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# IRRATIONALITY AND COGNITIVE BIAS AT A CLOSING IN ARTHUR SOLMSEN'S *THE COMFORT LETTER*

*Richard W. Painter\**

## INTRODUCTION

In *SEC v. National Student Marketing Corp.*,<sup>1</sup> the Securities and Exchange Commission ("SEC") alleged that the directors and officers of National Student Marketing Corporation ("NSM"), Interstate National Corp. ("Interstate"), and their lawyers had violated the anti-fraud provisions of the federal securities laws.<sup>2</sup> Shortly before the closing of a merger agreement between NSM and Interstate, the auditors for NSM discovered that NSM's earnings had been overstated, and hence, the proxy statements used to solicit the Interstate shareholders' approval of the merger were materially misleading.<sup>3</sup> The lawyers, nonetheless, allowed the merger to go forward without resoliciting approval from Interstate's shareholders, and allowed some of Interstate's principals to sell NSM stock they had acquired in the transaction without disclosing to the buyers the material changes in NSM's financial statements.<sup>4</sup> Federal District Judge Barrington Parker found that the lawyers representing Interstate aided and abetted the Interstate principals' violation of § 10(b) of the 1934 Securities Exchange Act ("1934 Act") and § 17(a) of the 1933 Securities Exchange Act ("1933 Act") because the lawyers had neglected their duty to protest their client's decision to go ahead with the merger.<sup>5</sup> According to Judge Parker, "[t]heir silence was not only a breach of this duty to speak, but in addition lent the appearance of legitimacy to the closing."<sup>6</sup> Unfortunately, Judge Parker was less clear about what the lawyers should have done.<sup>7</sup>

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1. 457 F. Supp. 682 (D.D.C. 1978).

2. *Id.* at 686-87.

3. *Id.* at 689, 695.

4. *Id.* at 696-97.

5. *Id.* at 715. The attorneys representing NSM had settled before trial similar SEC charges brought against them. *Id.* at 687.

6. *Id.* at 713.

7. Judge Parker stated that "it is unnecessary to determine the precise extent of their obligations here, since . . . they took no steps whatsoever to delay the closing." *Id.* at 713. One of the most difficult problems in *National Student Marketing* is

Judge Parker thus fired one of the first shots in what has become a continuing battle over the duties of a lawyer confronted with a client's securities law violations. This debate over the duties owed by a lawyer remains hotly contested between the securities bar on the one hand and the SEC on the other.<sup>8</sup>

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determining what the merging companies' shareholders would have wanted to do had they known about NSM's actual earnings. Would NSM's shareholders have wanted to hurry up and close the deal? Would Interstate's shareholders have wanted a chance to reconsider the merger, knowing that NSM was not as profitable as earlier thought? Would Interstate's shareholders have believed that they were still getting a good deal and that resoliciting shareholder approval posed an unacceptable risk that the merger might be called off? NSM, for example, could try to back out of the deal while the proxy solicitation was in progress. Alternatively, NSM's stock price could, before the merger was closed, go up on account of offsetting good news. NSM might then demand a higher price for the merger. *See id.* at 694. Thus, even if NSM did not earn as much profit as its financial statements said it did, Interstate's shareholders might still prefer to go ahead and close the deal without delay. There is simply no way of knowing.

Because corporations do not have the ability to solicit decisions about a merger at the last minute from widely dispersed shareholders, corporate directors are usually delegated the power to decide whether to close a merger transaction. Unfortunately for the defendants in *National Student Marketing*, this power did not extend to closing the merger if proxy votes approving the merger were obtained in violation of federal securities laws, particularly when some of the Interstate principals also sold their own NSM shares without disclosing the inaccuracies in NSM's financial statements to the buyers. Notwithstanding the possibility that some profitable deals may be lost as a result of the requirement to re-solicit shareholder approval if defects are discovered in already distributed proxy materials, the SEC, and presumably the courts, would agree that registrants' compliance with federal securities disclosure requirements takes precedence.

8. *See* Susan P. Koniak, *When Courts Refuse to Frame the Law and Others Frame It to Their Will*, 66 S. Cal. L. Rev. 1075, 1078-79 (1993) (discussing the conflict between the bar and regulatory agencies over the duties owed by a lawyer). Academic literature also debates the wisdom of imposing on lawyers an affirmative duty to disclose to regulators information which organizational clients are required to disclose but do not. Some commentators argue that mandating lawyer disclosure would interfere with the legitimate objectives of legal representation. *See* Joseph C. Daly & Roberta S. Karmel, *Attorneys' Responsibilities: Adversaries at the Bar of the SEC*, 24 Emory L.J. 747, 748 (1975). Professor Kraakman argues that "whistleblowing leaves all regulatory targets at the mercy of their private monitors" and creates for clients "a powerful incentive to withhold information from potential whistleblowers." Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. Econ. & Org. 53, 60 (1986). Other commentators argue, however, that "[u]sing lawyers as gatekeepers and whistleblowers is a relatively inexpensive mechanism to achieve widespread compliance with the law." George H. Brown, *Financial Institution Lawyers as Quasi-Public Enforcers*, 7 Geo. J. Legal Ethics 637, 718 (1994). The present author has already written extensively on this subject and will not do so again here. *See generally* Richard W. Painter, *The Moral Interdependence of Corporate Lawyers and Their Clients*, 67 S. Cal. L. Rev. 507 (1994) (arguing that lawyers often share responsibility for client conduct in business transactions); Richard W. Painter, *Toward a Market for Lawyer Disclosure Services: In Search of Optimal Whistleblowing Rules*, 63 Geo. Wash. L. Rev. 221 (1995) (proposing that lawyers and clients should voluntarily agree ex-ante that the lawyers will blow the whistle on illegal acts and arguing that this commitment is likely to be viewed favorably by regulators, transaction participants, and investors); Richard W. Painter & Jennifer E. Duggan, *Lawyer Disclosure of Corporate Fraud: Establishing a*

