

THE EVOLVING LEGAL AND ETHICAL
ROLE OF THE CORPORATE ATTORNEY AFTER
THE SARBANES-OXLEY ACT OF 2002

PANEL 1: THE COLLAPSE OF THE CORPORATE MODEL
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PROCEEDINGS

PROFESSOR WALLACE: Thank you Dean Pike and good morning, ladies and gentlemen. My name is Perry Wallace. I'm a member of the faculty here at the Washington College of Law. I have the great pleasure of serving as moderator for this first panel whose topic and subject will be, "The Collapse of the Corporate Model."

Over the past year, since the series of corporate debacles beginning with the collapse of the Enron Corporation, the world has watched with a great deal of concern. It's rare that members of the lay public and the non-financial media have concerned themselves so greatly with subjects such as corporate governance, financial reporting, audit committees, insider trading, and probably above all, accounting, even. But this collapse has evoked numerous discussions including the value of the model, the worth of it, whether or not it should be changed, and if so, in what ways.

We have with us, and we're awfully lucky to have, a distinguished panel of participants who will help us in answering some of the questions of the day.

They are, and beginning on the left, Charles Davidow, who is a Partner at Wilmer, Cutler & Pickering. Mr. Davidow is a specialist in securities law. He is particularly specialized in internal investigations. In fact, he served as special counsel to the special committee of the Enron Board of Directors and is now serving in a similar capacity in the WorldCom matter. So we're very pleased and happy to have Mr. Davidow with us today.

Next to him and to his right there is Jim Gunderson. Jim is former General Counsel and at present is Corporate Development Counsel with Schlumberger Ltd.

Next to him is Professor Jim Peters who is a professor of accounting at the Robert H. Smith School of Business at the University of Maryland.

Each gentleman will approach the subject from his own particular specialty, but we've invited them to share with us from their views that may range much more broadly than their particular specialties.

We're hoping that as they proceed this morning we'll find answers to a number of questions, or at least commentary on a number of questions such as, "What went wrong? Who or what, to the degree there may be systematic implications here, would be to blame?" Not to steal the thunder of any of the other panels, but "Will Sarbanes-

Oxley¹ and the various other reforms work?”

“What should be the goal of corporate governance today and on into the future going forward?” Finally, “Can you help us out? What can you tell students who are looking forward to joining your ranks and participating, and participating well, in a manner that’s consistent with concerns regarding value, concerns regarding social balance, economic justice, and the like?”

So, without more, I would like to have us begin if we could with Jim Gunderson of Schlumberger. We’ll then proceed with another Jim, Jim Peters, and we’ll end with Chuck Davidow. Gentlemen.

MR. GUNDERSON: Thank you. Good morning. I’ll give you a little bit of perspective, partly from having been the Secretary and General Counsel of Schlumberger Limited, which is a big, multinational oilfield services and other technology company listed on the New York Stock Exchange.² It’s a little bit unique in how global it is and how global its board is.

I’ll talk to you from the perspective of having worked for three years trying to facilitate good governance there and, since then, helping some other companies as a consultant to boards trying to help them perform good governance.

What I’d like to do is really make two points. One point is, “What is the governance model?”³ Then I’d like to talk a little bit about the key things we depend on boards for and the extent to which they may or may not have been doing their jobs in that respect.

The model of American corporate governance is not identical with that of the United Kingdom, the European continent, or other countries around the world.⁴ The United States is an extreme example of the model in which, basically, the Chief Executive Officer (“CEO”)⁵ runs the company. That’s the American model. We look

1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (to be codified at 15 U.S.C. §§ 7201-7266).

2. For more information on Schlumberger Limited, *see* Schlumberger Limited website at <http://www.slb.com>.

3. *See generally* GREGORY V. VARALLO & DANIEL A. DREIBACH, FUNDAMENTALS OF CORPORATE GOVERNANCE: A GUIDE FOR DIRECTORS AND CORPORATE COUNSEL (Section of Business Law 1996) (describing the structure, role, and duties of a corporate board of directors).

4. *See generally* DEREK HIGGS, REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS (2003) (reviewing recent corporate governance practice in the United Kingdom), *available at* http://www.dti.gov.uk/cld/non_exec_review/pdfs/higgsreport.pdf (last visited Mar. 3, 2003); REPORT OF THE HIGH LEVEL GROUP OF COMPANY LAW EXPERTS ON A MODERN REGULATORY FRAMEWORK FOR COMPANY LAW IN EUROPE (European Commission 2002) (describing the recent corporate governance practice in Europe), *available at* http://europa.eu.int/comm/internal_market/en/company/company/modern/consult/report_en.pdf (last visited Apr. 3, 2003).

5. *See generally* BLACK’S LAW DICTIONARY 232 (7th ed. 1999) (defining Chief Executive Officer as “[a] corporation’s highest-ranking administrator who manages

to the CEO for the vision. We look to the CEO for the leadership.⁶ We look to the CEO to be the ultimate manager of the company.⁷

As an investor, we don't worry about who the independent directors are very much. I don't think many asset managers even know who the independent directors are of some of the companies they follow closely. They look at the CEO and they would know the CFO, the chief financial officer, and some of the top operating managers better than they would know anything about the independent directors.

As employees we don't really think about the board of directors. Within companies—and this could be within a General Motors, it could be within a mid-cap company,⁸ people don't talk about the board that much. The symbol of the ultimate authority of the company is the CEO. That shouldn't be so surprising because in the United States, the idea of management by committee, or strategy by committee,⁹ is something we don't generally think makes much sense. We want to know who is in charge, and we want to make sure the right person is in charge.

Again, I'm not describing what the law says,¹⁰ nor am I describing what policymakers say. But that's really the way it works. I think there are reasons—cultural as I just mentioned. In the United States, the notion that the board is overseeing the management of the company, even that is problematic.¹¹

the firm day by day and reports to the board of directors.”).

6. See Ralph Khurana, *Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs* (Princeton Univ. Press 2002).

7. *Principles of Corporate Governance: Analysis and Recommendations* 82-84 (Student ed., American Law Institute 1994). See generally Harry G. Henn & John R. Alexander, *Laws of Corporations* §§ 180-256 (3d ed. 1983) (outlining the corporate management structure).

8. See *Paul Merriman Answers Your Questions: What Is Large-cap, Mid-cap and Small-cap*, FundAdvice.com (defining mid-cap as a means of characterizing the size of a company based on its market capitalization), at <http://www.fundadvice.com/QA/071801a.html> (last visited Feb. 27, 2003); see also *id.* (establishing that the general parameters of a mid-cap company's market capitalization as being between \$1 billion and \$30 billion).

9. See generally Nat'l Assoc. of Corp. Dirs., *Report of the NACE Blue Ribbon Commission on the Role of the Board in Corporate Strategy* (2000) (discussing the Board's role in contributing to, evaluating, and approving management's strategy for the company).

10. See *Principles of Corporate Governance: Analysis and Recommendations*, *supra* note 7, at 82-84 (contrasting what corporation law statutes say and what typically occurs in practice).

11. See, e.g., Robert A.G. Monks & Nell Minow, *Corporate Governance* 171 (2d ed. 2001) (“Directors are beholden to management for nomination, compensation, and information. Moreover, many directors are unable or unwilling to devote the time or energy necessary to oversee the operation of the company . . .”).

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Boards, in our system, are entirely dependent on management for information. They're entirely dependent on management for analysis. Most board presentations involve review of company performance; they're essentially management presenting the results, and what they've done. It's very unlikely that management is going to present their performance as unacceptable, even if the company's performance has not been very good.

This hasn't been helped by the advent of PowerPoint presentations. Boards have suffered the same thing that every other forum for discussion has suffered where the PowerPoint presentation drives home one point, maybe two points, and everything flows to that point.¹²

So management presentations to boards have become more and more like sales presentations. When it comes to the board overseeing strategy, or participating in strategy, the situation is even more extreme. Because you have the PowerPoint presentations, they very strongly present the views of management. Management has already had its internal discussions where they've brought up the issues. What happens when it gets to the board is, they have all agreed, "This is the direction we're going," and they present why it's a good idea and then they bring investment bankers in who only get paid if this deal goes through.

So the forces on boards are overwhelming. To expect them to be effective monitors of strategy, I think, is really unrealistic. In the American system, the market is really doing the assessment.

The market is assessing performance. The market is assessing strategy. Although it's true that boards from time to time fire CEOs, they generally don't fire CEOs because they've done the analysis and they've decided based on these performance figures we get in the boardroom. This has to be done. The market is already screaming for blood. Top managers are already leaving the company. The board pulls the trigger. But they don't really make the decision.

Now I'm oversimplifying for the sake of time and hopefully to generate some discussion and controversy. But essentially, that's the way it works. That's the first point. "What's the model?" *That's* the model.

The second point then, "Are boards important? What do we have boards for?" Because they are obviously the central subject when

12. See generally Ian Parker, *Absolute PowerPoint: Can a Software Package Edit Our Thoughts?*, *New Yorker* (May 28, 2001) (arguing that the way in which the PowerPoint software program organizes inputted information dictates how its users view their environment), available at <http://www.physics.ohio-state.edu/~wilkins/group/powerpt.html> (last visited Apr. 3, 2003).

people are discussing corporate governance.

