnings and chip away at market trust in terms of disclosure and the level playing field. For example, in the stock options backdating controversies, even academic researchers were reluctant to attribute what was becoming more and more obvious: that executives and boards were engaged in the manipulation of the dates for granting options in ways that afforded the grantees maximum returns on those options.¹⁸⁴ As one academic noted, those initial idea papers on the timing of options grants that suggested manipulation were met with skepticism because “[t]he whole idea was so sinister.”¹⁸⁵ The issue of options timing disappeared from the finance journals for a time because of the unwillingness to believe such blatant conduct would be permitted by boards, legal counsel, and a host of others often referred to as the gatekeepers for the corporate clients.¹⁸⁶ The date for options grants necessarily involved counsel because of the need for drafting and interpreting the options agreements, the board approval requirements, and the disclosures in the company 10-Ks. If the practices on options that are now under investi-

184. For more information and details on the stock option controversy, see Marianne M. Jennings, *Options: What Happened Here*, CORP. FIN. REV. (forthcoming).

185. Steve Stecklow, *Options Study Becomes Required Reading*, WALL ST. J., May 30, 2006, at B1.

186. The topic had been floating about since 1997 in the *Journal of Finance*. See David Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcements*, 52 J. FIN. 449 (1997).

gation in at least 100 companies did not raise a counsel eyebrow or two, then there is a larger question than privilege.¹⁸⁷ We return once again to the notions of either competency or blind eye. The impact of both is the focus in the discussion of the second assumption.

B. Flawed Assumption Two: If Clients Will Not Confide in Counsel, There Will be More Fraud.

The judge in one of the Steinberg cases provided a summary of this assumption in protecting lawyers from third party claims.

While we sympathize with plaintiff's position and certainly do not condone lawyers making misrepresentations, we find that public policy counsels against imposing such a duty. Attorney liability to third parties should not be expanded beyond liability for conflicts of interest. Any other result may prevent a client from reposing complete trust in his lawyer for fear that he might reveal a fact which would trigger the lawyer's duty to the third party. Similarly, if attorneys had a duty to disclose information to third parties, attorneys would have an incentive not to press clients for information. The net result would not be less securities fraud. Instead, attorneys would more often be unwitting accomplices to the fraud as a result of being kept in the dark by their clients or by their own reluctance to obtain information. The better rule—that attorneys have no duty to “blow the whistle” on their clients—allows clients to repose complete trust in their lawyers. Under those circumstances, the client is more likely to disclose damaging or problematic information, and the lawyer will more likely be able to counsel his client against misconduct.¹⁸⁸

The core of this assumption is that with protections for their disclosures to counsel, clients and their executives will bare their souls in order to obtain guidance on fraud. Not to put too fine a point on a response to the good judge's theory, but, “Flapdoodle!” Once again, the detailed history of the business frauds and the Steinberg cases demonstrate that counsel in these cases were used by clients and executives for their imprimaturs, not as sounding boards to keep them on the straight and narrow and away from the fraud's pyramids. These were not issues that caught counsel unawares. These were issues about which counsel had full knowledge but yet were allowed to continue without objection, or, to lower the bar just a bit, without advice on the business wisdom of the company practices highlighted in the histories presented in Part II. Capitalizing ordinary expenses is neither a nuanced ethical issue nor a proper accounting process, and it is not likely to produce a happy result for employees, shareholders, or officers of the company. Smoothing earnings to eliminate volatility in a company that operates in the volatile interest rate market is not a gray area and does not bode well for opera-

187. See generally Mark Maremont & Nick Wingfield, *More Questions About Options for Apple*, ACS, WALL ST. J., Aug. 7, 2006, at A3; U.S. Securities and Exchange Commission, <http://www.sec.gov> (last visited Nov. 15, 2006).

188. *Schatz v. Rosenberg*, 943 F.2d 485, 493 (4th Cir. 1991).

tions that are scandal-free. Ignoring the detailed and concerned voice of a knowledgeable and experienced employee on company accounting practices cannot have very many positive outcomes for companies, investors, employees, or counsel. The conduct and decisions of these companies and their executives were not close calls in an ethical, legal, or accounting standards sense; however, the presence of sullen but mute counsel in these cases and companies served to provide third parties with assurance about the bizarre levels of financial performance. While the companies' continued financial success and performance may have seemed too good to be true, the silence on the part of counsel afforded an unintended certification of the conduct of the company. This continuation occurred because it was difficult for investors and analysts to believe that counsel could remain in their roles with organizations that were building and executing such frauds.