Arthur Solmssen's novel, *The Comfort Letter*,<sup>9</sup> is based on *National Student Marketing*. This novel is not only an excellent introduction to the legal and ethical issues in securities practice, but also to the psychological pressures that bear down on lawyers and clients at a closing. The novel, like some securities transactions in real life, also includes a last minute crisis. This crisis might have been avoided had the lawyers in the story recognized earlier the irrationality and cognitive biases that affected the decision-making of the participants in the closing.

Part I of this Article summarizes the story in *The Comfort Letter*. Part II briefly mentions how the crisis that arose in that story might have been avoided had the lawyers better understood how the motivations and biases of the people in the company they represented could interfere with the due diligence investigation prior to the closing. Part III explains how irrationality and cognitive biases can lead individuals to ignore problems that exist in a company and how cognitive biases affect a lawyer's ability to evaluate the risks that a client undertakes. Part IV discusses how compensation arrangements for lawyers and auditors also can influence professionals' responses to risk.

### I. THE COMFORT LETTER

In *The Comfort Letter*, Charlie Conroy, President and CEO of Conroy Concepts Corporation ("CCC"), is planning to acquire Bromberg Instruments.<sup>10</sup> Bromberg's shareholders have already approved the merger, and their stock has appreciated considerably with news of the merger.<sup>11</sup> To obtain financing necessary to pay off short-term debt and increase working capital, Charlie also plans for CCC to close a \$100 million debenture offering.<sup>12</sup> As required under § 5 of the 1933 Act, CCC must register the debentures with the SEC.<sup>13</sup> The underwriting syndicate, managed by First Hudson Corporation, insists that before they will close the debenture offering, they must have a "comfort letter" from the auditing firm, Pennypacker Poole &

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*Firm Foundation*, 50 SMU L. Rev. 225 (1996) (proposing a default rule requiring a lawyer to report a corporate client's prospective illegal acts to its full board of directors unless instructed to do otherwise by the client's articles of organization).

9. Arthur R.G. Solmssen, *The Comfort Letter* (1975). Substantial portions of the chapter from *The Comfort Letter* which is discussed in this article, are included in John T. Noonan & Richard W. Painter, *Professional and Personal Responsibilities of the Lawyer* 123-42 (1997). Arthur R.G. Solmssen was admitted to practice in Pennsylvania in 1954, and was a partner, and is now of counsel, at Saul, Ewing, Remick & Saul in Philadelphia, specializing in corporate and municipal securities law. He is also the author of several novels.

10. See Solmssen, *supra* note 9, at 158-59.

11. See *id.* at 298.

12. See *id.* at 260.

13. See Securities Act of 1933, ch. 38, tit. I, § 5 (codified at 15 U.S.C. § 77e (1994)).

Co. ("PP").<sup>14</sup> This letter is to state that no material changes to CCC's financial condition have come to the auditors' attention since CCC's financial statements were prepared and published in the preliminary prospectus circulated to prospective investors before the date of the debenture offering.<sup>15</sup> Both the merger and the debenture offering require extensive due diligence by the underwriters and by CCC's lawyers to ensure that accurate disclosure of all material facts about the transactions has been made to the merging companies' shareholders and to the debenture purchasers.

The cast of characters includes: Ordway Smith, the narrator of the novel and a partner at the law firm of Conyers & Dean in Philadelphia, which represents CCC in the transaction; Tommy Sharp, an associate at Conyers & Dean;<sup>16</sup> Harry Hatch, a partner of Iselin Brothers & Devereaux and counsel to First Hudson and the other underwriters involved in the debentures offering;<sup>17</sup> Bernard Bromberg, the President and CEO of Bromberg Instruments; Justin Silverstone, lead counsel for Bromberg Instruments; and Sandy Simon, co-counsel for Bromberg Instruments.<sup>18</sup> The year is 1969.<sup>19</sup>

Just before the delivery of the comfort letter and closing, a serious problem emerges. A design defect is discovered at a nearly completed coal-burning power plant that Darby Turbine, a recently acquired subsidiary of CCC, has been building at Turkey River for a large utility company in West Virginia.<sup>20</sup> The new, expensive limestone scrubbers that Darby Turbine installed to bring the coal-burning plant into conformity with state environmental standards do not work.<sup>21</sup> Neither the proxy statements, used to obtain approval from both companies' shareholders for the merger, nor the prospectus, given to the prospective purchasers of the CCC debentures, discloses this problem and its potential impact on the value of CCC's stock.<sup>22</sup> The closing is just days away.