Boards are extremely important. They play a very important role in U.S. governance in two important respects. One, I'll leave primarily to Professor Peters, because I wouldn't dare go down that path in front of a true expert. So I'll leave aside the role of assurance on the financial reporting side.

The other central role they play has to do with incentives. Corporate governance in the United States since the 1930s has really revolved around one problem. It's this problem that shareholders for a number of reasons, although they in a sense own the company, do not control the company.¹³ Unless you have a major shareholder, or some other special factor, it is management that controls the corporation.¹⁴

The separation of ownership from control spawns this problem that it's tempting for managers, managing this company they don't own, to not actually do what's best for the shareholders, but do what's best for themselves. It could be from the standpoint of being lazy, poor performers or being dishonest and looting the company.

We call it the agency problem,¹⁵ and it's really the central problem of governance.¹⁶ The board of directors is all we have to look after the alignment of management's interests with the interests of the

13. See generally Adolf A. Berle & Gardiner C. Means, *The Modern Corporation & Private Property* (Harcort, Brace & World, Inc. 1932) (discussing the ownership and control issues of a corporation).

14. See MARCO BECHT ET AL., *CORPORATE GOVERNANCE AND CONTROL* 20-21 (European Corporate Governance Institute Finance Working Paper No. 02/2002, 2002) (explaining the purposes of disbursing shareholder interests). In the United States and U.K., ownership in listed companies tends to be widely disbursed for a number of reasons, including the size of investors' wealth compared to the market capitalization of the companies invested in, the desire for diversifying risk by spreading investment over a number of firms, and the investor's desire for liquidity of smaller stakes. With small interests in many companies, disbursed shareholders are unlikely to incur the monitoring costs of trying to oversee management and have the disincentives of the collective action and free rider problems against trying to exercise control. See *id.* at 31-38 (surveying literature on influence by major shareholders).

15. See ROBERT C. CLARK, *CORPORATE LAW* §§ 4.1-4.2, at 141-54 (3d ed. 1986) (explaining that the agency problem that confronts corporate officers and directors stems from their fiduciary duties to the corporation and the shareholders). See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 305-60 (1976) (discussing the costs of an agency relationship), available at <http://www.sciences-sociales.ens.fr/~adirer/textes/Jensen-Meckling.pdf> (last visited Apr. 3, 2003). Management is seen as the agent of the investors in the company, and the agency problem involves "moral hazard"—the agent, being self-interested, may not focus entirely on the investors' interests where they do not coincide with the managers' interests. The sum of the costs to the investor/principle of monitoring the manager/agent non-performance is referred to as the "agency costs" of the separation of ownership and management. *Id.*

16. BECHT ET AL., *supra* note 14.

shareholders. There is no one else who can do that.

Primarily we look to independent directors to look at compensation, incentives, perquisites, and the conflicts of interests that exist within companies and to align the interests of managers with the interests of the shareholders.¹⁷ We mainly look toward stock-based compensation as the tool for aligning the interests of management with shareholders. This is where things have gone horribly wrong in the last decade.

The idea of giving stock to directors at first blush seems very straightforward. That is, apparently, a perfect alignment of interests until you think about it a little bit. The idea that market value of stock is a good indicator of company performance requires that you believe the efficient capital market hypothesis,¹⁸ that the market actually has the best information on performance. That's probably true for portfolio managers. But management knows more than the market about how the company is performing.

If you think about it, if you give management a lot of stock, the intelligent time for them to sell is when they think the difference between the real value and the market value is greatest. So there is a bit of a potential conflict there. The way that used to be dealt with before the 1990s was with restricted stock.¹⁹ Restricted stock was the

17. See REPORT OF THE NEW YORK STOCK EXCHANGE ACCOUNTABILITY AND LISTING STANDARDS COMMITTEE 10 (2002) (explaining that aligning management and shareholder interest is typically done through a compensation committee of independent directors, which would be required under the New York Stock Exchange's proposed changes to its listing standards), *available at* http://www.nyse.com/pdfs/corp_govreport.pdf (last visited Mar. 4, 2003); SUMMARY OF NASDAQ CORPORATE GOVERNANCE PROPOSALS 3 (2003) (stating that under Nasdaq's proposed standards changes, CEO and other executive compensation would require approval by either an independent compensation committee or by a majority of the independent directors), *available at* http://www.nasdaq.com/about/Web_Corp_Gov_Summary%20Feb-revised.pdf (last visited Apr. 3, 2003).

18. See Fred Tam, *Markets Not Entirely Efficient*, BUS. TIMES (MALAYSIA), Nov. 4, 2002, at 7 (defining efficient market hypothesis (EMH) as security prices at anytime that "fully reflect" all available market information); Eugene F. Fama, *Efficient Capital Markets*, FOUND. FIN. 133 (1976) ("An efficient capital market is a market that is efficient in processing information. The prices of securities observed at any time are based on "correct" evaluation of all information available at the time . . . [I]f the capital market is to function smoothly in allocating resources, prices of securities must be good indicators of value.").

19. See REVISED MODEL BUS. CORP. ACT § 6.27 (1984) (allowing the articles of incorporation, bylaws, agreements among shareholders, and other agreements between the shareholders and the corporation to impose restriction on the transferability of a corporation's stock). Restricted stock grants are shares of stock granted to an executive subject to restrictions on sale or transfer for periods often ranging from three to five years, during which the executive receives dividends and has voting rights. If the executive's employment is terminated before the end of the restriction period, the unvested award generally is forfeited. *Id.* Most courts allow that the restrictions on shares must be reasonable, such as when the restriction preserves an state or federal securities law exemption. *Id.* § 6.27 cmt. Another

main stock-based compensation component used for executive compensation. You can't sell the stock. You have got to hold it just like the long-term institutions that can't afford to sell the stock. That was a good system.

But in the 1990s, because of tax and accounting advantages and basically this tremendous value it brought to executives, employee stock options took over.²⁰ Employee stock options do not at all align the interests of executives with shareholders.

If I get a stock option grant for 10,000 shares at the market price at that time, let's say it's \$50, if the stock moves up \$1, the value of that investment, in terms of what I can get for it if I exercise right away, goes from zero to \$10,000. Whereas, for the shareholder it goes from \$50 to \$51—a movement of 2% versus a movement of infinite percent. The next dollar it goes up, to \$52, doubles the value of that option to me in terms of what I can exercise, whereas for the shareholders, it's a 4% change.

In the other direction it's even more dramatic. For an executive with stock options, the difference between the stock dropping to forty-nine and the stock dropping to one is the same. The stock option goes underwater. Now, I'm exaggerating to make the point. But, largely, after a certain point, it doesn't matter how far it goes down. So, the incentive to take on risk to move that stock up is huge for executives with employee stock options.

Now picture the team responsible for financial disclosure: the CEO, the CFO, the general counsel, all having most of their wealth in employee stock options. The prospect of the market concluding that fortunes are turning for that company is going to cost those individuals responsible for financial disclosure. Maybe it's hundreds of thousands of dollars, maybe it's millions of dollars. That's the kind of pressure that management has had.

The companies that we have seen that have had the most problems have been high growth companies where the wealth accumulation of those executives has been enormous.

Compensation committees were supposed to be looking after that. Independent directors on compensation committees were supposed

example of a reasonable restriction is when a company has a few shareholders and those shareholders restrict the transferability of the stock to guarantee that the current shareholders maintain control of the corporation. *Id.*

20. Marcel Kahan, Symposium, *Norms and Corporate Law: The Limited Significance of Norms for Corporate Governance*, 149 U. PA. L. REV. 1869, 1888 (2001) (highlighting the increasing importance of stock options to executive compensation by stating that less than one-third of public companies provided executive stock options in 1980 compared to approximately two-third of the public companies in 1995).

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to be looking at the incentives. That's what they're there for. They were also supposed to have been looking at the prerequisites, at the executive use of company assets. That's one area where they completely fell down. The people supporting board activity, including company secretaries, board consultants and the like, fell down completely, in my opinion.

So, in the interests of time, those were the two points I really wanted to make. It is that as a practical matter, the CEO is in charge of the company, and I think it was a bit of a distraction during the 1990s that forums about corporate governance spent lots of time talking about how can boards enhance strategy, how can boards enhance performance.

They were looking at the wrong thing. They should have been looking at their central role, which is to align managers with the interests of shareholders and address the agency problem.

Now, in this group, in the questions later, I'd be glad to get into more specifics about the in-house counsel's role, but I just wanted to make those points because I think they're important starting points along with the others that we'll be hearing.

PROFESSOR WALLACE: Jim, thank you very, very much. Professor Peters.

PROFESSOR PETERS: Thank you. Let me first build on Jim's comment to set up my own comments and that is that the real discipline on these companies is in the stock market, not the board of directors.

The question is, "How does the stock market know what a company is doing?" I think Jim alluded to this fact—it's fundamentally their published financial statements that are supposed to be audited by us guys.

