Corporate Responsibility and the Regulation of Corporate Lawyers

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On July 30, 2002, in an effort to demonstrate to the American public a resolve to crack down on corporate scandals such as Enron[1], Adelphia[2], WorldCom[3] and Global Crossing, President Bush signed into law the "Public Accounting Reform and Investor Protection Act of 2002" (H.R. 3763).[4] Proclaiming that the new law will restore investor confidence, reform the oversight of public accounting and increase the transparency of corporate financial statements, the new act proposes to:

1. Create an independent public company accounting oversight board[5] to oversee the companies that are subject to the federal securities laws and require mandatory registration for all public accounting firms that audit publicly held companies. The board is empowered to inspect, regulate, discipline and sanction auditing firms and to promulgate ethical standards and other rules with respect to the issuance of audit reports. In addition the board shall report any illegal acts, practices or omissions to the appropriate federal and state regulatory and law enforcement agencies. The Securities Exchange Commission will have oversight authority over the board.

2. Amend Section 10A of the Securities Exchange Act of 1934[6] to make it unlawful for a public accounting firm—or any person associated with that firm—to concurrently provide non-audit services to clients they audit, including:

   A. bookkeeping or other services related to the accounting records or financial statements of the audit client;

   B. financial information systems design and implementation;

   C. appraisal or valuation services, fairness opinions or contribution-in-kind reports;

   D. actuarial services;

   E. internal audit outsourcing services;

   F. management functions or human resources;

   G. l*egal services and expert services unrelated to the audit*; and

   H. any other service that the board determines, by regulation, is impermissible.

   A public accounting firm may provide to an audit client other permitted non-audit services (i.e., tax services) but only if such activity is pre-approved by the board, meets the board's requirements and disclosure to investors is made. Section 201 (*emphasis added*).

3. Conduct a study to consider mandatory rotation of registered public accounting firms.

4. Prohibit the listing of the securities of any corporation that is not in compliance with the act's requirements.

5. Impose corporate responsibility for financial statements or reports by requiring the principal officers to certify in each annual or quarterly report that:

   A. the signing officer has reviewed the report;

   B. based on the officer's knowledge, the report does not contain any untrue statement of material fact or omit to state a material fact necessary to make the statements not misleading;

   C. based on the officer's knowledge, the financial statements and other information in the report fairly present in all material respects the financial condition and results of operations of the company;

   D. The signing officers:

      1) are responsible for establishing and maintaining internal controls;

      2) have designed internal controls to ensure that material information relating to the company and its consolidated subsidiaries is made known to such officers;

      3) have evaluated the effectiveness of the company's internal controls withing 90 days of the filing of the report; and

      4) have included in their report their conclusions about the effectiveness of the internal controls based on their evaluation as of that date.

   E. The signing officers have disclosed to the company's auditors and the audit committee of the board of directors—or person's fulfilling the equivalent function:

      1) all significant deficiencies in the design or operation of internal controls which could adversely affect the company's ability to record, process, summarize and report financial data and have

identified for the company's auditors any material weaknesses in internal controls; and

2) any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal controls.

6. Impose forfeiture of any bonus or equity based compensation earned by the chief executive and chief financial officers for the 12-month period following public issuance of any financial report, as a result of any misconduct defined by the act, or noncompliance with the act's requirements relating to financial reporting. Such profits or compensation will be reimbursed to the company, not the federal government. Section 304.

7. Prohibit insider trading during pension fund blackout periods. Section 306.

8. *Develop Rules of Professional Responsibility for attorneys appearing before the SEC on behalf of any company whose stock is publicly traded. The SEC will promulgate and implement minimum standards for professional conduct for attorneys acting of behalf of publicly held companies to include:*

   A. requiring an attorney to report evidence of a material violation of the securities laws or breach of fiduciary duty or similar violation by any company or employee or agent thereof, to the chief legal counsel or the chief executive officer of the company (or equivalent thereof); and

   B. if the counsel or officer does not adequately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors comprised solely of directors not employed directly or indirectly by the company, or to the board of directors. Section 307 *(emphasis added*).

9. Require enhanced financial disclosures, including, with respect to off-balance sheet transactions, disclosure of contingent obligations and the company's relationships with unconsolidated entities or other persons, that may have a material current or future effect on the financial condition, results of operations, liquidity, capital expenditures, capital resources or significant components of revenue or expenses.

10. Require more stringent regulations for pro forma figures. Section 401 (b).

11. Require a study and report on special purpose entities. Section 401 (c).

12. Require enhanced conflict of interest provisions, including prohibition of company loans to executives. Section 402 (a).

13. Require the SEC to implement a code of ethics for senior financial officers. Section 406.

14. Enhance SEC review of periodic disclosures by regulated companies. Section 408.

15. Increase regulation of securities analysts and research reports issued by analysts to address conflicts of interest, including rules requiring disclosure of the analyst's conflicts of interest in all reports and public appearances. Section 501.

16. Require that all audit records and papers be maintained by public audit firms for a period of five years from the end of the fiscal year in which the audit was concluded and making it a criminal act to knowingly destroy audit records prior to the expiration of the required retention period. Section 802.

The new legislation has already triggered significant criticism by the American Bar Association and other nationally known experts such as Lawrence Fox, a Philadelphia litigator, former chair of the ABA's Standing Committee on Ethics and Professionalism, author and frequent lecturer on the subject of legal ethics.

The ABA's concerns focused on: The act's "overly broad definition of 'persons associated with accounting firms,'" which some could interpret as permitting the newly created board to regulate attorneys "associated with public accounting firms;" the provisions authorizing the SEC to promulgate rules of professional conduct for attorneys appearing before that agency and a provision in the House legislation that would permit the controller general to study the *ABA Model Rules of Professional Conduct* and existing SEC rules and possibly recommend new federal legislation or regulations to override existing rules.[7]

The third concern of the ABA can be dispensed with quickly. The conference bill, which President Bush signed into law on July 30, contains no provision similar to the House bill's provision authorizing the controller general to study the *ABA Model Rules of Professional Conduct.*

The act's definition of "persons associated with accounting firms" could be interpreted as applicable to lawyers. However, the use of that phrase in the act always appears in provisions aimed solely at the accounting profession. Since the act has a section specifically applicable to lawyers representing publicly held companies—Section 307—the rules applicable to accounting firms and "persons associated with accounting firms" should not be construed as including lawyers.

The act's requirement that the SEC propose rules of conduct governing attorneys who appear before the commission has prompted great concern by the ABA and others who fear that the federal government is usurping the authority of the states to regulate the practice of law and discipline attorneys. Legal ethics expert Larry Fox, expressed his concern:

> The very idea of the Senate enacting or directing others to enact rules of professional responsibility for lawyers should be enough to cause collective professional indigestion. A fundamental tenet is that our rules shall be promulgated by the states. Lawyers often have correctly resisted efforts by the federal government to usurp the states' highest courts traditional role of regulating lawyers.[8]

Viewing the act as an intrusion by the federal government into lawyer regulation traditionally reserved to the states, more

particularly the judiciary, the ABA has commissioned a Task Force on Corporate Responsibility which recently issued a preliminary report recommending changes to the *Model Rules of Professional Conduct*.[9] The proposed changes are intended to encourage lawyers to report evidence of securities violations and other serious misconduct to the company's managers, executives or directors. Some of those who participated in writing the report have said they are troubled by the federal government's encroachment in this area.