Alex Morrisson, chief engineer of Darby Turbine, claims he warned CCC about this problem with the limestone scrubbers, but that he was ignored by the "fancy hotshot atomic energy people" who, despite their ignorance of coal furnaces, were brought in above him after CCC acquired Darby Turbine.<sup>23</sup> Political tension within Darby

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14. See Solmssen, *supra* note 9, at 266-67.

15. See *id.*

16. See *id.* at 20.

17. See *id.* at 11.

18. See *id.* at 160. In addition, Hewitt Robinson is President of Darby Turbine, Jack Renfrew is Executive Vice President and Chief Operating Officer of CCC, and Frank Fonseca ("the Frenchman") is corporate secretary of CCC. See *id.* at 10, 160, 169, 277.

19. See *id.* at 12.

20. See *id.* at 277-79.

21. See *id.*

22. See *id.* at 280-82, 297.

23. Morrisson says: "[N]obody will listen to what engineering people with forty

Turbine eventually explodes into hostile accusations when it becomes clear that a shut down of the Turkey River plant by West Virginia's environmental authorities may be unavoidable.<sup>24</sup> These same internal political problems probably compromised the due diligence process, which was supposed to detect problems of this sort before prospectuses and proxy statements were circulated to investors.<sup>25</sup> Now, CCC and its lawyers, accountants, and underwriters face a crisis on the eve of closing.

The utility company that purchased the defective limestone scrubbers from Darby Turbine is, understandably, disputing payment of the contract price—about \$170 million.<sup>26</sup> Instead of a profit, Darby Turbine may sustain a substantial loss on the Turkey River contract, although the exact extent of the loss is unknown. After spending \$200,000 on accounting fees, legal fees, and printing costs, CCC and its counsel suddenly discover that the prospectus for the sale of the

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years in the coal business have to say, they let a kid just out of engineering school call the shots about building a coal-burning power plant." *Id.* at 277. The utility company had specified a full-scale stack gas cleaning system to comply with state environmental regulations and Darby Turbine filled the order by installing the limestone injection system and wet scrubbers, despite Mr. Morrisson's warnings that the system might not work. *Id.* at 278.

24. Ordway describes the problem with the defective limestone scrubbers:

The fly ash and the limestone slurry tended to form hard cement-like deposits that clogged the marble beds, clogged the demisters, clogged the water jets, and clogged the inlets to the scrubbers. They were having so much trouble that the electric company had just refused to pay the last installment of the construction contract.

"Can't they operate the plant without the scrubbers?" asked Tommy Sharp.

Alex Morrisson shook his head. "Ever seen that valley? River's a hundred yards wide, then there's a railroad track, a highway, a half mile of bottom land, then mountains straight up on both sides. Unless you get a wind blowing down the river the smoke will lie in there, there's three little factory towns strung along that valley, they had to close a chemical plant because they couldn't get rid of the fumes—"

*Id.* at 279.

25. The investigating attorneys were unable to uncover the problem at the power plant being built by Darby:

"My God, we climbed all over that plant," said Tommy Sharp. "The underwriters were there, the people from Iselin Bros. were there, nobody said a word about this!"

I didn't like the way he sounded. He sounded frightened, and Tommy isn't easily frightened.

"Of course *they* didn't say a word about it." Alex Morrisson was not frightened at all. On the contrary, he sounded pleased. "This was *their* baby, *their* brilliant idea, Mike Barkus practically invented the scrubbers, you know—"

"Who's Mike Barkus?" I asked.

"Mike Barkus is a kid six years out of Carnegie Tech, a kid who's going to show the whole profession how to build coal-fired power plants, a kid who sold this whole ball of wax to people who know all about atomic energy—"

*Id.* at 283.

26. *See id.* at 280.

debentures, although correct at the time the preliminary prospectus was circulated, is now wrong.<sup>27</sup> Unless changes are made to the prospectus to disclose these new developments, the accountants will refuse to deliver their comfort letter confirming that the financials of CCC and its affiliates, including Darby Turbine, are correct as of the closing date.<sup>28</sup> Without the comfort letter, CCC and its officers, directors, and investment bankers, if they go ahead and close the deal, are legally responsible for the accuracy of the financial statements in the prospectus, and may be sued by purchasers of the debentures under the federal securities laws.<sup>29</sup>

Sticker the prospectus to note the change in the financial status of the company is one solution. Sticker would provide a way to update prospective debenture purchasers about the situation so that they could make an informed decision about whether to buy. First Hudson, the lead underwriter for the debentures transaction, however, rejects the idea of sticker the prospectus,<sup>30</sup> because once Darby Turbine's problem is exposed, hesitant buyers could leave the underwriters holding the debentures in what is known as a "sticky offering."<sup>31</sup>