So that's what I want to address is first of all; I want to spend a little time in history. One of my major points is that this isn't new. It's happened before. It's really kind of a fundamental artifact of the free market system. It will probably happen again no matter what we do. It's a matter of, "Can we do things to try to mitigate the damage next time it happens?"

Then I want to try to expand on that by looking at the role of the auditor, the role of the financial accounting standard setting process, and, if I get time, I'll pick on attorneys. But I really don't want to do that.

But it was a corporate attorney for Arthur Andersen's e-mail that actually brought that company down. It wasn't Duncan shredding documents that the jury hung up on. So attorneys can have some

significant impact in these companies.²¹

Anyway, the role of the auditor is to be the independent assurer of these financial statements. It's part of the agency problem. It's called moral hazard. If stockholders are assessing the company based on information, it's information that management produces. So you can see you're evaluating somebody and the only information you have is the information they're giving you. That's called moral hazard.

The independent auditor is supposed to break through that issue and provide an independent assurance that the information you're getting accurately reflects the economic activity of the company. So how did that part of the process break down?

I've got to go back to the turn of the last century. Every profession has anti-competitive provisions in their profession. Up until about the late 1960s, 1970s, accountants could not advertise. They could not solicit clients. I think the simplest thing to say is, it was a profession that recognized its social responsibility.

The Supreme Court lifted the prohibition against advertising,²² and at least one lower court found that partners in CPA firms were not owners and could be fired.²³ Those fundamental changes shifted accounting from being a profession to a business. All of the sudden auditors wanted to do what they saw attorneys do, which was make big bucks. Accounting became a commodity. Auditing became a commodity.

You think about it from the corporate standpoint, you're paying millions of dollars to a firm to come in and give you what used to be two and is now three paragraphs. That's what an audit opinion is;²⁴ it's three standard paragraphs that are a template right out of a textbook. That's what you're paying millions of dollars for.

21. See Jonathan Weil et al., *Auditor's Ruling: Andersen Win Lifts U.S. Enron Case—Shredding Wasn't Factor in Verdict Jurors Say; A Single E-mail Was Prelude to the Main Event*, WALL ST. J., June 17, 2002, at A1 (reporting that the jury pointed to an e-mail sent by Arthur Andersen's in-house counsel as the outcome determinative fact in convicting Andersen of obstructing the SEC's investigation of the Enron Collapse); see also *id.* (identifying David B. Duncan as the former Arthur Andersen partner who headed the Enron Audit).

22. See *Edenfield v. Fane*, 507 U.S. 761, 763 (1993) (finding that a prohibition against advertising by certified public accountants violates their constitutional right to free speech).

23. See *Simpson v. Ernst & Young*, 100 F.3d 436, 443-44 (6th Cir. 1996) (concluding that plaintiff was an employee and not a partner because he had no authority to direct the management of the accounting firm).

24. D. EDWARD MARTIN, *ATTORNEY'S HANDBOOK OF ACCOUNTING AND FINANCIAL REPORTING* § 12.01[1] (Matthew Bender 4th ed. 2002) (defining an audit opinion as the report prepared by an auditor that provides an opinion regarding the reliability of a company's reported financial information and the supporting data).

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From the corporate standpoint, it was a necessity that they had to have, but it wasn't something that they perceived as really adding value to the firm. So this put a lot of cost pressure on the accountants to reduce the cost of the audit. Their best and brightest people started to shift into consulting where they could make some money.

To try to mitigate this problem, auditors are supposed to be hired by the auditing committee of the board of directors, which is supposed to be made up of all outside directors. But as my colleague has already pointed out, on the surface that really may sound like a control, but it really isn't because these people are being driven by the information they get from managers.

For example, take Enron. Enron had seventeen on the Board of Directors. Of them, fourteen were outside Directors.²⁵ The Chairman of their Audit Committee was a former dean of Stanford Business School.²⁶ I can't remember his first name; Jaedicke was his last name.²⁷ He was an outstanding accountant.

The Sarbanes-Oxley Act and the stock exchange efforts and things to push more independent directors is fine, but Enron already met or exceeded those requirements. But it didn't make any difference because of the things that Jim pointed out. It is that management has such enormous control over the information that's being fed to these boards of directors, and consequently, when the boards of directors interface with the auditors, they are pretty much re-enforcing what the management wants.

From the auditor's standpoint, I mean it's fundamentally auditing the hand that feeds you. You're supposed to be hired by independent outside directors. We've already established that really isn't the truth. So, you deal on a day-to-day basis with management. If you're getting, as Andersen was with Enron, a lot more money from your consulting practice with that client than you are with the auditing practice, it's going to put your ethics in tremendous tension with your economics.

The one other thing that I think that we need to be very honest about is human behavior. I don't care who you are, if your ethics are constantly in direct conflict with your economics, eventually somebody is going to break. Eventually most of us would break. I don't think I or anybody else in this room would like to admit it, but

25. See ENRON CORP. 2000 ANNUAL REPORT 54-55 (2001), at <http://enron.com/corp/investors/annuals/2000/ar2000.pdf> (last visited Feb. 23, 2003).

26. *Id.*

27. Professor Peters is referring to Mr. Robert K. Jaedicke. *Id.*

if somebody walked up to me and handed me a \$100 million check to do something that was kind of unethical but nobody would die, I'd be seriously tempted. I'm sorry.

That's the—you got to understand that Ken Lay and Fastow,²⁸ that's the order of magnitude of the compensation that we're talking about. It's not hundreds of thousands. It's not millions. It's hundreds of millions of dollars that are on the line with these—with the stock options and the changes in the stock prices.

So that's the environment that auditors live in. Unfortunately, unlike attorneys where you have a clear social responsibility to be an advocate for your client, we are supposed to be an advocate against our client. We are supposed to be the independent outside check of the client who hired us. That puts us in a tremendous conflict of interest.

I think that we can do—first of all, I think auditors and accountants in general are highly ethical people. I think attorneys are the same. We are good people. They are good people in a very difficult situation. I don't care how good you are eventually something is going to hang up.

This has happened before. I mean, I imagine there were conferences like this around the late- 1920s, early 1930s when the stock market crashed. That's where we got the Securities and Exchange Acts,²⁹ that created the Securities and Exchange Commission. That was the attempt at the time to deal with the same sort of abuses that happened when the stock market collapsed in 1929.

The other commonality here is that things turned sour. Jim made the very excellent point—the stock market expects continuous growth in earnings. That's what they expect companies to do. They like stability because it's predictable.

That's where you get what's called earnings management. You get some gains that are being played that sometimes don't look quite optimal because companies are trying to make themselves look worse. But they're trying to make themselves look smooth. If they're coming into an environment where they're making a heck of a lot of money in one year, they will often cook the books downward, in order to set them up to do better the next year and keep that stable growth rate.

28. Ken Lay and Andy Fastow sat on Enron's Board of Directors. ENRON CORP. 2000 ANNUAL REPORT, *supra* note 25, at 54-69. Mr. Lay was Chairman of Enron while Mr. Fastow was Executive Vice President and Chief Financial Officer. *Id.* Both Mr. Lay and Mr. Fastow were members of Enron's Policy Committee. *Id.*

29. Securities Act of 1933, 15 U.S.C. § 77a-77aa (2000); Securities and Exchange Act of 1934, 15 U.S.C. § 78-78mm (2000).

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Well, we had a nice stable run-up in the 1990s, and the party was going fine. But eventually the party has to come to an end. It always does. It's what they call the business cycle. But when you get to the end of the party, nobody wants to be the first one to leave.

Consequently, managers started cooking the books upward to try to maintain that growth, so they could go to the stock market and say, "I know the economy is turning—softening. But we're hanging in there and we're doing well on the earnings."

That's what started to happen with WorldCom when they started capitalizing expenses. It's kind of like taking the money you put into your gas tank and saying well, that's going to give me benefit for the next ten years, so I'm not going to write that off as an expense. I'm going to call it an asset. They were taking daily expenses, and there was nothing particularly complicated about what WorldCom was doing. It was just good old-fashioned fraud.

What Enron was doing was something much more creative. They created what are called special purpose entities,³⁰ hundreds of them. Enron is a good example of the other group that I want to bring into play here, it is the standard setters. But let me finish off with the auditors.

First of all, the fundamental point here is that they're in a very difficult situation. They are being placed in a situation where they have to audit the hand that feeds them. Here's where I'm going to first of all say that I speak for myself and no other accountant because I'd probably get shot at dawn for saying this. I think it's time to go back to what was considered in the 1930s when they had the SEC Acts³¹ on the table and nationalize auditing. We've got to change the system where the companies hire their own auditors.

The only mechanism I can see that has the credibility, and the power, and the strength to do that is some arm of the federal government, particularly the GAO.³² I think the GAO has had a tremendous reputation of being an independent agency in an enormously politically charged environment. They get away with this because the Comptroller General is appointed for fifteen years. So changes in administration don't affect them.

30. See BLACK'S LAW DICTIONARY, *supra* note 5, at 1405 (defining special purpose entity as "[a] business established to perform no function other than to develop, own, and operate a large, complex project (usually called a single-purpose project), especially so as to limit the number of creditors claiming against the project.").