While the act proposes federal regulation of lawyers, the IRS, INS and PTO and other federal agencies already regulate lawyers who practice in areas of particular federal concern. So why shouldn't the same be true of practice before, or directly related to, the SEC? Granted, some legal practice is intensely local, such as real estate, trusts and estates, family law, etc. However, the representation of public companies is a matter of national, if not global, concern. The federal government has regulated the national economy for some time now. Isn't it inevitable and appropriate for federal agencies to have a say in the practice of lawyers?

Sperry v. The Florida Bar[10] made clear that the federal supremacy doctrine permits a federal agency to establish rules of practice for persons authorized to practice before the PTO. The states could not interfere with the federal regulation of practitioners before that agency by prosecuting a registered patent examiner for UPL. Indeed, the states have accepted the concept that a federal agency may discipline a lawyer to the extent that state bars have imposed reciprocal discipline based on disciplinary actions taken by a federal agency such as the PTO.[11]

Moreover, the authority given the SEC to regulate attorneys representing public companies regulated by the SEC does not supplant or pre-empt the states' power to discipline the attorney for the same conduct. All the SEC can do under the act is censure, suspend or disbar the attorney from practicing before that agency. Only a state bar can take action against the attorney's license to practice law.

Finally, isn't it somewhat ironic that the ABA objects to the federal government attempting to develop national standards of practice for securities lawyers, when the ABA promulgates and encourages the states to adopt uniform rules of professional conduct? While some lawyers may be uncomfortable or feel threatened by federal or national standards of conduct, a lawyer's professional obligations in terms of reporting serious misconduct higher up the corporate ladder should not differ from state to state nor depend on where the corporate lawyer is licensed.

The media's hyperventilation over these recent corporate scandals creates the impression that these corporate scandals are unprecedented. Regrettably, this simply is not so. Over the past 50 years, this country has witnessed a series of newsworthy corporate frauds. All of these scandals raise questions about a lawyer's responsibilities when a lawyer discovers, or has reason to know, that officers or other agents of the lawyer's corporate client are engaged in conduct that violates the law or breaches their fiduciary duty to the corporation and is likely to result in harm to the corporation, shareholders or other third persons. Examples include the National Student Marketing[12] scandal in the late 1960s, O.P.M. in the early 1970s[13], Lincoln Savings & Loan during the S & L crisis of the 1980s[14] and the more recent BCCI bank failure and fraud of the 1990s, which involved Washington insiders Clark M. Clifford and Robert Altman.[15] In each of these situations, without admitting liability, outside law firms paid massive sums of money to settle liability claims in which injured parties asserted that the lawyers assisted their corporate clients in conduct that was fraudulent or illegal. Moreover, in addition to criminal prosecution as an accessory to the client's criminal conduct, a lawyer may be disciplined if he or she counsels or assists the client in conduct that the lawyer knows is criminal or fraudulent. *See* Virginia Rule 1.2 (c).

Critics of the new federal law assert that it changes the rules governing a lawyer's duties when learning that an employee or officer is engaging in misconduct that could seriously injure the company. In fact, the requirements imposed by Section 307 of the act are not inconsistent with the lawyer's obligations under Virginia Rule 1.13 or ABA Model Rule 1.13.[16] Neither the act nor Rule 1.13 require or even authorize the lawyer to publicly reveal or report evidence of past corporate wrongdoing. The lawyer's ethical duty of confidentiality under Rule 1.6 (Virginia or ABA version) prohibits the disclosure of client information related to a client's *past* crimes. Unlike the ABA version of Rule 1.6 that has no mandatory disclosure exceptions to client confidentiality, Virginia's Rule 1.6 requires a lawyer to report a client's intent to commit a *future* crime.[17] In addition, unlike the ABA Model Rules, Virginia permits a lawyer to reveal otherwise confidential information where the lawyer has information that clearly establishes that the client has, in the course of the representation, perpetrated a fraud on a third party related to the subject of the representation. Thus, the new federal act does not impose any obligations on a Virginia lawyer that would place the lawyer at risk of violating the Virginia rules of conduct.

One could argue perhaps that the ABA Model Rules need revision in this area to enable or require lawyers to disclose information necessary to prevent a continuing fraud by a client. At least 37 states have rules that permit lawyers to disclose such information.[18]

The primary rules that govern the lawyer's ethical obligations when faced with corporate client fraud are Rules 1.6 and 1.13. Although Virginia's Rule 1.13 and ABA Model Rule 1.13 are identical, the obligations of an attorney under Virginia's Rule 1.6, in contrast to ABA Model Rule 1.6, are very different.

Issues Facing the Corporate Lawyer When Officers Engage in Illegal or Fraudulent Conduct

The issues that arise in these situations are complex ones that turn on factual and legal issues including the following:

(1) When and what did the lawyer know at the time of the alleged illegal or fraudulent activity?

(2) What scienter (intent) standard should be applied to the lawyer's conduct? Stated differently, when does a lawyer "know" that employees or agents of an organization are engaging in illegal or fraudulent activity that could result in substantial harm to the organization?

(3) Does a lawyer who learns of facts or circumstances suggesting possible fraud have a duty to inquire further?

(4) When the lawyer knows, or has reason to know, that officers of his corporate client are pursuing a fraudulent course of conduct, should or must the lawyer take this information to the client's highest authority, the board of directors?

(5) If the officers and/or the board refuse to cease or rectify what the lawyer believes is fraudulent conduct, may or must the lawyer disclose this information to defrauded third persons or a public officer?

Disclosure of Information Adverse to the Corporate Client to Third Parties

When may a lawyer inform others outside the company when the corporate client is engaged in fraudulent or illegal activity? This question is harder to answer than it looks. The circumstances, if any, under which an attorney may disclose client fraud or criminal wrongdoing to prevent harm to others has always been the subject of controversy.

ABA Model Rule 1.6 provides exceptions to the duty of confidentiality; only:

(1) where the lawyer "reasonably believes disclosure of client information is necessary . . . to prevent the client from committing a criminal act that the lawyer believes is likely to result in imminent death or bodily harm;"

(2) when disclosure is required by law or court order;

(3) when necessary to seek advice about compliance with the ethics rules; or

(4) for purposes of the lawyer's self defense or to establish his or her fees.

Other than perhaps the "self defense" exception, ABA Model Rule 1.6 is likely to have little application in the context of fraud or criminal conduct within an organization represented by the attorney. The exceptions do not cover fraud or criminal conduct typical of corporations. Assuming that perhaps some corporate behavior may be deemed likely to result in death or substantial bodily harm (i.e., toxic tort or product liability case), the exception's requirement that harm or death be "imminent" rules out this exception, and most corporate wrongdoing is likely to result in financial loss or injury to property.