The Bromberg side of the transaction is even more problematic because it poses a dilemma for the parties to the merger similar to that in *National Student Marketing*:<sup>32</sup>

"What good would a sticker do you?" asked Tommy [Sharp], munching. "Even if the underwriters let us sticker their Prospectuses, what about your Bromberg stockholders? They got the same financials in their Proxy Statement. Are you going to send

27. See *id.* at 282.

28. According to John Lundquist, the CPA partner in charge of the auditing firm, Pennypacker Poole & Co.:

[S]omething happened, you see, a subsequent event that changed the facts. So in the light of these new facts we obviously can't deliver the same letter on Tuesday—at least not in the form required by the underwriters. I can't very well say that nothing has come to my attention that would indicate a material adverse change in consolidated results of operations . . . .

*Id.* at 282.

29. In particular, CCC and its officers, directors, and investment bankers could be liable under § 11 of the 1933 Act. 15 U.S.C. § 77k(a) (1994). In addition, if intent to defraud or recklessness can be shown, they may be liable under § 10(b) of the 1934 Act. *Id.* § 78j(b).

30. See Solmssen, *supra* note 9, at 296, 322. Underwriters sometimes place a sticker on the prospectus notifying prospective investors of material changes to the registrants' financial condition that are discovered after the effective date of the registration statement.

31. Sticky offerings can also pose regulatory problems for the underwriters. See generally Daniel J. Winnike & Christopher E. Nordquist, *Federal Securities Law Issues for the Sticky Offering*, 48 Bus. Law. 869 (1993) (describing securities law problems that arise when an underwriter takes part of an unsuccessful offering into its investment account and later tries to resell the securities).

32. See *supra* note 7 and accompanying text.

them another Proxy Statement, hold another meeting, have them vote on the merger all over again?"

Sandy [Simon—co-counsel for Bromberg] lighted his pipe, looking profound. "Mm. We've considered that."

Tommy plowed ahead. "And if you postpone the merger, call another stockholders' meeting, then our Prospectus is wrong again because it contains the Bromberg earnings and it says the Bromberg holders *have* approved the merger!"

Sandy nodded. "Fortunately, you'll recall the merger agreement says that Bromberg's officers can waive certain conditions of closing, if it appears to be in the best interests of Bromberg's stockholders."

That was the first time the word "waive" was heard in the room.

Now Tommy Sharp looked skeptical. "You're going to waive the comfort letter?"

"Not the whole letter, of course, but perhaps we could work out some change in the wording . . ." At the other end of the table, the accountants stopped talking among themselves. Sandy Simon rose and went over to confer with John Lundquist [CPA and partner in charge from Pennypacker Poole & Co.].

Tommy Sharp leaned toward my left ear: "I don't know if Bromberg realizes it, but he's really in something of a box."

"Why?"

"Well look, when the merger was first announced, before it was announced, Bromberg stock was worth what? Sixteen-seventeen dollars a share, something like that? But now it's traded as if the merger's accomplished, and CCC is up, so right now Bromberg stock is worth about forty. Right?"

"Right."

"So let's say the merger aborts, the merger doesn't take place because the Bromberg control people—that's Bernard and Bob [Bromberg]—insist that every technical closing requirement be met, that the comfort letter says word for word what the merger agreement requires . . . so the merger doesn't come off, what happens? Each and every Bromberg stockholder has a loss of twenty-three or twenty-four dollars a share. Who are they going to go after for that loss?"

"Charlie? [Conroy]"



"No, not if Charlie was willing to go ahead with the merger. They're going to go after Bernard and Bob, that's what they're going to do!"<sup>33</sup>

Ordway Smith, the partner in charge of the due diligence being performed for CCC and Tommy Sharp's supervisor, knows however that the legal position of the Bromberg principals, if they decline to resolicit the proxies, is also dubious.<sup>34</sup> In view of the shakiness of Bromberg's legal position, and the underwriters' refusal to sticker the prospectus, Ordway knows he must persuade Charlie to call off the closing at least until CCC's financial statements can be corrected and new prospectuses circulated to the debenture purchasers.<sup>35</sup> Charlie, unfortunately, neither understands, nor wants to understand, the problem:

Charlie Conroy's scowl reflected anger and impatience. "So what's the big problem?" he finally interrupted. "It's a new concept, it's going to take some time to make it work, why are we making such a big deal about it?"

Patiently John Lundquist explained again: percentage-of-completion method, earnings already taken in might have to be backed out, adjustments might be required . . . .

"So what? So we'll make the adjustments! It can't amount to more than a couple of cents a share. . . ."

"But you see, the comfort letter requires us to say . . ."

. . . .