31. See statutes cited *supra* note 29.

32. See BLACK'S LAW DICTIONARY, *supra* note 5, at 691 (defining General Accounting Office (GAO) as "[t]he federal agency that provides legal and accounting assistance to Congress, audits and investigates federal programs, and settles certain contract claims against the United States.").

The current Comptroller General, David Walker, is a former partner of Pricewaterhouse Coopers. I've met him. He's a really nice guy, and I'm on some committees with him. I commented one day to him that I consider him to be the ultimate example of auditor independence, because George Bush I appointed him and he basically served George Bush II with a landmark suit to try get at the information behind the development of the Bush energy policy. Technically, he is suing Vice President Cheney, but you get the picture. This is definitely an indication of independence on the part of the GAO.

The other major problem we have is standard setting. Accounting standards to most of you are probably a nightmare. They are a nightmare to us. They are a law. I mean, fundamentally they are a law and they're set by what is a political body.

The Financial Accounting Standards Board ("FASB")³³ is a private non-profit institution that is funded by what's called the Financial Accounting Foundation. The Financial Accounting Foundation gets all its money from corporations and accounting firms and it is responsible for setting these standards. It has absolutely no force of law. It gets its force of law, because the SEC says if you want to do business in the United States you got to go by their rules.

Well, let's take stock options and the problem that they generated. The FASB was trying to come up in the mid-1990s with a pronouncement on stock options. The fundamental problem of accountants is that we are the reality check. We're there to bring the party down to reality and try to say, "What is the true economic essence of these transactions that you're creating?" Well, stock options are a classic example.

In the mid-1990s the Financial Accounting Board said, "You're paying people for services rendered. That's an expense. It should show up on your income statement as an expense. It doesn't make any difference whether you're paying them with cash, or paying them with cars, or paying them with perks, or paying them with stock options. The economic essence is you're paying somebody for services rendered. That's an expense, that's a wage, and that should go on the income statement."

Of course if you do that, companies like eBay and Yahoo would go from making money to losing money very quickly, because it's a significant expense, particularly for the high-tech industry. As a

33. *See id.* at 644 (defining the Financial Accounting Standards Board (FASB) as "[t]he independent body of accountants responsible for establishing, interpreting, and improving standards for financial accounting and reporting.").

result, the industries rebelled. They even lobbied Congress, and Joe Lieberman introduced a bill in Congress.³⁴ I'm not sure of all the technical details, but fundamentally Congress got on board and pretty soon the Financial Accounting Standards Board backed off.

There is a standard out there that says you've got to expense stock option compensations.³⁵ But you have a choice: (1) you can either expense them in the income statement, where it's right there in front of everybody and it cuts your earnings per share that the stock market looks at;³⁶ or (2) you can put it off in the footnotes and tell everybody what it would look like if you had expensed it. The information is all there.³⁷ But our great, efficient markets really don't see it when it's in the footnotes. It's got to be in that income.

If we really believe the efficient markets hypothesis,³⁸ who would care whether the information was in the footnotes or the financial statement? I can guarantee you, industry cared a lot, enough to lobby the Financial Accounting Standards Board into pulling back from that standard.

The other part of the puzzle that needs to be seriously addressed is the impact of political pressure on the accounting standard setting body. What kind of scares me a little bit is that one of the calls that is now out there is for accounting standards to go the way of the international accounting standards. This is where we get into some conceptual stuff.

The international accounting standards are what is called principles-based. The American accounting standards are what is called rules-based, which means that the American accounting

34. See S. 1175, 103d Cong. § 4 (1993) (prohibiting charging options as expenses on balance sheets).

35. See David Tice, *Employee Stock Option Costs Don't Show on Bottom Line: Lax Accounting Standards help Companies Hide Big Expenses*, ON WALL STREET, Jan. 1, 1999 (describing Financial Accounting Standard Board (FASB) 123, which provides corporations with two options for reporting the costs of employee stock options); ACCOUNTING FOR STOCK-BASED COMPENSATION, Statement of Financial Accounting Standards No. 123 (Federal Accounting Standards Bd. 1995) [hereinafter Statement 123].

36. See Statement 123 (suggesting that companies will rarely report the costs of stock options in their income statements because the alternative allows the companies to hide this information in footnotes). On December 31, 2002, FASB amended Statement 123 with Statement 148 which provides two supplemental means of expensing stock options. ACCOUNTING FOR STOCK-BASED COMPENSATION—TRANSITION AND DISCLOSURE, Statement of Financial Accounting Standards No. 148 (Federal Accounting Standards Bd. 2002) [hereinafter Statement 148]. Statement 148 also requires that companies improve the clarity and prominence of disclosures so that they are easier to find and understand. See *id.*

37. See *id.* (stating that all the information regarding stock-option compensation be included in a company's expense report).

38. See Tam, *supra* note 18 and accompanying text (defining the efficient market hypothesis).

standards are thick, and they're very, very detailed.

The problem you get into is that the auditor-client discussion turns into a very detailed legalistic argument. It really boils down to the client saying, "Why can't I do this? Show me something specific in the rule book that says, I can't do this." The auditors try to go to the Financial Accounting Standards Board and say, "Well, you got to give us some guidance so we can hang our hat on something here."

Then, of course, the Accounting Standards Board tends to get heavily lobbied by industry and tends to back off. As a matter of fact, the accounting firms tend to lobby the Financial Accounting Standards Board for their clients. Some of the studies that have been done in academic accounting look at the lobbying behavior of the "Big Five," now four, Certified Public Accounting ("CPA") firms³⁹ and they're almost parallel to the lobbying activity of their major clients. You can say that they really are in bed with each other. But, as I've explained, that's a pretty natural behavior.

I'm a little bit leery about how to do this, but the other piece of the puzzle is to find some way to isolate the Financial Accounting Standards Board from the tremendous lobbying that comes in from industry and the funding that comes in from industry and the fact that four out of the five members on the Financial Accounting Standards Board come from industry, either from corporations or from the accounting firms.⁴⁰

There is only one member of the board that has to come from academia, because the American Accounting Association,⁴¹ which is our academic group, is a sponsoring organization and insisted on that.

So basically, that's kind of my story. It is that I think the system is fundamentally flawed in that when you've got an economic situation where the consumer cannot assess the quality of the product, where the consumer is so distant from the actual purchase transaction—and

39. Arthur Andersen fell from the ranks of the "Big Five" accounting firms, leaving Deloitte & Touche LLP, Ernst & Young LLP, Pricewaterhouse Coopers LLP, and KPMG LLP as the "Final Four" premier accounting firm. Weil et al., *supra* note 21, at A1.

40. The Financial Accounting Standards Board is comprised of seven members, who "are required to sever all connections with the firms or institutions they served prior to joining the Board." Financial Accounting Standards Board Website, *FASB Facts: Board Members*, at http://www.fasb.org/facts/bd_members_staff.shtml (last visited Feb. 23, 2003). Of the seven members, four had previously worked in industry. *Id.*

41. See BLACK'S LAW DICTIONARY, *supra* note 5, at 81 (defining the American Accounting Association as "[a]n organization of accounting practitioners, educators, and students."). The American Accounting Association promotes accounting as an academic discipline by sponsoring research products and continuing education seminars. *Id.*

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here the consumer is not just the stockholders.

Our stock market has changed radically since the 1920s and 1930s. Today, everybody is a stockholder. Your 401(k) declined, so did mine. I imagine everybody in this room, or the vast majority of you have money in the stock market someplace. You are the consumers of financial information. You are the people who benefit from accurate, reliable accounting information.

But you're not the ones who are hiring the accountants. You're not the ones who are evaluating the quality of their work and you're not the ones who are making the decisions on how much they should be compensated.

The problem is that you probably would be clueless as to how to evaluate the quality of an audit. That's why before the turn of the last century there were these anti-competitive practices. The fundamental belief was that free markets will not work in these kinds of professions, in legal, medical, and accounting professions, because the consumer is incapable of judging the quality of the product and therefore we need to look at this as a social good.

What competition is going to do is create a race to the bottom, because it's going to emphasize cost reduction and that's exactly what's happened in auditing.

This is where my liberal politics come out. Until we can realize that accurate financial information is critical to our society and that that is a social good that probably cannot be adequately allocated within a free market, we have to make some fundamental change in the way auditors are hired, compensated, and evaluated.

Although some of my auditor colleagues would shoot me for saying that, I think if they really stepped back and looked at it a little bit more objectively, I think that they would find that it would upgrade the quality of the audit and it would probably increase their fees, and turn it back into a profession where they can really meet their social obligation. Thank you.

PROFESSOR WALLACE: Jim, thank you very much. Chuck?

MR. DAVIDOW: Thank you very much. I think that the two talks we've had so far have been very useful in describing what some of the pressures are that the system places on the various participants. I want to step back from that for just a minute and talk a little bit about a narrower set of issues.

That is, what is it that happened in the case of the scandals that we've been reading about over the last year, so that we can build from that? Once we have talked about what the problem is, what are the solutions that would address those problems?

I think it is particularly important because some of the solutions that we've read about seem to me to be interesting, provocative, maybe good things, but not to relate to the particular problems that we're dealing with here. So, let me take it in that narrower way.