Virginia's version of Rule 1.6 permits, but does not require, disclosure where a lawyer possesses information that "clearly establishes" that the client has, during the course of the representation, perpetrated a fraud on a third party related to the subject of the representation. Rule 1.6 (b)(3). A lawyer confronted with a client fraud situation must consider:

1. When did the fraudulent activity occur, i.e, did it occur during the lawyer's engagement (or prior or subsequent thereto)? Is the fraudulent activity ongoing?

2. Is the fraudulent activity related to the subject matter of the representation? Stated differently, is there a nexus between the services provided by the lawyer and the fraudulent activity?

3. What is the source of the lawyer's information or knowledge of the client's fraudulent activity? Is the information reliable? Does the information or evidence "clearly establish" that the client has perpetrated a fraud on third party? *See* Virginia Rule 1.6 (b)(3); *X Corp. v. Doe,* 805 F.Supp. 1298 (E.D. Va. 1992), *aff'd sub nom. Under Seal v. Under Seal*, 17 F.3d 1435 (4th Cir. 1994) (interpreting predecessor DR 4-101 (c)(3) and holding that "clearly establishes" standard imposes a heavier burden on the party seeking disclosure than the prima facie standard of the crime-fraud exception to the attorney-client privilege).

In regard to the first issue, "timing is everything." If the client's fraudulent activity occurred *before* the lawyer's engagement, it did not occur "in the course of the representation" as required by Rule 1.6 (b)(3), and, therefore, the information cannot be disclosed pursuant to that rule. *Past* criminal and fraudulent acts by a client are presumptively protected under Rule 1.6 and cannot be revealed unless the client consents.[19] Under those circumstances, it would be necessary for the lawyer to obtain the client's consent after consultation, including the lawyer's assessment of the legal consequences of making the disclosure.

Similarly, if the client's fraudulent conduct occurs after the lawyer's engagement has ended, it did not occur "in the course of the representation" and cannot be revealed without the client's informed consent. *See,* LEO #1643 (1995) (divorce lawyer's disclosure of former client's concealment of assets from bankruptcy court not authorized because client's fraud did not occur in the course of the representation).

In summary, Rule 1.6 (b)(3) permits disclosure of client fraud only if: the lawyer has evidence that clearly establishes that the client has perpetrated a fraud on a third party; the fraud occurred in the course of representing the client[20]; and the fraud is related to the subject matter of the representation.

Failure to analyze theses issues carefully before making disclosure may create malpractice and disciplinary exposure for the attorney. The duty to protect client confidences and secrets is far more protective than the attorney-client privilege. Except as permitted under Rule 1.6 (b)(3), disclosure of any information that the client has engaged in fraud on a third party would be detrimental and embarrassing to the client and therefore a violation of Rule 1.6.

A more difficult problem is when the client continues to engage in an "ongoing crime or fraud." The parameters of a continuing or ongoing crime or fraud are not very clear. An example of a continuing wrong would be the client's unlawful possession of stolen goods. Confidential communications between attorney and client concerning the indictment for theft and possession and the facts underlying those offenses are privileged. However, client-attorney communications about how the client may continue to remain in possession of the stolen property or information concerning the property's current location are not protected.[21] In LEO 929 (1987), the Virginia Legal Ethics Committee concluded that a lawyer receiving an unsolicited letter from a fugitive client (capias outstanding for failure to appear in court) indicating that the fugitive intends to leave the United States may not reveal the client's intent because it amounts to a continuing wrong rather than a future crime (which would have to be revealed). This opinion is confusing because the committee characterizes the client's

intent to flee the country as a "continuing wrong" that does not fit in the category of a prospective crime. Therefore, the client's whereabouts cannot be revealed. In later opinions, however, the committee refers to an "ongoing" crime or fraud as not protected under the confidentiality rule. *See* LEO 1688 (1996). Unless some valid distinction can be drawn between a continuing and an ongoing wrong, it is difficult to reconcile these conflicting positions. Some legal authorities state that the so-called "crime-fraud" exception (permitting or requiring disclosure of client information) to the attorney-client privilege does apply to client crimes or frauds that are ongoing.[22] In addition, if the lawyer's services are used to perpetuate a past wrong or fraud, some courts hold that the "crime-fraud" exception will apply and the communications between attorney and client relating to the lawyer's services are not privileged.[23]

Is There a Duty to Investigate, or Can the Lawyer Do Nothing and Remain Silent?

What should a lawyer do when he or she learns information suggesting employees or officers are engaged in wrongdoing that could result in substantial harm to a corporate client? Some argue that the lawyer has a duty to investigate and make an inquiry, and there is some legal authority to support that position. In *FDIC. v. O'Melveny & Myers*, 669 F.2d 744 (9th Cir. 1992), *rev'd and remanded on other grounds*, 512 U.S. 79 (1994), *reaffirmed on remand*, 61 F.3d 17 (9th Cir. 1995), the receiver of a failed thrift stated a claim against a law firm that had assisted the thrift in two real estate syndications offered to investors. When the private placement was made, the thrift was in unsound financial condition; its officers had fraudulently overvalued assets, embezzled funds and generally "cooked the books." The complaint alleged that the law firm, knowing of the recent resignations of the thrift's prior auditors and outside law firm, failed to question the auditors, the law firm, federal or state regulators, or the thrift's financial officer about the thrift's financial status before rendering legal opinions and doing other work that assisted the thrift in soliciting investors. After the thrift failed, the FDIC, acting as conservator, rescinded the investments and was assigned the investors' claims against O'Melveny. The receiver then brought suit against O'Melveny for professional negligence and negligent misrepresentation.

In *FDIC v. Clark*, 978 F.2d 1541 (10th Cir.1992), the receiver of a failed bank sued the bank's outside counsel for failing to investigate claims made in a civil lawsuit against the bank that alleged that the bank's president had conspired to defraud the bank of several million dollars through a fraudulent loan scheme. The lawyers accepted the president's explanation of the situation and failed to inquire further or to inform the board of directors of the allegations. The court upheld a jury verdict against the lawyers, stating that "there was ample proof for the jury to find that defendants were negligent in their professional duties to the bank, and that their negligence was a cause of loss" to the bank.

On the other hand, some cases have held that the lawyers owe no duty to third persons defrauded by a corporate client, even though the lawyer could have taken some measures to protect the third party's interests. *Schatz v. Rosenberg*, 943 F.2d 485 (4th Cir.1991), *cert. denied*, 503 U.S. 926 (1992), held that a lawyer has no duty to correct client misrepresentations to third persons before closing a transaction with the defrauded person. The lawyer, aware that the client's financial situation had deteriorated, forwarded the client's false financial statement to the person buying the client's business and taking in return an unsecured note for a portion of the purchase price. When the client filed for bankruptcy, the purchaser suffered financial loss. The court affirmed dismissal of counts charging the firm with liability as an aider and abettor under federal securities law and Maryland tort law. The court stated that "lawyers have no duty to disclose information about clients to third party purchasers or investors in the absence of a confidential relationship between the attorney and the third party." When the lawyer merely documents the transaction and does not himself make representations to the third party or provide a legal opinion that does so, the lawyer is not liable even though ordinary agency law (applicable to agents of sellers generally) would impose liability.