Rather than having the effect of decreasing fraud, counsel silence seems to have had the effect of allowing fraud to take hold and continue. The natural market force of discernment is thwarted by the artificial constraints of the legal imprimatur. By taking shelter in the privilege, the profession interferes with free market forces. Investors are not investing or holding stock in these companies based on just their technical and public filings. Markets function on the basis of an amorphous concept of trust. Part of their perception of trust is formed on the basis of the continuing association of credible professionals with the companies in which they hold investments. To the extent that material information about a company's accounting, performance, or financial reporting decisions is withheld from the market (whether diabolically or in the name of the privilege), the void creates inefficiencies and permits more fraud.

This issue of market inefficiencies and asymmetric information has been explored extensively in the accounting and audit literature, but it has not been explored in terms of its application to counsel because of the privilege discussion role as a barrier to any other considerations in this critical public policy and market systems issue. The exploration in that literature focuses on whether holding auditors liable to third parties, whether under contract or tort law, increases efficiencies in terms of audit disclosures because of the incentives for accuracy and self-preservation such liability exposure provides.¹⁸⁹ The concept in auditing

189. The following list was offered as a summary of the tort liability/auditor efficiency in the work of Hans-Bernd Schäfer:

F. Parisi, Recovery for Pure Financial Loss: Economic Foundations of a Legal Doctrine, in M. Bussani and V. Palmer, eds, *Pure Economic Loss in Europe* 75-93 (Cambridge, 2003); see also M. Bussani, V.V. Palmer, and F. Parisi, *Liability for Pure Financial Loss in Europe: An Economic Restatement*. 51 *Am J Comparative L* 113, 113-162 (2003); E. Silverstein, *On Recovery in Tort for Pure Economic Loss*, 32 *U Mich L Rev* 404 (1999); E. Banakas, ed, *Civil Liability for Pure Financial Loss* (cited in note 1); W. Bishop, *Economic Loss in Tort*,

in terms of market functions can be described simply: "A wrong audit can cause damages to shareholders in secondary markets, to buyers of firms, or shares in primary markets. This happens especially if outside investors base their decision on the audit and buy overpriced company shares."¹⁹⁰

The principle, for purposes of discussion, can be carried over to the role of general counsel. Investors base their decisions on a host of factors when they make an investment, but one part of that is whether credible professionals are willing to have their reputations and firms affiliated with the company.¹⁹¹ To the extent that assumption is not accurate, there is overvaluation of the shares and a loss to those shareholders who purchased them based on incomplete or inaccurate information when the bad news that was withheld is released to the public.

This assumption on fraud prevention carries a sub-assumption that counsel would stand in front of the fraud train and prevent the client from engaging in that behavior (or, at a minimum, offer greater disclosure when the proposed act has not yet reached the legal definition of fraud), thereby offering protection for the market by playing the role of counseling the client company out of fraud or deception. The detailed histories and the Steinberg cases demonstrate that counsel have not undertaken that role and have rather simply assisted in continuing their legal imprimaturs for as long as possible. The parsing, the technicalities, and the loopholes have not served as a human stop sign for fraud. Rather, counsel in some cases have served as engineer and conductor. For example, UnitedHealth Group became one of the first companies to emerge as problematic with stock options. In fact, William W. McGuire, UnitedHealth Group's now former CEO, acknowledged that his company would have to book an additional \$1.6 billion in options expenses that had not been booked previously.¹⁹² Mr. McGuire's statement, perfectly parsed, on the occasion of the announcement of the options difficulties, was

I can say that, to my knowledge, every member of management in this company believes that, at the time, we collectively followed appropriate practices for those option grants which affected all of our employees, not

2 Oxford J Legal Stud 1, 1-29 (1982); V. Goldberg, Recovery for Pure Economic Loss in Tort Following the Exxon Valdes Oil Spill, 23 J Legal Stud (1991); M. Rizzo, A Theory of the Economic Loss Problem in the Law of Torts, 11 J Legal Stud 249, 249-275 (1982). [sic] Hans-Bernd Schäfer, *Efficient Third Party Liability of Auditors in Tort Law and in Contract Law*, 12 SUP. CT. ECON. REV. 181, 183 n.2 (2004).

190. *Id.* at 181-82.

191. The very foundation of public accounting and the requirement of the external auditor certification of financial statements is public protection from the self-interest of those within the company charged with keeping the books, policing internal expenditures and controls, and developing the financial reports. In effect, lawyers enjoy an exemption from liability for their role in certifying the public filings of the company.

192. Like all the other companies studied in detail in Part II, it is no small task to forget one-and-one-half billion in expenses. That's a chunk of change for any company.