My involvement started almost exactly a year ago, when we were hired by a special committee of the Board of Directors of Enron to come in and do an internal investigation and prepare a report which was ultimately made public and called the Powers Report⁴² because Dean Bill Powers from the University of Texas chaired our committee.

Since Enron there have been a number of other public scandals including Tyco, Global Crossing, Adelphia, and WorldCom. In WorldCom we were hired a few months ago to perform the same role—which is to come in and investigate exactly what happened in contemplation that we'll publish a report that will describe what the facts are.

It has been very illuminating, not only because it gave me the chance to sit in a room with Ken Lay and with Andy Fastow and with the others and ask them the questions, but also because it forced us to learn about transactions which, as Jim said, in the case of Enron were enormously complicated transactions. I do complicated transactions for a living and the Raptor transactions there took me the better part of a month before I was comfortable that I had any idea what they were all about.⁴³

In each of those cases, things went wrong, but they weren't the same thing in each of those cases. Each one of them involved separate types of problems. In some cases, they were the sort of thing that are pretty simple and you learned in kindergarten you weren't supposed to do—steal from other people, for example. Others of them were very complicated and involved efforts by people to—I won't even say game the rules—but try to look at the rules and figure out a way, without violating them, to get around them, to defeat the purpose of the rules.

42. See WILLIAM C. POWERS ET AL., ENRON BD. OF DIRS., REPORT OF INVESTIGATION BY THE SPECIAL INVESTIGATIVE COMMITTEE OF THE BOARD OF DIRECTORS OF ENRON CORP. (2002) [hereinafter POWERS REPORT] (identifying William C. Powers, Jr. as the Chairman of the Special Investigative Committee of the Board of Directors of Enron Corporation, which was created to investigate transactions and investment partnerships created by Enron's former Executive Vice President and CFO and other Enron employees), at <http://www.nysscpa.org/enron/report.htm> (last visited Feb. 23, 2003).

43. See *id.* at 97-128 (addressing Enron's complex "Raptor transactions," which allowed the company to avoid reflecting almost \$1 billion in losses on its income statement), at <http://www.nysscpa.org/enron/Powersreport3.pdf> (last visited Feb. 23, 2003).

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Indeed to the point I think it's fair to say that at least in Enron, it wasn't a situation where you would go in and people would want to hide from you what they had done. In many cases, people were proud of it because they thought they had come up with an artistic and creative triumph, a way to interpret accounting rules that was both permissible, yet achieved some sort of counter-intuitive result.

As we put it in describing it internally, someone thought he had figured out how to turn lead into gold and thought that it was just the neatest thing that had ever happened.

Ultimately we disagreed with them, as have the members of the criminal task force that are examining it. But it's a very different problem from someone saying, "I'm going to figure out a way to enter into a transaction where I make a bunch of money and nobody's the wiser for it, or where I get to buy a bunch of property but have the company pay for it."

Without going deeply into the particulars, there are a few common aspects that I think these different scandals have. One, and the most important one, has to do with culture. There is nothing more important than the culture of an organization. One of the things that is really striking in each of the scandals I have talked about is that it wasn't a case of someone embezzling money and hiding it from everybody else there. These were all situations in which lots of people knew what was going on.

It's right there in front of you. Based on the public statements by WorldCom, capitalizing line costs,⁴⁴ something that's clearly impermissible, you have to ask yourself, "How could a number of people have seen that and no one said, 'Wait a minute, this is wrong, you can't do that.'"

In cases where there was looting, how can a bunch of people in the company who saw it not have said, "Wait a minute, you've got to stop." What kind of culture is it in an organization that permits that kind of conduct to occur, and no one raises their hand and says—in a way that actually accomplishes anything—"Stop, it can't go on any longer."

Cultures like that don't grow up immediately. But if you look at the companies, one thing you will find is they have tended to be relatively new companies, companies that don't have long histories. They tend to be companies where the CEO or the very top people are

44. See PRACTICING LAW INSTITUTE, WHAT EVERY LAWYER NEEDS TO KNOW ABOUT ACCOUNTING NOW—OR ELSE!, BEHIND THE NUMBERS: A REVIEW OF SIX ACCOUNTING PROBLEM AREAS IN THE NEWS 627 (2002) (explaining that "line costs" represent fees that WorldCom paid to third party telecommunication network providers for the right to access the third parties' networks.).

viewed as super heroes.

The way most organizations work is they thrive because a number of people who are working together in a way to build the organization. When you have a company where people say, "We're a great company, and we're a great company because we've got the greatest CEO on earth, and we depend on him, and we don't need to think about who the successor is because no one could possibly stand in the shoes of this person," you're asking for trouble. You're creating an environment where it's very hard for anyone to challenge that person.

It often is the case that those are the companies where that CEO has a very large influence over the board, the kind of problem we were just talking about before as well. Situations where there is an authoritarian is too strong a word, but a very strong central figure, where dissent is not encouraged, where there is a view that your compensation comes from showing loyalty to the person you report to or to the boss rather than from long-term performance, where compensation comes from closing a great deal rather than waiting to see how it pans out over a period of time. This tends to encourage short-term type of conduct that it seems to me has been characteristic in all of these cases.

The first thing that I would focus on is culture. If I were a member of a board of directors or an audit committee, that's the thing I would be focusing on the most too. Not merely listening to the presentation of the CEO and the CFO, and leaving it at that, but actually getting to know people throughout the organization.

The second thing that I think has been a common problem in a number of these cases, and it's been a failing of lawyers as well, comes down to this basic proposition: if you're asked to evaluate something, you have to understand it first.

That seems like an obvious proposition. But to pick perhaps unfairly on one case, there has been a lot of criticism of the investigation that Vinson & Elkins did of the so-called whistleblower allegations from Sherron Watkins.⁴⁵

As that has been described, a woman who worked for Enron sent an anonymous letter to Ken Lay, the Chairman. He received it and gave it to the General Counsel. The General Counsel asked Vinson & Elkins to come in and take a preliminary look at it to decide if it was

45. See generally Richard Lacayo & Amanda Ripley, *Persons of the Year: The Whistleblowers*, TIME, Dec. 30, 2002, at 30 (describing the circumstances surrounding Watkins' actions at Enron and naming her one of the persons of the year), available at <http://www.time.com/personoftheyear/2002/poyintro.html> (last visited Feb. 23, 2003).

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something that required further examination.

There are an assortment of issues about whether that was the right choice or the right firm. That is really not to the point that I want to discuss. It's that what Vinson & Elkins was told, according to all who were involved, was "just take a preliminary look at this so that we can decide whether we need to do more. You don't need to get behind the accounting."

It's very hard to evaluate a letter that says there is an accounting fraud here without getting behind the accounting or at least looking into the accounting. But that was the nature of the assignment that was given. I don't know how you do an assignment like that.

We were asked to come in and examine Enron just as we've been asked to come in and examine WorldCom. It's very complicated, and it takes a lot of time and in the end there may well be parts of it that we got wrong or that we get wrong because it's very complicated.

I don't understand how you can come in and say, "I'm going to investigate this situation and give my client the answer that it needs" if you haven't had the opportunity to actually get to the bottom of it and satisfy yourself that you understand what you're doing.

It has come up in a variety of other aspects of each of these scandals, but it has been essentially that people have been brought into a situation that they probably thought was okay. In Enron, I would venture that the people who received that anonymous letter thought that this was some sort of crackpot.

I've seen plenty of whistleblower letters, and I've read plenty of articles in the newspaper that are hostile, and in some cases the letter writer is a crackpot. You look at them and you say, "I'm not sure how big of an investigation we need to do to figure whether the CEO really is intercepting the brain waves of this person who works in the accounting department." You say, "Okay, that one, I'm not going to spend a lot of time on."

But on the other hand, when someone says, "This complicated set of accounting transactions is enabling, in effect, the company to record income based on increases of the value of its own stock," that's not something where you do not just say to yourself, "Geez, this is some kook." That's something you take a look at. You have to make an evaluation of what needs to be done, but you have to bring skepticism to the process as well. You have to come into it assuming that there may be something here.

In the case of Enron, there were two or three published articles in the six or eight months before Enron imploded in which people said things along the lines of, "There is a significant problem here. They

are doing very complicated transactions. They are not explaining them. It looks like smoke and mirrors.”⁴⁶

Plenty of people saw those columns. Indeed Enron responded to them.⁴⁷ The people in management wanted to portray the analyst as an idiot, someone who doesn't understand what the company was doing. It turns out she was right.

The reason that those warnings were not heeded was not, I think, because people said, “We're engaged in a fraud, let's continue covering it up.” We interviewed Bob Jaedicke, the Chairman of the Audit Committee,⁴⁸ as well as a number of other people. They are honorable people who I believe were trying to do their jobs right.

One of the failures here is acceptance of what management tells you based on the trust that you've built up over years. It's understandable and not an entirely bad thing. To the extent when you hear something that should engender skepticism or at least a close second look, people were disinclined to do it for a variety of reasons.

The next issue I want to mention has to do with disclosure; that is a function that lawyers are very much involved in. My work has generally been in litigation defense and enforcement proceedings, investigations, and not in drafting disclosure. It's easy for me to sit here and challenge something that's often quite difficult to do.