The United States Supreme Court brought some relief to securities lawyers in its decision in *Central Bank of Denver v. First Interstate Bank of Denver*[24], rejecting a *federal* claim of civil liability for lawyers and other advisors, i.e., accountants. However, lawyers and other advisors may still be held liable under *state* securities and tort law.

Also critical is the extent of the lawyer's knowledge and involvement in the transaction. In *Barker v. Henderson, Franklin, Starnes & Holt*[25], the court rejected a claim on summary judgment that a lawyer assisted the corporate client in a fraudulent transaction, because the lawyer's participation in the transaction was too insubstantial. The lawyer, a general practitioner, assisted the corporate client in corporate and property matters which were part of the project in which interests were sold to the plaintiff-investors. Although the lawyer received the client's selling materials, he did not review or approve them, nor was his name on them. The corporate client engaged a large firm to handle the securities issues. That firm settled claims made against it for assisting client fraud to the tune of $612,500. In regard to the general practitioner, the court observed:

> . . . A plaintiff's case against an aider, abetter or conspirator may not rest on a bare inference that the defendant "must have had" knowledge of the facts. The plaintiff must support the inference with some reason to conclude that the defendant has thrown in his lot with the primary violators.
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> Law firms and accountants may act or remain silent for good reasons as well as bad ones, and allowing scienter or conspiracy to defraud to be inferred from the silence of a professional firm may expand the scope of liability far beyond that authorized in [controlling Supreme Court decisions].[26] If the plaintiff does not have direct evidence of scienter, the court should ask whether the fraud (or cover-up) was in the interest of the defendants. Did they gain by bilking the buyers of the securities? *Cf. Dirks*, 463 U.S. at 662-64. In this case the firms did not gain [an accounting firm was also involved]. They received none of the proceeds from the sales. They did not receive any fees for rendering advice in connection with the sales to the plaintiffs. Both firms billed so little time . . . that it is inconceivable that they joined a venture to feather their nests by defrauding investors. They had nothing to gain and everything to lose. There is no sound basis, therefore, on which a jury could infer that the firms joined common cause with other offenders or aided and abetted a scheme with the necessary state of mind.[27]

Going Up the Corporate Ladder

When does a corporate lawyer need to climb the corporate ladder and report misconduct to the board of directors? Virginia Rule 1.13 (b) states:

> If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, and is likely to result in substantial injury to the organization, the lawyer shall proceed as is reasonably necessary in the best interest of the organization. In determining how to proceed, the lawyer shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyer's representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters and any other relevant considerations. Any measures taken shall be designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organization. Such measures may include, among others:
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> (1) asking reconsideration of the matter;
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> (2) advising that a separate legal opinion on the matter be sought for presentation to appropriate authority in the organization;
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> (3) referring the matter to higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act on behalf of the organization as determined by applicable law.

Critics of the rule assert that it is too imprecise and really requires nothing. Some lawyers may conclude that remaining silent and doing nothing is in the best interest of the organization. Considering some of the civil liability cases cited, such an interpretation may be a recipe for disaster.[28] *FDIC v. Clark*, *supra*, is a good example of a case based on failure to climb the corporate ladder. Once a corporate lawyer has reason to believe that officers or employees are engaging in wrongdoing that could cause substantial harm to the organization, isn't it always in the best interest of the organization for a lawyer to "climb the corporate ladder" as high as necessary to address the problem? Since Rule 1.13 (b) gives the lawyer the discretion to "climb the corporate ladder" why wouldn't a lawyer choose this approach? A practical answer may be that the lawyer, particularly in-house counsel, does not wish to be seen as a "whistleblower" by the person(s) who hire and fire him or her. The problem may be extremely difficult if these are the same persons whose conduct needs to be reported and addressed.

General Overview of the Enron Scandal

On October 16, 2001, Enron announced that it was taking a $544 million after-tax charge against earnings related to its transactions with LJM2 Co-Investment, L.P. (LJM2), a partnership created and managed by former CFO Andrew Fastow.[29] Enron also announced a reduction of shareholders' equity of $1.2 billion related to transactions with LJM2. Less than one month later, Enron announced that it was restating its financial statements for the years 1997 though 2001 because of accounting errors associated with another Fastow partnership—LJM Cayman, L.P. (LJM1) and an additional related party, Chewco Investements, L.P. (Chewco). Chewco was managed by another Enron employee, Kopper, who reported to Fastow. The financial restatements for these related party entities was very large, reducing Enron's reported net income by $28 million in 1997 (of $105 million total), by $133 million in 1998 (of $703 million total), by $248 million in 1999 (of $898 million total), and by $99 million in 2000 (of $979 million total). The restatement reduced shareholders' equity by $258 million in 1997, by $391 million in 1998, by $710 million in 1999 and by $754 million in 2000. Reported debt was increased by $711 million in 1997, by $561 million in 1998, by $685 million in 1999, and by $628 million in 2000.[30] Enron also revealed, for the first time, that Fastow received more than $30 million from LJM1 and LJM2. These announcements killed market confidence and investor trust in Enron. Less than one month later, Enron filed for bankruptcy.[31]

According to the media, from 1993 to 1999, executives and directors of Enron formed a number of different "off-the-book" partnerships which, if properly formed, permitted Enron to lawfully record debt and losses in a manner other than on Enron's balance sheet. These "special purpose entities," some of which were named after "Star Wars" characters and vacation properties, became the subject of an SEC investigation last year. Using these complex financial structures, Enron stands accused of concealing millions of dollars of debt so that shareholders were unaware of Enron's actual financial picture. Enron, like all other publicly held companies, was required under federal securities law to make public disclosures concerning these related party transactions (LJM, ChewCo, JEDI, etc.). Enron purportedly failed to disclose material facts necessary for shareholders and the investing public to understand these transactions and Enron's actual financial condition.

The Powers Report[32] identifies significant problems in addition to those publicly disclosed by Enron or the media. Enron employees involved in the partnerships enriched themselves by tens of millions of dollars they never should have received. More critically, the partnerships were used by Enron management to enter into business transactions that it could not do with proper unrelated commercial third parties. Many of the transactions were solely for the purpose of creating favorable financial statements and were not in furtherance of a bona fide business objective.[33]

What Role Did the Lawyers Play in this Mess?