2006]

Fraud is the Moving Target

69

simply selected executives, and that such activities were within guidelines and consistent with our stated program objectives.¹⁹³

The translation and qualifiers in the statement require a score card and an interpreter:

- There may be other facts that change my statement (“to my knowledge”)
- Everybody here thought it was okay (“we collectively”)
- It may not be right, but we thought it was (“every member of management . . . believes that, at the time”)
- More than just we executives got options; the employees were in on this too (“not simply selected executives”)
- Not sure about propriety now, but they sure did meet our own goals and rules (“such activities were within guidelines and consistent with our stated program objectives”)

Knowing that a company had an additional billion-plus in expenses is the type of information that drives share price and market movement. Allowing the options program to continue at UnitedHealth in the form it took and without requiring that the options be expensed was also not a close legal or ethical call, as the company’s actions and admissions now demonstrate. The revelation and belated expensing by UnitedHealth present us with one of three alternatives on the role of counsel: (1) counsel did not know about the issue on the options; (2) counsel did not understand the significance of the options issue; or (3) counsel knew and understood the options issues but did not insist on disclosure of the real cost of the options program. The first is difficult to believe; the second is an issue of competency; and the third possibility represents the bulk of the situations explored in Part II, and it represents the crux of the matter when it comes to counsel disclosures of client frauds.

IV. IF THE ASSUMPTIONS ARE FLAWED: WHAT NOW?

With the flaws in the assumptions revealed, the question should be, “What now?” The extensive histories and market dependence of investors on counsel credibility leaves us with far more than the attorney-client privilege hanging in the balance. The focus of the discussion should shift to a re-examination and re-alignment of the role of counsel with regard to corporate clients. What dangles by a thread is the reputation of the profession when counsel is working closely with corporations that are teetering on the fraud line and yet counsel remain silent about the conduct. There are several palatable alternatives that would not reduce the debate to the technical rule of the lawyer-client privilege.

193. *UnitedHealth Chief Seeks End to Options*, N.Y. TIMES, April 19, 2006, at C9.

A. *Lawyer as Counselor: Introspection on Professional Decline and One's Moral Compass*

Reinvigorating the notion of the lawyer as counselor is not new.¹⁹⁴ Others have proposed that counsel undertake the role of counselor.¹⁹⁵ This proposal finds the lawyer offering specific advice on accounting issues, strategic financial structure decisions, deal structuring, and financial reporting. The lawyer as counselor draws definitive lines for clients and reminds them of the difference between what is legal and what is ethical. The following monologue was included in a discussion of the role lawyers once played in influencing client conduct in business decisions that, while legal, are not consistent with either the lawyer's or the client's ethical standards:

You and I go back a long way. I opened this office at about the same time that you took over your company from your dad. Back then people told me that, if I was lucky, good, and honest, I might be fortunate enough to work for you some day. I aimed for that. Not just because your business was big enough to have some real legal issues worth sending to a lawyer, but because simply being associated with your business, and with you Jack, was something of an honor.

You were known to be a hell of a businessman. You were also known always—and I mean always—to play fair and square.

You talk to me tonight like the person I sought to represent never walked the earth. You come here asking that I help you to cheat a man who has done nothing but right by you for more than a decade.

Oh, I'm not telling you that you cannot do what you propose. If you did, and it went to court, you might win because there is no written contract, not even a purchase order yet. We could even sit here tonight and go over the facts again and maybe I could give you a legal opinion saying that the law, when examined closely, is unclear on whether you are required to deliver that inventory to your longtime customer or not.

But I'm not going to do that, Jack, because both you and I know that what you are considering is wrong. You know it's wrong, otherwise you would not be here at ten o'clock at night when there is no one else to see you and no one else to hear you.

Now, you go on home. You hug your wife, Sally. You kiss those two young children of yours good night. You get up tomorrow and do the right thing.¹⁹⁶

As the author went on to note, it is difficult to imagine this of the lawyers of today who bring together the venture capitalists with their clients and pen the deals designed to make all of them wealthy within moments after the shares hit NASDAQ. We have difficulty envisioning a lawyer in those circumstances offering caution about the long-term

194. See Jennings, *supra* note 39.

195. See William O. Fisher, *Where Were the Counselors? Reflections on Advice Not Given and the Role of Attorneys in the Accounting Crisis*, 39 GONZ. L. REV. 29, 86 (2004).

196. *Id.* at 31.

impacts of an IPO with no business plan in place to provide a return on investment to the investors who will ante up the dough that will fill their coffers at a young and inexperienced age.¹⁹⁷ The focus then is perhaps not so much on the lawyer as counselor and its disappearing role, as on the decline in the moral standards of the profession that counsel have become comfortable multi-tasking in business deals, including playing the role of beneficiary in an IPO in which they offer their imprimatur on the technical filing requirements and public disclosures about the company. That dual role presents a classic conflict of interest that is easily spotted at a very basic level of a study in ethics. Yet, somehow, we have come to allow entire firms to be built on this form of securities law practice.