Suddenly Charlie exploded: "All right, let's cut out all this bullshit! What are we going to *do*? I've got sixty-five million in bank notes coming due next week. Are you people trying to tell me you're walking away from this deal on account of some trouble at one power plant in West Virginia? One project out of two dozen we've got going all over the world? On account of a *possible* adjustment of five cents a share? Is that what you're trying to tell me? We're going to write off six months of work and two hundred thousand in expenses and tell the banks, 'Sorry, fellas, our limestone scrubbers got clogged, you'll have to wait a while!?' And what about Bernard [Bromberg's] stockholders? They think their stock's worth forty bucks a share because they're merging with CCC tomorrow. What are we going to tell *them*? Now come on, wake up! We're paying you guys the kind of fees we're paying you because you're supposed to be the best lawyers, and the best

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33. Solmssen, *supra* note 9, at 297-98.

34. See *supra* text accompanying notes 1-7 (discussing *National Student Marketing*).

35. See Solmssen, *supra* note 9, at 325.

accountants and the best investment bankers in the country, and I'm telling you you'd better come up with the answer!"<sup>36</sup>

Later, immediately before the scheduled closing, Charlie continues to be obstinate:

At first [Charlie] didn't understand. "What do you mean you can't give an opinion? We all agreed it was okay, we'll make the scrubbers work and if it costs us money we'll adjust the earnings . . . . They've all agreed it's okay!"

[Ordway:] "They're kidding themselves, Charlie. It's not okay. We've either got to put on a sticker to tell people about the problem, or we can't take their money."

"They *won't* put on a sticker, you heard them explain that yesterday!"

"Then we can't close."

The color left his face. "You gotta be kidding."<sup>37</sup>

Eventually, Ordway makes it clear to Charlie that he cannot close the deal. Their discussion, however, exposes the raw emotion Charlie has invested in this transaction:

"Ordway, what the hell has gotten into you? You heard the engineers, they spent all day explaining, they're going to use the plant, it's just a question of working out some bugs in a new process—"

"Charlie, I hope to God the scrubbers will work, but that isn't the point. The point is we've got to tell people we've got a problem. This is the kind of thing an investor would want to be told, isn't it? Wouldn't you want to be told? We've somehow talked ourselves into the position that it's not a big problem, it's not what they call material—well, that's bullshit, it *is* material, and both of us know it!"

He stared at me for a long moment. His face changed.

"You're chicken!"

"Aw Charlie!"

"We run into a few problems and the Messrs. Conyers & Dean develop cold feet. Oh, they don't mind collecting two or three hundred grand in fees every year, even from the gardener's son—it's all money, after all—but when we get down to the nitty-gritty, when the client really has his balls in the wringer, then the Messrs. Conyers & Dean suddenly develop very high ethics—"

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36. *Id.* at 301-02.

37. *Id.* at 322.

"That's unfair, Charlie! You know we've overcome one hurdle after another, we've moved heaven and earth for you —"

"For Christ's sake, Harry Hatch thinks it's okay. Are you smarter than he is? One of the biggest law firms in the world?"

"I think he's wrong. This thing is going to come back to haunt us all—"

"Sandy Simon thinks it's okay, one of the biggest firms on the Coast. Are you so much smarter than they are, Ordway? Would you really call yourself a top-notch lawyer? Or would you call yourself a guy who's had every goddamned thing in life handed to him on a silver platter." He was shouting now, his face red. I was thankful the door was shut, but even so—

"Now wait a minute—"

"Every goddamned *thing!* While I had to work my ass to the bone morning, noon and night since I was sixteen years old and I built a four-hundred-million-dollar company out of nothing. Out of nothing! A sick old sheet and tube company eighteen months away from bankruptcy, and I built it all up by myself, and you're supposed to be my lawyer! Aren't you supposed to be my lawyer?"

"Yes, I am your lawyer."

"You're my lawyer? A lawyer is supposed to help when his client gets in trouble, isn't he? Here we run into a little flak and it isn't the other guys' lawyers that shoot me down, *it's my own lawyer!*"

There was no use arguing with him. He was frantic. I knew it would be bad but I didn't think it would be this bad. I looked down at the carpet while he struggled to control himself, breathing heavily.

"House of cards," he said, more quietly, his voice shaking. "Banks going to move in—"

"We'll work out something with the banks—"

"We'll work out *shit!*" It came quietly now, through clenched teeth. "You and I are through, Ordway!"

"I'm sorry."

"Are you? Really? Now that everything is going to hit the fan? Or are you just as glad to get those fine gentlemen at Conyers & Dean out of the line of fire?"

"No, I'm as sorry as I've ever been about anything in my life, Charlie. We could really help you, but you've got to play it our way."

"Yeah. Play it your way. You know where I'd be today if I always played it your way? You wouldn't even *know* me, Ordway!" He was speaking more quietly now, but his eyes were still wild and he couldn't catch his breath. "I'm going out there now . . . and I'm going to tell them . . . I'm going to tell them what the great firm of Conyers & Dean has done to me . . . what my own lawyer . . . has done to me—"

"Wait a minute, Charlie." I stood up and blocked his way.

We stared into each other's eyes. He was sweating. I thought he was going to hit me. "If you go out there in this state, you'll really blow everything. Just look at yourself. What are they going to think when they see you? The only way to handle this—after you've calmed down—is to tell them it's *your* decision: *you've* decided to withdraw the issue—on advice of counsel, of course—because of the Turkey River contract, because you may have to restate your earnings and you want the investment community to know that before you put out the Debentures. Honest to God, Charlie, it's the only way!"