But if you read over the disclosure in Enron's 10-K for the year 2001,⁴⁹ there is a footnote on related party disclosure. It's about two paragraphs long. It includes disclosure of almost all of the elements of these Raptor transactions that I referred to before.⁵⁰ When I read

46. See Bethany McLean, *Is Enron Overpriced?*, FORTUNE, Mar. 5, 2001 (detailing concerns about Enron's earnings and stock price before its declaration of bankruptcy); Peter Eavis, *Why One Firm Thinks Enron is Running Out of Gas*, THESTREET.COM, May 9, 2001 (discussing a research firm's recommendation to sell Enron stock as it believed, correctly, that the company was faring much poorer than its published reports), available at http://www.thestreet.com/_tscs/comment/detox/1422781.html (last visited Apr. 3, 2003).

47. See *Good-bye Houston, Hello Federal Prison: Enron Executives Should Get Ready to Move to Their New Home*, THE COPERNICUS MZINE, Feb. 2002 (reporting that Enron CEO Jeffrey Skilling degraded Bethany McLean of *Fortune Magazine* for delving too far into Enron's business practices), available at <http://www.copernicusmarketing.com/about/mzine/monthlyeds/feb02.html> (last visited Apr. 3, 2003).

48. See *supra* notes 26-27 and accompanying text.

49. See ENRON ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES AND EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2000 (FORM 10-K) 76 n.16 (2001) (describing transactions entered into by Enron with limited partnerships “whose general partner's managing member is a senior officer at Enron”), <http://www.sec.gov/Archives/edgar/data/1024401/000102440101500010/0001024401-01-500010.txt> (last visited Feb. 23, 2003).

50. See POWERS REPORT, *supra* note 42, at 97-128 and accompanying text (describing Enron's related party disclosures).

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through it after I understand the transactions, the pieces of it are all there, but it's totally incomprehensible. You can't read it and come up with an answer, "Why are you doing this transaction? What's the purpose of it? How do these different pieces fit together? What are you trying to accomplish here?"

I suspect, although I can't prove, that someone, at some time, thought that was a masterpiece of drafting. That it had disclosed all the things they had to disclose. It had all the pieces there. It was truthful. It's hard to find statements that you can look at it and say, "Aha, that's a lie!" But it didn't perform the basic purpose, which is to treat the shareholders as owners and give them a basis to decide whether they like what their company is doing or not.

This is something that I think has been evolving over time. It's partly a result of the fact that transactions are very complicated. It's partly the result of the fact that it's difficult to explain them in a way that's understandable. The result has been some kind of gamesmanship. But an important role for the people doing financial disclosure, including the lawyers, is to take a look at it and say, "I don't understand it. It doesn't make sense."

I picture members of the audit committee and members of the board who signed the document sitting as they probably will be someday, if they haven't been already, in one of those little basement conference rooms at the SEC on plastic chairs with someone three years out of law school asking them questions, saying, "I read this language here. You signed it. What does it mean? Do you understand it?" I wouldn't want to be in the position of having to answer those questions.

Stepping back and taking the view of not have we put the facts in here technically, but have we written something that's actually understandable, would, I think, have led to the discovery and end of virtually all of these scandals. Once you read about them in the *New York Times* or heard about them in congressional hearings, it was obvious to everybody that bad things had happened here.

If the transactions had been described earlier, I think the fraud would have been discovered earlier. Although I must say, analysts whose job it is to figure out what's there could have done a whole lot more based on that technically accurate disclosure.

The last point I want to make with respect to the lessons that I take from these scandals has to do with the role of the lawyer. In an adversary system, one of the things that we are taught all along is that it is our job to carry out the desires of our client and to do so in a lawful way, but to be their advocate.

Being the person who says no is not a good position to be in. It's uncomfortable in many cases. Often part of the task is figuring out a way to say yes, but do it lawfully.

Nonetheless, there is an enormous temptation to do what your client wants you to do, to try and say yes. In part, this is because the client pays your bills and does not have to hire you again if management is unhappy with the work you've done. In part, because you work with people. You're a team player. You see yourself that way and you want to be able to get things accomplished.

But you're not always doing yourself a favor and you're not doing your client, the corporation, a favor. In many cases, you're not even doing the manager that you're talking to a favor if you don't bring the independence of mind to the task that's needed.

When you talk to the people who were the top management even at Enron, not the people who were stealing money, but the people who were behind these transactions, my guess is that they are saying to themselves, probably with at least a grain of truth, I asked the lawyers if this was okay and if it wasn't, they needed to tell me, "No."

They might well not have received that "no" answer very happily at the time. I've had the experience with a couple of very strong-willed clients who have said, "I want to do this, or that, or the other thing." I have said, "No, you can't do that." The two I'm thinking of are two of my clients who are most loyal to me today, because I think their view is that it kept them out of trouble.

Getting past the desire to please your client in the short-term and, on to the longer term, doing what's best for the corporate client, its managers, and your individual client is a critically important part of the role of the lawyer. You need to bear this in mind even when there is a temptation to forget about it for a few minutes.
PROFESSOR WALLACE: Good. Thank you, Chuck. Questions? Yes, please.

SPEAKER: You're talking about alternatives to hiring auditors and I wonder if you thought it was appropriate [portion of question inaudible] insurance companies [portion of question inaudible] because they're the ones that have their money [portion of question inaudible].

PROFESSOR PETERS: Frankly I haven't heard that proposal, which means I ought to read the newspaper more frequently. My initial reaction is that I'd be a little bit concerned, because the insurance company has money on the line. But its money is on the line for certain specific risks like liability and fire damage, et cetera. I'm not sure that an insurance company would have to pay off if a

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company's stock price plummeted because they were caught cooking the books. Therefore, the incentive on the insurance company might be a little limited in terms of really speaking for the shareholders. That would be my main concern that they would look after their own pocketbooks and their own pocketbooks may not be aligned with the stockholders.'

MR. DAVIDOW: I share that view. A company's insurers have a set of incentives of their own. It's true that they have a desire to have accurate as opposed to inaccurate information. On the other hand, if they have doubts about the information, they can solve the problem by canceling the policy or not renewing the policy. It is probably more in their interest to do that than to cause disclosure which is going to bring about a bunch of lawsuits in which the insurance company will be on the line to pay the defense costs or possibly the judgments in those lawsuits. There would need to be an alignment of interests to make that work.

PROFESSOR PETERS: Yes, sir.

SPEAKER: [Question inaudible].

MR. DAVIDOW: The solution of Sarbanes-Oxley is addressing the problems that I see as the most important ones now.

To the extent Sarbanes-Oxley is saying that you need to remember that your client is the corporation, that you may need to go up to the board, that's a good thing, not a bad thing, as a reminder.

But I don't think it was the case in any of these scandals, that what you had was a lawyer sitting in his or her office saying, "There is something terrible here, what do I do? Who do I go to? What do I do about it?"

The problems in these cases tend to be more along the lines of what I described before, lawyers throwing themselves into the effort wholeheartedly and bringing about the things they were trying to bring about. The first question I have in my own mind is whether Sarbanes-Oxley is the solution to the particular problem that we have.

I do worry, just as you say, that the result will not be to give the lawyer more leverage. Lawyers have a lot of leverage as it is. You may get fired for it, but you can make your client very uncomfortable if they're doing something wrong and you threaten to go up the line, whether or not the law says you have to go up the line.

I worry that what you're going to end up generating, though, is a series of CYA-type communications going back and forth. It may be the client doesn't share information or it may be the lawyer sends a letter to the general counsel saying, "We have received evidence, x, y, and z." The general counsel has to figure out how to send a letter

back that covers his rear end. You wind up with a process that creates an antagonism between the two rather than the kind cooperation that you really want to have.

That's all speculative. It may be—and I'm genuinely open to this—that reminding lawyers and pushing them to escalate issues when they have them will in the end be a good thing. I haven't really made up my own mind.

SPEAKER: [Question inaudible].

MR. DAVIDOW: I'm not sure that you need protection to take a concern up with your client. You're not going to get sued for malpractice for having brought something to the attention of the general counsel.

Maybe the place that we should be focusing here is on the proposed rule requiring the lawyer to bring an issue to the government. That is controversial. That's a place where you, as a lawyer, could be viewed as taking action that's inconsistent with what has often been viewed as the role of the lawyer.

It may well be that making this sort of reporting mandatory does give some cover in a situation where lawyers feel that they have been used to give an opinion that has then been used in an offering document and they come to conclude that their opinion is wrong because they were misled. They have to say to themselves, "Now what do I do? Do I go to the SEC to tell them that it's wrong or not?" Making it compulsory may help in that setting.

But in the normal back and forth between client and law firm it's always seemed to me that lawyers with the appropriate independence of mind know how to make themselves effectively heard already. But making it clearer is not a bad thing in my mind.

MR. GUNDERSON: If I could address the in-house question, because I think there probably was a component of that to your question. I think it is probably more important for in-house counsel than for outside counsel. Outside counsel, I believe, is legitimately worrying about communication and what's going to happen to communication and the openness. For in-house counsel, under the Model Rules,⁵¹ we've traditionally had a choice between bumping it up. If you're not the general counsel, you know you have to evaluate whether the general counsel dealing with it or not.