Enron apparently looked to the law firm of Vinson & Elkins (V & E) for legal advice in connection with a number of questionable transactions, and V & E appears to have been Enron's primary outside counsel. Indeed, prior to terminating the relationship, Enron was V & E's largest client, accounting for more than seven percent (7%) of V & E's revenue in 2001.[34] The Enron account generated over $150 million for V & E over the years 1996 to 2001.[35]

Beginning in April of this year, V & E was named as a defendant in two Enron-related class actions filed in federal court in Houston, Texas: a securities class action suit filed by investors alleging that the law firm participated in a scheme to defraud investors with misleading disclosures that inflated Enron's profits and financial condition;[36] and a class action suit

filed by participants in Enron's 401(k) plan charging V & E with violations of the Racketeer Influenced and Corrupt Organizations Act.[37]

The Enron scandal raises many questions about V & E's professional responsibility as Enron's chief outside counsel. How did V & E let Enron make these tragic mistakes? Did the law firm aid and abet Enron and Andersen in committing fraud? Did V & E lose its independence when it advised Enron of the legality of the "special purpose vehicles" and partnerships used by the company to deflect ever increasing losses and debt from the company's financial statements? Did V & E have an ethical duty to require more information from Enron and Andersen or audit its client more diligently? Did V & E participate in the cover-up and obstruction of the SEC's investigation of Enron's accounting procedures? What are the ethical duties of corporate counsel when they learn that officers or employees are engaging in conduct that creates a substantial risk of serious harm to the corporation? Can a lawyer ethically remain "passive" when a corporate client engages or intends to engage in activity that will cause substantial economic harm to third parties that the lawyer does not represent?

Although many questions still remain, a preliminary report issued February 1, 2002, written by William Powers, Jr., a Texas law school dean and member of the Enron board of directors ("Powers Report"),[38] reveals some information about V & E's involvement. Essentially, the Powers Report holds V & E, as well as Enron management and Arthur Andersen, responsible for the inadequate disclosures that misled investors into believing that Enron's dealings with these special purpose entities were "arm's length" transactions.[39] According to the Powers Report:

> Enron's related party disclosures in its proxy statements, as well as in the financial statement footnotes in its periodic reports, resulted from collaborative efforts among Enron's senior management, employees in the legal, accounting, investor relations and business units—and outside advisors at Andersen *and Vinson & Elkins*. Nevertheless, it appears that no one outside of Enron Global Finance, the entity principally responsible for the related-party transactions, exercised significant supervision or control over the disclosure process concerning these transactions.[40]

Various disclosures were approved by one or more of Enron's outside auditors *and its inside and outside counsel.*[41] According to the Powers Report, the related party transactions were so complex that the accountants and lawyers relied heavily on, and generally deferred to, the officers in Enron that were familiar with these transactions. However, V & E was supposed to make sure that the disclosures were correct and complied with federal securities law and SEC rules. On pages 25–26 of the *Powers Report*, in the executive summary, it states:

> Vinson & Elkins, as Enron's longstanding outside counsel, provided advice and prepared documentation in connection with many of the transactions discussed in the Report. It also assisted Enron with the preparation of its disclosures of related party transactions in the proxy statements and the footnotes to the financial statements in Enron's periodic SEC filings. Management and the board relied heavily on the perceived approval by Vinson & Elkins of the structure and disclosure of the transactions. Enron's Audit and Compliance Committee, as well as in-house counsel, looked to it for assurance that Enron's public disclosures were legally sufficient. It would be inappropriate to fault Vinson & Elkins for accounting matters, which are not in its expertise. However, Vinson & Elkins should have brought a stronger, more objective and more critical voice to the disclosure process.[42]

On pages 176–77, the report discusses the Watkins letter[43] that triggered a limited internal investigation by V & E:

> The result of the V & E review was largely predetermined by the scope and nature of the investigation and the process employed . . . The scope and process of the investigation appear to have been structured with less skepticism than was needed to see through these particularly complex transactions.

Sherron Watkins forewarned CEO Kenneth Lay that V & E should not handle the "preliminary investigation." In her view, V & E's relationship with Enron was so unusual and uncharacteristically close, for outside corporate counsel, that Sherron Watkins recommended that an "independent" law firm review the questionable partnership transactions.[44] Watkins had doubts that V & E could impartially investigate the negative impact on Enron of these transactions. Nevertheless, James Derrick, executive vice president and general counsel of Enron hired V & E to conduct a limited preliminary investigation of the concerns and issues Sherron Watkins had raised with former CEO Kenneth Lay.[45]

The allegations against V & E in the two pending federal cases are far more unkind than the criticism levied in the Powers Report. The employees' RICO suit alleges that V & E's investigation of Enron's transactions was nothing more than a coverup of Enron's illicit activity; and the securities suit alleges that V & E participated in structuring illegal partnerships, knowing that they were designed to conceal massive debt, which truly belonged on Enron's balance sheet.

In addition, according to Sherron Watkins, V & E provided "true sale" opinion letters on some of the "special purpose" partnerships—the so-called "Condor" and "Raptor" deals. While the exact details of V & E's work is unclear, "true sale" letters are opinion letters that law firms write vouching for the fact that these transactions meet particular legal requirements. Indeed, one of the primary issues Watkins raised that V & E was asked to investigate was the adequacy of the public disclosures for the Condor and Raptor transactions.[46] Specifically, the financial statements and disclosure materials were criticized as not disclosing sufficient detail so as to reveal the true nature of these transactions. Not apparent from the financial statements and disclosure materials were issues including: the use of Enron stock to provide the equity necessary to do the transactions with Condor and Raptor; recognizing earnings through derivative transactions with Raptor when it could be argued that there was no true third party involved in those transactions; the inability of the Raptor entities to meet their obligations to Enron due to the falling value of Enron's stock over the course of 2001,thus raising the question of "who ultimately bears the loss; apparent conflicts of interest problems arising out of a number of Enron executives having controlling and ownership interests in some of these "off-the-books" partnerships and the decision by Enron management to withhold dis-

closure, for example, of Andrew Fastow's compensation from these related party transactions.

What were V & E's Ethical Duties as Enron's Outside Corporate Counsel?

At the very least, V & E owed a duty to represent Enron competently under Rule 1.1.[47] That required properly advising Enron on the related party issues and applicable federal securities laws. Enron, like all public companies, was required by federal securities law to describe its related-party transactions to shareholders and to members of the investing public in a number of different disclosure documents and reports filed periodically with the SEC on a quarterly and annual basis, and the annual proxy solicitation material sent to shareholders.[48] Generally, Enron failed to disclose material facts that were necessary for an understanding of these transactions.

Under Rule 1.2, V & E could not counsel Enron to engage, or assist Enron, in conduct that it knew was criminal or fraudulent. When a lawyer knows that a client expects assistance not permitted by the Rules of Professional Conduct or other law, the lawyer shall consult with the client regarding the relevant limitations on the lawyer's conduct. Rule 1.2 (d). If the lawyers at V & E had a reasonable basis to conclude that Enron's activity was criminal, fraudulent, unlawful or unjust, then V & E should have withdrawn from representing Enron pursuant to Rule 1.16 (b) (1) or (2). Indeed, even if V & E was unsure about whether Enron's conduct was unlawful, it could have withdrawn simply if Enron insisted on pursuing an objective that the law firm considered repugnant or imprudent. Rule 1.16 (b) (3).