A curtain fell over his eyes. "I need legal advice," he muttered, turning away from me, opening the door . . .<sup>38</sup>

The story ends with Charlie announcing that, on the advice of counsel, the deal will not go forward.<sup>39</sup>

## II. RECOGNIZING PROBLEMS EARLY

While professional responsibility courses often expose students to difficult decisions in "no win" situations, they sometimes neglect to emphasize the importance of spotting and preventing problems before they become crises. The last-minute crisis in *The Comfort Letter* is an excellent example of a situation that might have been avoided with more careful due diligence.<sup>40</sup> The problems with Darby Turbine's limestone scrubbers might have been discovered earlier had the lawyers understood the motivations and psychology of the people they interviewed during their investigation of CCC's business. As already discussed, however, political problems within Darby Turbine made adequate due diligence difficult.<sup>41</sup>

A professional responsibility class, in discussing this story, should focus on what a lawyer representing either the issuer or the underwriters in due diligence can do to recognize and address

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38. *Id.* at 322-25.

39. *See id.* at 325-26.

40. Indeed, the entire point of due diligence, in which lawyers for both the issuer and the underwriters carefully investigate every aspect of the issuer's business, is to discover and disclose in the preliminary prospectus anything that would be material to an investor's decision to buy the issuer's securities.

41. *See supra* notes 23-25 and accompanying text.

problems as early as possible. Clearly, it is not enough for lawyers conducting due diligence simply to know the industrial and financial aspects of an issuer's business. Businesses are run by people, and a lawyer should understand the interpersonal dynamics within an organizational client. As the Conyers & Dean lawyers found out at Darby Turbine, interpersonal rivalries and employees' personal investments in particular projects can prevent unbiased information about hidden risks from reaching the lawyers. Lawyers who understand an employee's possible motivations to slant his or her assessment of a project's risks, or even to conceal deliberately technical problems, will know enough to ask more questions, to verify information they receive from employees in one part of a company with employees in another part of the company, and, where prudent, to call in independent experts. Although due diligence does not always uncover everything, it can be more effective when lawyers make an effort to understand the motivations and psychology of the people who answer due diligence questions, instead of treating on-site interviews as a mere formality demanded by "due diligence checklists."

Although due diligence work is often done by junior associates, part of what the client pays for is a lawyer who, although not yet an experienced practitioner, has the good judgment to think about the transaction and the people involved, and to ask tough questions, instead of merely going through the motions. By asking these tough questions, lawyers may be able to avoid the last-minute ethical dilemmas faced by the attorneys in *The Comfort Letter*.

Even if a lawyer asks the right questions, however, it is sometimes difficult to respond appropriately to known risk because of the client's or one's own irrationality, or because of cognitive biases that affect evaluation of risk. The next part of this Article discusses the ways in which both irrationality and cognitive biases can affect decision-making of both lawyers and clients.

### III. RECOGNIZING IRRATIONALITY AND COGNITIVE BIASES

Many of the problems encountered in *The Comfort Letter* developed because decision-making was affected by irrationality and cognitive biases. Learning to anticipate how people's judgment may be affected by these factors is an important element of evaluating the problems that may arise at a closing.

### A. *The Irrational Client*

There is wide debate among economists and legal scholars over whether a rational actor model accurately predicts human behavior.<sup>42</sup> The underlying issue in this debate is whether decisions that depart from the rational actor model in a significantly large population randomly cancel each other out or whether irrationality and cognitive biases affect human behavior in a systematic manner, leading a population as a whole to be overly optimistic (and risk-preferring) or pessimistic (and risk-averse).<sup>43</sup>

Regardless of whether people in the aggregate behave consistently with the rational actor model, both sides of this debate readily acknowledge that people often do not behave rationally.<sup>44</sup> While the rational actor model may be a useful tool for discussing how legal rules affect human behavior generally, it is far less useful for understanding the behavior of any single person or organization. Professors do their students a disservice if they rely exclusively on an unqualified rational actor model in classroom discussion rather than discussing the real world in which *individuals*, including lawyers' clients, are often irrational.

Charlie Conroy is no exception. In the following scene, which takes place shortly after the defect in Darby Turbine's limestone scrubbers is discovered, Ordway Smith visits Charlie at his home:

I . . . marched upstairs. The door to the master apartment was shut. I knocked. No answer. I knocked again. When I opened the heavy oak door, I heard the television, Redskins and Dallas Cowboys, but it was dark as I turned through the dressing room into the master bedroom, and the smell was stale beer and cigarette smoke. The curtains were closed and the only light came from the television set.

Charlie slouched in a leather armchair, enormous, dressed in striped pajamas, black silk kimono, slippers. Around him, empty beer cans and overflowing ashtrays.

"Are you all right?" I asked, still standing by the door.