If they are not dealing with it, then you have two choices, resign or kick it up yourself. At the general counsel level, then the general

51. See MODEL RULES OF PROF'L CONDUCT R. 1.13 (2002) (requiring in-house counsel to contact a higher authority if illegal activity within the company is suspected, also known as "climbing the corporate ladder").

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counsel is talking to the CEO and he's got that choice. Is the CEO understanding and dealing with it? If not, kick it up to the board of directors or resign.

Those are both very powerful tools. You have to be willing to use both of them and they may amount to the same thing. Because if you cannot get along with your CEO, he doesn't just gratuitously fire you. It's a big deal for the CEO to be firing his general counsel and it's a big deal for the board. But the prospect that you're going to be able to work together after that is questionable.⁵²

I think it's been useful, though. At the American Corporate Counsel Association,⁵³ we would debate these things. You had some in-house counsel who said, "The Model Rules are a joke. We don't do that. We do what we're told."⁵⁴ Others responded, "Are you kidding?" Again, they're talking about what happens to them, you know, if they do this.

I think for that group, constituency within the in-house bar, this is very important because it says, "Sorry, debate is over. This is the way it is." I think it's public opinion as well. I think the coverage of Enron and what went on in-house has helped that.

The general counsel wants to be able to say to the CEO, "Look, I'm doing this because it's my duty to do this. I've got to do this. I'm doing this. No hard feelings. It's not personal. I've got to do this and we've got to get it to the board or all kinds of people have problems." It's a bit like the auditors looking for cover. It's right there. It's in black and white, and the CEO has read about it in the paper.

52. See PRELIMINARY REPORT OF THE AMERICAN BAR ASSOCIATION TASK FORCE ON CORPORATE RESPONSIBILITY 37-38 (2002) ("In any event, the general counsel will pay a substantial price for going around the CEO. At a minimum, such action will disturb the relationship of the CEO and the general counsel.").

53. See generally American Corporate Counsel Association Website (describing the American Corporate Counsel Association as "[a]n effective voice on issues of importance to the corporate legal community," most specifically in-house counsel), at <http://www.acca.com> (last visited Feb. 23, 2003).

54. See *Role of the General Counsel*, ACCA DOCKET (September/October 1996) ("In discussing the role of general counsel as corporate cop, it was clear that the group hated adopting that role. It puts us in a no-win position since there is an inherent tension between the roles of adviser and enforcer. To enforce, the general counsel must compromise the trust and credibility needed to be an effective adviser. All general counsel fear this role as one with the potential for precipitating a career defining moment in which the general counsel must resign or be fired."). However, as an organization, the American Corporate Counsel Association has stated clearly its policy on the responsibility of a general counsel. See *In-House Counsel's Role in Ensuring Corporate Responsibility*, ACCA POLICY STATEMENT (2002) ("If [seeking to resolve the issue internally does] not result in appropriate action to resolve an issue of material impact on the entity, the attorney must take the matter to the board or an appropriate sub-group of the board."), available at <http://www.acca.com/advocacy/corpresponspolicy.pdf> (last visited Apr. 3, 2003).

I think it's got a very positive effect that I have seen, not just in the companies I have worked with, but with my colleagues who work in other companies.

You have middle-level lawyers who are saying, "Well, under Sarbanes-Oxley, don't I have to do something?" Because they've seen something that they didn't think about as hard as this before. I think it's actually quite favorable on the in-house side but presents some communications problems in the relationship with outside counsel. Outside counsel has got to do it through the general counsel or you really have a messed up situation.

PROFESSOR WALLACE: Professor?

SPEAKER: [Portion of comment inaudible] the 2001 version of the SEC's rule⁵⁵ [portion of comment inaudible] I think in place at the time that Enron [portion of comment inaudible] that the result would have been [portion of comment inaudible].

MR. DAVIDOW: I can give him a quick yes on the first one. After that I haven't seen anything that suggests that anything different would have occurred had this been in place.

SPEAKER: That's my instinct.

MR. GUNDERSON: Well, I believe that the mid-level attorney who had hired Fried Frank would have had a lot more going for him.⁵⁶ He was in a very difficult situation because there did not seem to be a strong functional line up to the General Counsel. That did not seem to be the operative chain. It seemed to be the Chief Financial Officer was in effect able to dominate decisions about whether what that guy was doing was appropriate or not. I think that the new rules would have helped in that sense.

SPEAKER: The second question is whether the state law was more [remainder of question inaudible].

MR. GUNDERSON: I think the whole notion of federalizing corporate governance is a very problematic issue. The business-judgment rule,⁵⁷ the whole regime around corporate governance,

55. See SEC Procedural Rule 102(e), 17 C.F.R. § 201.102 (2003) (authorizing the SEC to regulate lawyers appearing before it based on their professional conduct).

56. See Jake Tapper, *More than One Enron Official Warned Company About Growing Crisis*, SALON.COM, Jan. 18, 2002 (reporting that Enron Staff Attorney Jordan Mintz, before Enron was forced to reveal its actual finances, hired outside counsel from New York law firm Fried Frank Harris Shiver & Jacobson to look into what he thought were questionable partnerships created by Enron), at http://archive.salon.com/tech/feature/2002/01/18/enron_partnerships/ (last visited Feb. 23, 2003). Fried Frank advised Enron to stop setting up these partnership. *Id.*

57. See BLACK'S LAW DICTIONARY, *supra* note 5, at 192 (defining the business-judgment rule as "[t]he presumption that in making business decisions not involving self-interest or self-dealing, corporate directors act on an informed basis, in good faith, and in the honest belief that their actions are in the corporation's best

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under state law, is what directors are familiar with. I think it can be made to work.

On top of that, to add federalizing attorney ethics, where we already had to deal with the Model Rules versus our home state's rules, I would say it should be done by the state because that's the normal place [for] both of those.

SPEAKER: Would you tighten state corporate law to deal with [remainder of question inaudible].

MR. GUNDERSON: Our system, when it works, is two-fold. First, what do directors need to do to be doing their job right vis-à-vis the company? Second, is a system where the shareholders have what they need to know to make a decision as to whether to invest or not.

I think what you're describing actually does fit more on the disclosure side of the regime which is a federal regime, as opposed to legislating the proper way to deal with situations, and is very difficult. Legislating what you have to talk about so that the market can make decisions in these areas it is more straightforward.

I was more commenting on the ethics. The professional ethics and what lawyers are supposed to do belongs in the states. The ABA and the Model Rules just did not get enough airing; they were not really adopted by in-house counsel to the extent they should have been.

SPEAKER: My concern was focusing on the management side rather than the lawyer side [remainder of question inaudible].

MR. GUNDERSON: A lot of these companies were violating the law in not disclosing related party transactions. The law was already there and they were just flat out violating them and if they had been disclosing the related party transactions, with Fastow's interest in those companies, anybody could have looked at that and said, this is insane. That's my view.

PROFESSOR WALLACE: Thank you.

SPEAKER: I have a slightly more, I guess, philosophical question. You mentioned in your comments about the importance of organizational culture and I wonder if [portion of question inaudible] in the corporate model. I raise that question not because I question the existence of corporate culture or organization culture but I always feel, to make a reference to Steven Spielberg, it sort of feels like a "force."

It's sort of this thing that drives the protagonists either to do good or to do evil. But do we harness it to correct problems in the future?

interest."). "The rule shields directors and officers from liability for unprofitable or harmful corporate transactions if the transactions were made in good faith, due care, and within the directors' or officers' authority." *Id.*

I raise that question because it seems to me that the law is how we harness and drive that culture. It doesn't seem to be working [portion of question inaudible].

Also, I think with sort of a broader cultural phenomena which is [portion of question inaudible], auditing, that you raised, the legal profession, to business in general. It's much more about producing and selling and not necessarily a family profession any longer. How do we harness corporate culture?

MR. GUNDERSON: If you look at the companies that had these big problems there are some similarities among them. One of them is that they were radically changing companies, tremendous growth companies, big acquisitions so that there wasn't much chance for them to have good corporate culture.

I think you need to look at companies in that category. There are certain areas where governance really matters, and that's one of them—where you see a company that you can't really expect to have a good mature company culture.

The one we always like to refer to, General Electric ("GE"), I mean after the 1929 crash, when people were looking to inspiration from captains of industry, it was GE's Chairman in the 1930s who was guiding. That's a company that has a strong company culture.

There can be problems at the top, you know, but that's not affecting the rank and file. That's not really driving the way a company—and most—I think the markets do have a sense of what are strong companies with good company culture because they are, the analysts and the directors are, meeting middle management.

I mean that's a whole side, a practical side of governance where the board does get exposure to the management and does see that it does have a strong culture, and I mean, involving ethics and all of that. That is far more powerful than anything else you can put in place. I mean, if it's there, that's great. If it's not there, all these other substitutes like the law, the board, and everything else, they're pretty poor substitutes.

SPEAKER: I agree with you. I just think that's the problem. How do we get there? I mean it seems to me to be a very intricate process.