Did V & E have an obligation to press management and employees for more information about the related party transactions? The Powers Report notes that although there was discussion by the board for a review and disclosure of Fastow's compensation from the LJM partnerships, no one—not members of senior management (i.e., Lay, Skilling or Causey), not the board and not V & E—ever pressed for the information, and Fastow did not volunteer it.[49] In regard to whether the SEC disclosure rules required Enron to reveal Fastow's compensation, or his personal interests in these transactions, "[t]he lawyers apparently searched for and embraced a technical rationale to avoid that disclosure."[50]

Another interesting ethical question is why V & E accepted such a limited preliminary investigation of Sherron Watkins' allegations as denoted in the opinion letter dated October 15, 2001, by Max Hendrick III of Vinson & Elkins. Why did V & E accept such a limited engagement in the face of Ms. Watkins' bold statement in her whistle-blowing memo that V & E had a conflict? A possible reason mentioned in the Powers Report is that V & E had quick access to the information to do the evaluation. However, did V & E consult with and obtain Enron's consent to material limitations on the preliminary investigation as required by Rule 1.2? Considering Rule 1.7 (b)[51], could V & E reasonably believe that it could adequately review its own work product and advice concerning these related party transactions? Wasn't it Enron's best interest, as recommended by Watkins, to have an "independent" law firm conduct an audit?

Finally there is the issue of the destruction of Enron's documents by Arthur Andersen, evidently with the direction and knowledge of at least one in-house counsel for Andersen, Nancy Temple. At the very least, Temple owed a duty to advise that destruction of the Enron documents with knowledge that the SEC was undertaking an investigation of Enron's reports and disclosures was improper, if not a criminal offense. Given the presumed knowledge of the SEC's investigation of Enron, efforts should have been made to preserve rather than shred pertinent documents. Temple's failure in this regard, led to the demise of a respected accounting firm and severe economic consequences for many of its employees.

Are Reforms Needed?

The ABA rules, in my opinion, provide inadequate guidance for corporate counsel faced with fraud or illegal conduct within an organization. The confidentiality rules in all states should provide an exception to at least permit, if not require, disclosure of client information necessary to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result, or has resulted from, the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services. The ABA House of Delegates in August 2001 rejected such a proposal made by the Ethics 2000 Commission. The ABA should be a leader for reform of the pertinent ethics rules instead of opposing the federal government's authority to require securities lawyers to do the right thing.

Fortunately, as stated earlier, most states have not followed the ABA's approach and allow or require disclosure when a client abuses the protection of Rule 1.6 by using the lawyer's services to commit fraud on a third party. The ABA and the states should also amend Rule 1.13 to *require* a lawyer to report to the organization's highest authority illegal or fraudulent conduct by its agents that is likely to cause substantial injury to the organization. The new Sarbanes-Oxley Act will have the SEC issuing rules to mandate this disclosure for securities lawyers, but the requirement should apply to other corporate fraud scenarios beyond the SEC's purview. Moreover, when the wrongdoers control the organization and, therefore, reject counsel's advice to rectify or mitigate ongoing illegal or fraudulent activity, counsel should be permitted to disclose necessary information to third parties outside the organization when necessary to prevent substantial economic harm to third parties or further liability on the part of the corporation. Given that the attorney's duty is to act in the best interests of the organization (the "entity" concept), rather than its constituents, disclosure under such circumstances should not be viewed as adverse or disloyal to the client.

Congress should enact legislation overruling the Central Bank decision and restore a private cause of action for defrauded investors against lawyers and accountants who aid and abet their clients in the commission of federal securities violations. In so doing, the law should impose civil liability if the lawyer or accountant either knew that a corporate client's agents were engaged in fraudulent activity or reasonably should have known under the circumstances, and failed to take appropriate measures to prevent, rectify or mitigate the consequences of the wrongdoing.

Finally, the SEC should adopt stronger independence rules prohibiting a professional service firm from conducting an audit, preliminary investigation or other compliance review of a client if that firm's own advice or work product is the subject matter of the audit, investigation or review. *The Rules of*

Professional Conduct should be amended to include a comment under Rule 1.7, indicating that such circumstances trigger a conflict of interest under that rule.

ENDNOTES

1 A description of some of the events leading up to the Enron collapse can be found at pages 13-14, *infra*.

2 In June 2002, Adelphia Communications filed for bankruptcy protection under Chapter 11, having disclosed three months earlier that the company had made unsecured loans to the Rigas family, Adelphia's controlling shareholders, to the tune of $2.3 billion. Joseph B. Treaster, "Adelphia Files for Bankruptcy," *New York Times*, June 26, 2002, p. C 2. Adelphia's common stock, having reached a peak of $28 per share, is now essentially worthless. Peter Lauria, "Adelphia Bottoms Out," *The Daily Deal*, June 27, 2002.

3 After months of questioning of its financial statements, executives at WorldCom finally admitted that the company had overstated its earnings by over $3.8 billion in the past five quarters. This gross overstatement of earnings was caused by the company treating operating costs, such as maintenance, as capital investments instead. WorldCom announced in July 2002 that it would eliminate 20% of its workforce and its marked capitalization plummeted from $115 billion in 1999 to less than $1 million now. *See* Simon Romero & Alex Berenson, "WorldCom Says it Hid Expenses, Inflating Cash Flow $3.8 Billion," *New York Times*, June 26, 2002, p.A1.

4 Also known as the Sarbanes-Oxley Act of 2002.

5 The board shall have five members but shall not include more than two persons who are or have been certified public accountants. No member shall be employed by any firm providing professional services to a publicly held company or engaged in any other business activity. The members of the board shall be appointed by the SEC, after consultation with the Chairman of the Board of Governors of the Federal Reserve System and the Secretary of the Treasury. The board shall not be a federal agency nor any of its members regarded as federal employees or agents. The members selected shall be "appointed from prominent individuals of integrity and reputation who have a demonstrated commitment to the interests of investors and the public, and an understanding of the responsibilities for and nature of the financial disclosures required of accountants with respect to the preparation and issuance of audit reports with respect to such disclosures." Section 101 (e)(1).

6 15 U.S.C. §§ 78j-l.

7 Letter to The Hon. Paul S. Sarbanes dated July 19, 2002, from Robert D. Evans, Director, Government Affairs Office, American Bar Association.

8 Lawrence J. Fox, "Corporate Balancing Act: Courts, Not Capitol Hill, Should Regulate Lawyers," *Forum* Column (July 30, 2002).

9 The Report of the Task Force on Corporate Responsibility can be found here: http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf

10 373 U.S. 379 (1963).

11 *See*. e. g. *In the Matter of Martin G. Mullen*, VSB Docket No. 02-000-1877 (2002). (On May 7, 2002, the Virginia State Bar Disciplinary Board suspended Martin G. Mullen's license to practice law in Virginia for four years. The Board took this reciprocal action based on a four year suspension by the U.S. Patent and Trademark Office (PTO) of Mr. Mullen's license to practice law before that federal agency. The PTO suspension was agreed to by Mr. Mullen and was based upon his neglect in handling 14 patent applications.)