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42. See, e.g., Richard A. Posner, *Rational Choice, Behavioral Economics, and the Law*, 50 Stan. L. Rev. 1551 (1998) (advocating rational actor model); Christine Jolls, Cass R. Sunstein, and Richard Thaler, *Theories and Tropes: A Reply to Posner and Kelman*, 50 Stan. L. Rev. 1593, 1599 (1998) (criticizing rational actor model).

43. See Posner, *supra* note 42, at 1556-57 (assuming that irrational smokers respond randomly to an increase in the tax on cigarettes). According to Judge Posner, "[i]f the distribution of these random behaviors has the same mean as the rational smokers' reaction to the tax, the effect of the tax on the quantity demanded of cigarettes will be identical to what it would be if all cigarette consumers were rational." *Id.* But see Jolls et al., *supra* note 42, at 1599 ("[Judge Posner's argument] is a common response to behavioral economics, and conceivably it could be true; but there is absolutely no reason to think it is, and (as is usually the case) none is offered by the source of the criticism."). Irrationality and cognitive biases are two distinct phenomena which are discussed separately in this article.

44. See Jolls et al., *supra* note 42, at 1599; Posner, *supra* note 42, at 1556-57.

No answer.

I walked in, walked past him, turned off the sound of the television.

Still no comment.

I pulled one of the curtains just a little bit, so that a beam of sunlight pierced the smoky darkness.

"Cut that out," Charlie snarled. "The light hurts my eyes."

He rubbed his hands across his face, then looked up angrily. He hadn't shaved or combed his hair, but he sounded sober.

"Have you got a hangover?" I asked. "What you need is some coffee and some fresh air."

"What I need is peace and quiet. I slept two hours last night. Can't I have some privacy and quiet in my own home?"

"Charlie, we've got a problem with the accountants, they've turned up a serious mess at Darby Turbine—"

I sat down on the unmade bed and told him about the limestone scrubbers.

I suppose I expected an explosion: shouts of rage, galvanic action, telephone calls, threats, decapitations . . . .

There was no reaction at all. He seemed to be listening, but his eyes strayed back to the television screen.

"Charlie, you understand what this means? If [Pennypacker Poole & Co.] doesn't give comfort, Harry Hatch [underwriters' counsel] won't let the underwriters close, won't let them pay for the Debentures, and that in turn means we can't merge with Bromberg—"

"—and I can't pay off the banks," said Charlie, his voice like lead, still staring at the silent football game. He understood, all right. I waited.

After a long time he said: "It also means I'm a shitty manager, a guy who doesn't know what's going on in his own companies." He looked at me with an expression I'd never seen before. "It confirms what you and a lot of other people have known for years—Conroy's a big fraud, CCC's a house of cards."

"Now wait a second, Charlie—"

"A fucking house of cards! You know it better than anybody! Bank debt, convertible debentures, stock trading at crazy price-earnings ratios, earnings based on creative accounting . . .

What's going to happen if I can't pay off the banks? You know what those loan agreements say!" With that he sank back into the chair and lit a cigarette, his hands shaking.

I'd never seen him like this. I knew he had his ups and downs, but I couldn't believe this was the same man who soared to the skies last night, who was going to buy Manayunk Steel, who was going to build his tower sixty stories over Thirtieth Street Station—

"And you know it better than anybody," he said again, through a cloud of cigarette smoke. "Charlie Conroy, the gardener's son who had to wear patched knickers, who had to walk down to the road to meet the school bus, whose father stank of cheap rye, whose mother cried. And now he's a big shot! I can hear all of you laughing!"<sup>45</sup>

Ordway confronts this outburst of emotion with a combination of reassurance and reason as he tries to get Charlie to face facts:

"Nobody's laughing at you, Charlie. You've built an empire with your own energy, your own courage and brains, you've built yourself an empire out of nothing, but every empire has troubles out along the borders, and it's a long way from the emperor's palace to the places where troubles develop, so you've got communications problems. But when you see the trouble you've got to jump in and deal with it. Now we have this mess down in West Virginia, it's no use crying over it, we've got to decide what to do. We've got a meeting with the underwriters in New York tomorrow. We've sent for the engineers to explain the problem to everybody, but you're going to have to be there, Charlie! They'll want to hear what *you* plan to do about it."

He sat there and stared at the football game.

"I've done what I can, Charlie. I've told Renfrew to send the Learjet out for the engineers. I've got our best people reviewing the construction contract, to see if they can tell whose responsibility those scrubbers are. I've arranged for the helicopter to take us to New York first thing in the morning. But when we meet with the underwriters they'll be looking at *you*! You're going to have to convince them that you're on top of the situation."

"Never should have bought Darby. That's what changed everything. If I was so damned smart, why did I go into hock to buy Darby?"

"Charlie, you're stuck with Darby! You've got to deal with this particular crisis tomorrow morning, and I've got to tell Bromberg and Silverstone about it, right now before they find out from somebody else. We've got to have them on our side in this, or the whole house of cards really will collapse." I stood up. "Will you be

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45. Solmssen, *supra* note 9, at 289-91.



ready at dawn? I want to see the engineers for an hour or so before the underwriters have a go at them.”

No answer.