MR. GUNDERSON: It is and it takes time. I mean, you don't get it overnight. Many of these companies were overnight sensations.

PROFESSOR PETERS: The market does discipline companies for breaches of corporate culture. I mean after all these things blew up other companies that started to revise their earnings were penalized in the market because these accounting things came out. So, I think one piece is to try to deal with this disclosure issue, to let the market

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know what kind of corporate culture you have.

I think there are two other parties here, and we need to be careful, that are parties to the corporate process that also have some serious conflicts of interests.

One is the analyst community, which the Attorney General of New York has kind of gone after,⁵⁸ and the conflict of interest between the investment bankers and the analysts. The analysts are supposed to be kind of independent purveyors of information to the market and we find that they are being heavily influenced by the investment banking community.

The other is the stockholders themselves. A lot of the stockholders are large institutional stockholders, pension plans and things like that, that also have a conflict of interest. When Hewlett-Packard and Compaq were discussing a merger, one of the major stockholders—and I can't remember which company it was—was also the manager of one of the company's pension plans.

So you have investors who have conflicts of interest because on the one hand they're investing in stock, but on the other hand they are managing 401(k) plans. Actually there were some e-mails and letters going around in that merger that put pressure on this one investment company to switch sides in the merger, kind of as a promise to keep management of the pension plan.

So disclosure also has to include some of the conflicts of interest that are going on in the mechanisms that are supposed to be providing objective information to the market. It's not just the auditors that are involved with that.

PROFESSOR WALLACE: Let me ask about another actor—prison. Are we going to need much more of this or is one big burst enough? The role of sort of the criminalization of the securities and corporate law. I wanted to get your take on the extent that this actor needs to be very present much anymore. We've had some participation so far.

58. See Charles Gasparino & Michael Schroeder, *Pitt and Spitzer Butted Heads to Overhaul Wall Street Research*, WALL ST. J., Oct. 31, 2002, at A1 ("Over the past year, Mr. Spitzer has transformed the New York State attorney general's office into a de facto federal regulator of the securities markets. His weapon: The Martin Act, a once-obscure state law that gives him broad power to charge Wall Street firms with civil- and possibly criminal-fraud violations."); Pradnya Joshi, *Merrill Lynch Set to Pay \$100M: Also agrees to new safeguards to settle Spitzer probe of analysts*, NEWSDAY, May 22, 2002, at A7 (detailing the settlement between Merrill Lynch and the New York Attorney General where Merrill Lynch agreed to pay a \$100 million penalty, institute reforms, and issue an apology for "inappropriate communication"). See generally Office of NYS Attorney General Eliot Spitzer, *Biography of Eliot Spitzer* (stating that New York State Attorney General Eliot Spitzer is "a national leader in investor protection" and "Spitzer's investigations of conflicts of interest on Wall Street have been the catalyst for dramatic reform in the nation's financial services industry"), at <http://www.oag.state.ny.us/bio.html> (last visited Feb. 2, 2003).

MR. GUNDERSON: You send people to prison when you're really mad and actually you need somebody to blame for it. You don't want to blame yourself. We had so many of these just astounding scandals. Somebody will probably figure out what the cycle is. *National Student Marketing*,⁵⁹ before that, after that.

It has so much to do with the state of the market. I mean when the drinks are free, nobody shoots the bartender. When the drinks aren't free you take him out and shoot him. So I think the market is going to turn around and I think we will have incrementally improved things. I think that later we'll hear from the panel about the evolution of corporate governance and where we're going.

But I think that telling these guys they can't turn themselves in—"We're going to put you in handcuffs and march you down." I mean all of that. I mean that's more of a signal that we're taking care of the problem than anything else.

PROFESSOR WALLACE: Absolutely.

MR. GUNDERSON: It's more political than anything else.

PROFESSOR PETERS: It would be nice to see Michael Milken's personal financial statements today after his—I mean that was the other scandal in the 1980s when the savings and loan went down and he did go to prison.⁶⁰ As I understand it, he has made quite a bunch of money since prison. He's come back out a fairly wealthy man.

MR. DAVIDOW: I take a different view on this one. I think it's an absolutely great thing to send people to prison.

Typically, financial frauds have been dealt with by the SEC. The SEC has a respectable arsenal of weapons⁶¹ available to it but none of them come anywhere close to prison, particularly where people can make tens or hundreds of millions of dollars through fraud.

If the SEC enjoins them from going out and doing it again, if it imposes a bar from serving as officer or director of a public company,

59. See *Wachovia Bank & Trust Co. v. Nat'l Student Mktg. Corp.*, 650 F.2d 342, 345 (D.C. Cir. 1980) (recounting that Wachovia purchased "five million dollars worth of NSMC stock from the corporation and two of its directors" and that the stock's market price dropped by sixty percent two months after the purchase because NSMC announced that it expected to report a loss for the previous quarter).

60. See generally JESSE KORNBLUTH, *HIGHLY CONFIDENTIAL: THE CRIME AND PUNISHMENT OF MICHAEL MILKEN* (1992) (providing an in-depth look at the life of the infamous Michael Milken and his involvement in the Saving & Loan scandals).

61. See THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 16.2, at 865-91 (4th ed. 2002) (discussing the various enforcement powers available to the Securities and Exchange Commission, including: disgorging ill gained profits, seeking injunctive relief, imposing civil monetary penalties, barring individuals from serving as officers and directors of '34 Act reporting companies, providing criminal referrals to the Department of Justice, issuing cease and desist orders against individuals violating the securities laws, and suspending individuals from practicing before the Commission).

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that's a bad thing for them. They don't like explaining it to their kids. They don't like explaining it to their neighbors. But it's not the same thing as being afraid that if you do this transaction, if you loot your company, you're going to go to jail.

We've had this spate of frauds discovered recently. We can argue whether in particular cases criminal prosecution was justified or not, whether the perp walk is overshooting the mark or not. But, in general, bringing criminal charges in egregious cases is a terrific thing to do. It ought to be done periodically, because managers can forget about it if too much time goes by.

PROFESSOR PETERS: Well, the felony conviction ended a ninety-year-old company. Arthur Andersen can no longer certify financial statements in the United States because they've got a felony conviction. With a felony conviction, they're gone.⁶²

MR. DAVIDOW: Bringing criminal actions against companies versus individuals is another issue that is very much a fair ground for debate. But in the case of prosecution of individuals, then you've actually got someone who goes to jail and you don't have 70,000 other people getting put out of work because of it.

PROFESSOR WALLACE: One last question, Professor .

SPEAKER: [Question inaudible].

MR. DAVIDOW: . . . As I understand it from the SEC rules—the SEC just came out with a full set of rules, I think yesterday afternoon.⁶³ It's ninety-three single-spaced pages which I have not, I'm sorry to say, parsed in time for this session.

But one of the issues to be addressed there and that I presume is addressed is, "What sort of disclosure needs to be made to the SEC in cases of so-called noisy withdrawal?" That wouldn't go as far as what you're describing, public disclosure, but perhaps it will provide at least some level of information for the SEC to get involved.

SPEAKER: [Question inaudible].

MR. GUNDERSON: . . . [T]he other thing to keep in mind, and maybe this is a little self-serving, but the general counsel would rather have it be mandatory that they have to go to the board than have it be mandatory that they have to resign. If you have other things that are going to hurt the company—keep in mind, if the general counsel is

62. See Weil et al., *supra* note 21, at A1 (describing the Arthur Andersen felony conviction).

63. See Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71670 (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. pt. 205) (requiring an attorney "to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company.").

resigning, he is still the general counsel. His duty is still to protect the company and to make the best things for the company happen.

It's going to be very difficult for a general counsel to resign if he thinks he's going to generate harm to the company from that. The best thing is to put the general counsel in the position of being able to say to the CEO, I don't have a choice. You either deal with this properly or if I don't judge in my professional judgment that you are, I have to go to the board. That way it keeps it within the company. By the way, one of the nice things I think about the recent public debate is, it's easier for company employees now, including the general counsel, to think of the board as part of the company. Even look at the terminology we use, "outside directors." We're the only country that calls them outside directors as if they are not even part of the company.

I think now rules saying you've got to go to the directors are far better for the general counsel than putting them in the position—there's the attorney-client issue and there is the issue about vigorously representing the corporation and what the impact would be.

PROFESSOR PETERS: I think that while the rules might help, there are limits to them. They don't have—as you point out, if an auditor resigns they have to report—both the auditor and the company have to file statements with the SEC about the reason surrounding the resignation. That doesn't happen very often and you can kind of figure out why. I mean from the auditors standpoint, resigning from a client in the first place is a huge economic loss. But now they've got to disclose all of this to the SEC. They're probably going to find a way to kind of cover it over because they don't want to send up a big red flag to the next client that comes down the road that they're a trouble-maker.

So it helps in the sense that it's there and it's a hurdle that people have to get over. It's really not going to—at least on the auditing side it hasn't done a lot to really get at the fundamental economic conflict that auditors face.

PROFESSOR WALLACE: Let's give this excellent panel a big hand.

WHEREUPON, A RECESS WAS TAKEN