12 *SEC v. National Student Marketing Corp.*, 457 F.Supp. 682 (D.D.C. 1978). This was a civil enforcement action brought by the Securities and Exchange Commission against the law firms of White & Case, and Lord, Bissell & Brooke (LBB) for their role in the 1969 merger of two companies, National Student Marketing Corporation (NSMC) and Interstate National Corporation (Interstate). The SEC alleged that the two law firms aided and abetted corporate officers in securities fraud by failing to disclose material information revealed in a comfort letter written by accounting firm Peat Marwick International, which would have disclosed to investors substantial problems concerning NSMC's financial health. After the merger, in 1970, when the press discovered NSMC's true financial condition, the value of the stock decreased dramatically. The court concluded that the merger had been approved by the Interstate shareholders based on information that was misleading and that the attorneys involved owed a duty to take steps designed to insure that this material information would be disclosed to the shareholders. Instead, they took no measure to delay the closing of the merger pending disclosure and their silence added to the appearance of the closing's legitimacy. The court therefore found that the attorney defendants in this suit aided and abetted the violations of Section 10 (b) of Securities Exchange Act of 1934 and Rule 10b-5 promulgated by the Commission pursuant to the Act.

National Student Marketing was a conglomerate purportedly selling to college students everything from coffee mugs to computer dates. Its stock skyrocketed from $1 to a high of $69 and was seen by investors as one of several glamour stocks of the period. Some of NSMCs officers and one accountant from Peat Marwick suffered criminal convictions and went to prison for their participation in this securities fraud. The protracted civil case, dragging on for over 10 years, settled with some $30 million paid to NSMC investors. White & Case contributed $1.95 million and LBB paid $1.3 million to the fund. Hazard, Koniak & Crampton, *The Law and Ethics of Lawyering* (3rd Ed. 1999) at 118 (hereinafter "Hazard, Koniak & Crampton").

13 The O.P.M. Cases, that arose in the early-1980s, arose out of a company created in 1970 that purchased mainframe computers from manufacturers like IBM and, in turn, leased them to businesses such as A T & T and Rockwell. Financial institutions would loan O.P.M. the money to purchase the computers, hold a security interest in the computer, and collect from the lessee periodic payments to repay the loan. During the 1970s, O.P.M. became one of the largest computer leasing companies. It got that way by slashing its prices, but in doing so, O.P.M. found itself incapable of meeting its operating costs while its owners continued to maintain their extravagant life styles. O.P.M. was practically insolvent from its beginning, but the company kept increasing its market share by creating fraudulent loan transactions, using a single computer as security for several loans, and overstating the value of the equipment to get larger loans. The arrangement became a classic "Ponzi Scheme" with O.P.M. fraudulently obtaining new loan proceeds to cover payments due on other computers. Inevitably, though, the new loans had to be repaid, requiring O.P.M. to resort to more fraudulent transactions to obtain more proceeds to make payment on its last round of fraudulently obtained loans. Throughout the decade, the law firm of Singer Hutner handled O.P.M.'s legal work, closing these loan transactions and providing opinions for lenders to rely on concerning the financial condition of their client and the soundness of the security for these loans. Ultimately, a corporate officer at O.P.M. resigned and notified the law firm by letter that numerous transactions with Rockwell, a large defense contractor, were fraudulent. Having discovered that the law firm had closed transactions for O.P.M. that were fraudulent, the lawyers consulted with two experts in legal ethics to ascertain what they should do. The ethics consultants told Singer Hutner what the lawyers wanted to hear: namely, that the transactions amounted to past fraud, which the New York Code of Professional Responsibility did not require the lawyers to reveal or rectify, and that the firm could continue to close new loans for O.P.M. if the firm had certification that the new transactions were legitimate. Moreover, the ethics experts advised that as long as the Singer Hutner lawyers had no direct knowledge that the officers at O.P.M. intended to continue the fraudulent loan transactions, the law firm was not required to withdraw from the representation. Taking comfort in the ethics advice given, Singer Hutner continued to close loans for O.P.M. for the next eight months. O.P.M. continued its fraudulent transactions, providing the law firm with false certifications that these subsequent transactions were legitimate, while cheating lenders out of another $85 million before the principal owners of O.P.M. were arrested. The law, accounting and investment banking firms that assisted O.P.M. in these transactions settled liability claims totaling $65 million, with Singer Hutner contributing $10 million. The law firm dissolved and the reputations of the lawyers involved were damaged. *See* Hazard, Koniak & Crampton, *supra*, 304-08.

14 In the 1980s, hundreds of thrifts failed and the federal government's obligation to stand behind federally insured deposits cost taxpayers hundreds of billions of dollars. Federal agencies brought both criminal and civil actions against many of the managers of these failed thrifts, as well as their accountants and lawyers. One of the most frequently publicized cases arose out of the business activities of Charles Keating and Lincoln Savings & Loan involving fraudulent land/tax transactions and overvaluation of real estate created to show "profits" on the books and placate federal regulators and examiners questioning the S & L's "risky" loans. The law firm of Jones Day was hired to represent Lincoln. During a regulatory compliance audit, that Jones Day insisted was merely a pre-FHLBB examination compliance review, Jones Day found multiple regulatory violations and knew that Lincoln had backdated files, destroyed appraisals, removed appraisals from files, told appraisals not to issue reports when their oral valuations were too low and violated regulations concerning direct and affiliated investments. The court stated, among other things:

> [Where] a law firm believes the management of a corporate client is committing serious regulatory violations, the firm has an obligation to actively discuss the violative

conduct, urge cessation of the activity and withdraw from representation where the firm's legal services may contribute to the continuation of such conduct.

In re American Continental Corp./Lincoln Savings and Loan Securities Litigation (Jones Day), 794 F. Supp. 1424 (D. Ariz. 1992). Jones Day lost its motion for summary judgement and ended up settling with the bondholders and stockholders in this class action suit for $24 million. *See Wall Street Journal*, Mar. 3, 1992, p. A2. Similarly, Kaye Scholer's aggressive representation of Lincoln during a bank examination as outside counsel caused the Office of Thrift Supervision (OTS) in March 1992 to file administrative charges against the firm and three of its partners. The central charge was that Kaye Scholer knew, but failed to disclose to bank examiners, material facts thereby making representations made by Kaye Scholer to the bank board false, fraudulent and misleading. OTS sought restitution in the amount of $275 million and froze the law firm's assets. Kaye Scholer settled the matter for $41 million without contesting the injunction order or admitting or denying the allegations. Hazard, Koniak & Crampton, *supra* at 756-57. Finally, in *Federal Deposit Ins. Corp. v. O'Melveny & Meyers*, 969 F.2d 744 (9th Cir. 1992) the court held that a receiver of a failed thrift stated a cause of action against a law firm that assisted the thrift in the issuance of two real estate syndications offered to investors. The thrift was in unsound financial condition; its officers fraudulently overvalued assets, embezzled and generally "cooked the books." 969 F. 2d at 746. The court made a very scary statement:

[A]ttorneys, in rendering opinions relating to the securities laws, are not justified in assuming facts as represented to them by their clients [are correct]. Rather . . . the attorney must make a reasonable effort to independently verify the facts on which the opinion is based.