The shift in the moral compass is evident also in the UnitedHealth Group statement offered by the CEO. The parsing and interpretation were flawless. The ethics of the company's practices with regard to options were fundamentally flawed, but legal counsel saw fit to see the company through the nondisclosure of such a large expense.

The lawyer as counselor requires a re-examination of ethical lines for counsel, not focused on the technical aspects of the code, but rather on the realization of the market impact that the professional has. What is profoundly lacking in the discussion of "to tell or not to tell" is the recognition that the resolution of that dilemma goes well beyond the privilege and SEC regulations. The decision of counsel to remain affiliated with an organization where fraud is afoot is in itself a market mover. And there is a reminder once again of the intense case studies in Part II—none ended as close calls in either law or ethics. At the heart of all of the cases was the fundamental issue of fairness to investors in the companies. When regulations, accounting standards, and mandated disclosures are synthesized to their simplest terms, they are detailed definitions of fairness: fairness to investors; fairness in the depiction of the value of the company, and fairness in terms of the behaviors and rewards to the officers of the company.

B. The Lawyer as Technical Expert: Counsel as Detached Observer

The discussion of assumptions in Part III cautioned that the missteps in the companies in Part II were so profoundly obvious that either counsel turned a blind eye or they did not understand the profound implications of the conduct. If the former is true, the lawyer-as-counselor-discussion applies. If the latter is true, future debate requires a warning about the need for counsel expertise. Those who would serve as corporate counsel, whether internal or external, must have a working knowl-

197. See *id.* at 33-42.

edge of both accounting and financial reporting. More importantly, counsel must understand the activities in the last days of a quarter or of the fiscal year and what it means to make “on-top” adjustments. A lawyer cannot counsel a company unless there is more than a superficial understanding of the accounting rules and the areas for interpretation in application of those rules. Indeed, the role of corporate counsel cannot be that of advocate, but it should be one of technical expert who is able to dispassionately discuss the accounting rules, the company’s interpretation of them, and the reasons others would find the company’s approach problematic. Advocacy is not the role of counsel in the application of accounting rules. Detached observer who offers candid thoughts is a better job description.

Overall, a lack of detachment contributed to a failure to follow up on red flags at Fannie Mae, Tyco, WorldCom, HealthSouth, and too many others where litigation and regulatory questions should have warranted detailed investigations, not merely argument for management’s positions. Advocacy on accounting issues results in boards and investors who are “shocked, shocked” by the eventual accounting improprieties.

In fulfilling the role of detached observer, counsel needs to caution clients about the landmines that affect those in the clients’ industry. This task demands an understanding of the areas of contention, in terms of accounting. From inventory to off-shore transactions, counsel must be there for the first accounting decision because, as the histories show in great detail, there is a step-by-step road to fraud.

C. Some Final Thoughts on Not Being “Shocked, Shocked”

Perhaps one final observation would prove helpful in the debate on what counsel should disclose and when to make that disclosure. The debate seems to be more of a struggle to retain the client as long as possible without losing the immunity afforded by the attorney-client privilege. The desire is to carve out some exception to the rule that ethical courage does demand its pound of flesh. The debate fails to acknowledge the desire to have the best of both worlds: continuing representation with that stream of income without accountability for the client’s evolving fraud. Those two goals are incompatible in both the legal and moral sense. Increasing liability to third parties is the public policy adjustment that seeks to offset the lack of information investors experience when counsel remains part and parcel to a company’s fraudulent activities.

There is no waiver of privilege in the simple act of counsel deciding that representation of the client in the path it has chosen is no longer an option for a person of integrity. The benefit of walking away (without

2006]

Fraud is the Moving Target

73

further mandated disclosure) is that the market problem of asymmetrical information could be solved. If the standard was for counsel to decline further representation in cases such as those presented here, the clients who were engaged in fraud would find that the lack of representation was the market's natural adjustment. Without counsel's imprimatur, the fraud cannot continue.

Professor Steinberg raises a critical issue for counsel at a critical juncture. His suggestion of a second opinion does not, however, end the debate or provide a resolution that can correct the market impact of corporate counsel. The issue is not the sanctity of the privilege or immunity from liability. Rather, the issue is one of restoring the role of lawyer as counselor; it is one that never finds them shocked at a client's conduct even as they continue to enjoy full responsibility and compensation for that conduct. Corporate counsel is the target because they have become inextricably intertwined with the client. Amoral advocacy has produced the case studies here and the liability exposure. Assuming the role of a detached counselor with technical expertise who understands the critical function of walking away from evolving fraud could not only eliminate the need for the debate, but it might well prevent the third-party liability that has many wringing their hands.