969 F.2d at 749.

15 Former Secretary of Defense Clark M. Clifford and his law partner, Robert Altman, settled claims for $5 million and were forced to resign their positions as top officials of First American Bank. They were the key figures in BCCI's acquisition and management of United States banks. BCCI, or Bank of Credit and Commerce International, was shut down by regulators in 1991 amid allegations of arms smuggling, drug running and financing of terrorists. Clifford and Altman were accused of participating in a plot to help BCCI secretly gain control of U.S. banks. "Fed Settles BCCI Case," *The New Republic,* February 3, 1998.

16 Rule 1.13 provides, in pertinent part:

(b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law which reasonably might be imputed to the organization, and is likely to result in substantial injury to the organization, the lawyer shall proceed as is reasonably necessary in the best interest of the organization. In determining how to proceed, the lawyer shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyer's representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters and any other relevant considerations. Any measures taken shall be designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organization. Such measures may include among others:

(1) asking reconsideration of the matter;

(2) advising that a separate legal opinion on the matter be sought for presentation to appropriate authority in the organization;

(3) referring the matter to higher authority in the organization, including, if warranted by the seriousness of the matter, referral to the highest authority that can act in behalf of the organization as determined by applicable law.

(c) If, despite the lawyer's efforts in accordance with paragraph (b), the highest authority that can act on behalf of the organization insists upon action, or a refusal to act, that is clearly a violation of law and is likely to result in substantial injury to the organization, the lawyer may resign or may decline to represent the client in that matter in accordance with Rule 1.16.

17 Virginia Rule 1.6 (c)(1).

18 Hazard, Koniak & Crampton, *supra* at 308. The vast majority of U.S. jurisdictions have not adopted Model Rule 1.6 as recommended by the ABA. Thirty-seven states permit a lawyer to disclose confidential information to prevent a client's criminal fraud; four states require a lawyer to make such a disclosure; and only nine states and the District of Columbia may be viewed as forbidding a lawyer to reveal such information. See "Attorneys' Liability Assurance Society, Inc., Ethics Rules on Client Confidences" (2001), reprinted in Thomas D. Morgan & Ronald D. Rotunda, 2002 *Selected Standards on Professional Responsibility* 134-144 (tabulating the current law of all U.S. jurisdictions on disclosure of confidential information to prevent harm to third persons).

19 Wigmore draws a distinction as to whether the fraud was committed before or after the attorney was hired. A client who, in the past, has committed a wrongdoing is entitled to the protection of the attorney-client privilege. The culpable, as well as the innocent, client is entitled to confidential communications with an attorney. *First Union Nat'l Bank v. Whitener*, 715 So.2d 979, 983 (Fla. Dist. Ct. App. 1998).

20 *See also In Re Sealed Case*, 754 F.2d 395, 402 (D.C. Cir. 1985) ("Clearly the crime-fraud exception will defeat the attorney-client privilege only as to misconduct that occurred during the period of representation . . . .")

21 *Restatement (Third) of Law Governing Lawyers* § 82 cmt.e at 617 (2000).

22 *Restatement (Third) of Law Governing Lawyers* § 82 cmt.e at 617 (2000); Commonwealth v. Maguigan, 511 A.2d 1327, 1336-37 (Pa. 1986) (in dicta, court states that lawyer giving advice to client who was a fugitive from justice would become accessory to continuing criminal conduct which excepts the communications from attorney-client privilege under the "crime-fraud" doctrine).

23 *In re Witness Before the Grand Jury*, 631 F.Supp. 32 (E.D. Wis. 1985) (client admitted sales of cocaine but reported no income from the sales on tax return prepared by lawyer; failure to report income was fraudulent if not criminal act); *In re Grand Jury Subpeonas*, 144 F.3d 653, 660 (10th Cir.), cert. denied, 525 U.S. 966 (1998). (The exception does not apply if the assistance is sought only to disclose past wrongdoing, but it does apply if the assistance was used to cover up and perpetuate the crime or fraud.)

24 511 U.S. 164 (1994).

25 797 F.2d 490 (7th Cir. 1986).

26 Citations omitted.

27 797 F.2d at 497.

28 *See, e.g., In re American Continental Corp./Lincoln Savings and Loan Securities Litigation*, 794 F.Supp. 1424, 1453 (D.Ariz. 1992) ("[w]here a law firm believes the management of a corporate client is committing serious regulatory violation, the firm has an obligation . . . to urge cessation of the activity;" failure to go to the board of directors could not be excused because such action is thought to be "futile"); and *FDIC v. Clark*, 978 F.2d 1541 (10th Cir.1992). (jury verdict affirmed when lawyer failed to take allegations of officer misconduct to the board of directors.)

29 Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp., February 1, 2002 at 2 ("Powers Report").

30 *Id.* at 3.

31 *Id.*

32 *Id.* at 3-4.

33 *Id.* at 4.

34 *One Big Client, One Big Hassle*, *Washington Pos*t, January 28, 2002.

35 *Houston Law Firm Helped Craft Enron Deals*, *Washington Post,* January 27, 2002 at A06.

36 *Newby v. Enron Corp*., et. al, No. 01-3624, United States District Court, Southern District of Texas.

37 *Despite Efforts to Break Free, Enron Web Traps Vinson & Elkins,* TEXAS LAWYER, April 18, 2002. The employee suit is styled *Pamela M. Tittle, et al. v. Enron Corp., et al*.

38 *See* note 29, *supra*. The Powers Report can be viewed on line at http://news.findlaw.com/hdocs/docs/enron/sicreport.

39 Powers Report, note 29, *supra* at 178.

40 *Id.* at 181.

41 *Id.* at 17.

42 *Id.* at 25-26.

43 The so-called Watkins letter refers to an anonymous document delivered to Enron CEO Kenneth Lay by an employee, Sherron Watkins, who later claimed responsibility for the document. Watkins met with Lay to discuss her concerns about the propriety of Enron's accounting treatment and public disclosures for some of the special purpose entities known as "Condor" or "Whitewing" and certain transactions with a related party, LJM, sometimes referred to a the "Raptor" vehicles.

See Hendrick Letter, note 44, i*nfra*; *See also* Powers Report, note 29, *supra* at 172. In her letter, Watkins concluded "I am incredibly nervous that we will implode in a wave of accounting scandals." *Id.*

44 *Houston Law Firm Helped Craft Enron Deals*, *supra* at note2.

45 *Id. See also* Letter dated October 31, 2001 from Max Hendrick, III of V & E to James V. Derrick, Jr. of Enron (copy ("Hendrick letter") available at "FindLaw.com" under "Enron Investigation" documents).

46 *See* Hendrick letter, *supra*, note 45 at p. 3.

47 "A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for the representation."

48 Item 404 of SEC Regulation S-K sets out the requirements for disclosing related party transactions in the non-financial statement portions of SEC filings, including proxy statements and the annual reports.

49 Powers Report, note 29, *supra* at 190.

50 *Id.*

51 A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, *or by the lawyer's own interests*, unless: (1) the lawyer reasonably believes the representation will not be adversely affected; and (2) the client consents after consultation. (*Emphasis added*.)