“Charlie? Would you rather I go over first thing with Tommy Sharp and send the chopper back for you and Bernard? I’ve got to be there when Harry Hatch examines the engineers.”

He stared at the football game, smoking a cigarette.

“Charlie?”

“What difference does it make? Do what you want, just leave me alone.”

I got up and left him alone and went downstairs to tell Bernard Bromberg and Justin Silverstone about the limestone scrubbers.<sup>46</sup>

Alcohol clearly has affected Charlie’s judgment and has reinforced his detachment from problems in his business. This method of escape makes reality that much harder to confront in the end. Although Ordway manages to stay sober throughout the ordeal of the CCC transaction, alcohol abuse is also a serious problem among lawyers, perhaps even more so than among their clients.<sup>47</sup> The effect of alcohol on rational decision-making is an important topic to discuss in a professional responsibility course, and Charlie’s behavior is a good example.

Later, at the closing, Charlie has sobered up but is still unwilling to face facts.<sup>48</sup> He hides from himself the irrationality of his own actions by conflating, in his mind and in his rhetoric, the issues raised by the crisis at hand with a different issue: his resentment of an insular Philadelphia establishment that he perceives is trying to isolate him and frustrate his success. When Charlie sees this hostile establishment personified in his own lawyer, Ordway Smith, there is almost a collapse of the communication that is critical to the success of their relationship.

Ordway is simply trying to conform his own conduct to the rules of professional responsibility and Charlie’s conduct to the federal securities laws. To Charlie, however, Ordway represents a “Main Line” elite that judges people not by their conduct and accomplishments, but by ancestry and whether money is “old” rather than “new.”<sup>49</sup> If success under the rules of Philadelphia Society is defined by a listing in the Social Register, then perhaps Charlie is right

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46. *Id.* at 291-92.

47. *See* Noonan & Painter, *supra* note 9, at 359-60 (discussing substance abuse in the legal profession).

48. *See* Solmssen, *supra* note 9, at 322-25.

49. *See id.* at 323-24.

to believe that these social rules are stacked against him, no matter what he does. Charlie makes a profoundly illogical leap, however, in reasoning that his own lawyer wants to undermine him and that obeying the law—e.g., “play[ing] it your way”—puts him at a disadvantage vis-à-vis hostile elites who want to keep him in his place.<sup>50</sup> Charlie’s observation of a social prejudice thus degenerates into a belief that anyone who disagrees with him is against him and that law is little more than a tool used by the elite to oppress people like him.<sup>51</sup>

Rationalization about law in its social context is important to discuss in a professional responsibility course because illogical conclusions can be drawn when bias, however real, is observed.<sup>52</sup> People have prejudices and sometimes law reflects these prejudices, but this does not mean that all of society’s rules are instruments of bias and oppression. Just as law professors who overemphasize the assumption that people are “rational” can do their students a disservice, law professors who assume that law is simply a tool for powerful persons to oppress others can lead students down the same road that Charlie’s reasoning takes him—rationalization that eventually becomes an excuse for breaking the law. Oversimplified assumptions of this sort, even if useful for constructing theoretical models in academic literature, need to be qualified by a healthy dose of realism in the classroom, particularly in a course such as professional responsibility.<sup>53</sup>

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50. *Id.* at 324.

51. *See id.*

52. Charlie’s arguments reflect sentiments repeatedly expressed by persons of perhaps more profound intellect. Former President Richard Nixon’s sense of persecution by a hostile “establishment” was a recurring theme both in his early career and throughout Watergate. *See, e.g.*, Abuse of Power, The New Nixon Tapes 373 (Stanley I. Kutler ed., 1997) (transcript of a recording of Nixon telling Henry Kissinger on April 29, 1973: “And the man who . . . would be trusted by the so-called damned establishment is Elliot Richardson.”). This sense of persecution eventually became an excuse for Nixon to ignore the ramifications of his refusal to obey the law. Some thinkers on both the right and left have lent a seemingly sophisticated theoretical touch to such rationalization by asserting that laws are primarily, if not exclusively, instruments used by one dominant group to oppress others. *See generally* Matthew W. Finkin, *Quatsch!*, 83 Minn. L. Rev. 1681 (1999) (discussing how the criticism of Western liberal orthodoxy by Carl Schmitt and other National Socialist legal scholars fell on willing ears after Germany’s humiliation at the hands of the Allies in World War I, and how “law as oppression” arguments have again surfaced in deconstructionist scholarship of the 1980’s and 1990’s).

53. This belief that law is a tool to oppress others stubbornly persists because it is partially true—laws, including professional responsibility rules, are promulgated by persons in power and sometimes are designed to perpetuate that power. *See generally* Richard L. Abel, *United States: The Contradictions of Professionalism*, in 1 *Lawyers in Society* (Richard L. Abel & Philip S.C. Lewis eds., 1988) (excerpted and discussed in Noonan & Painter, *supra* note 9, at 753-61). However, law is a lot more. Law also reflects the values of the society it governs—for example, there is a social consensus that someone should not sell securities to the public without truthful disclosure and that a lawyer should not assist a client in such conduct. *See supra* notes 1-7, 29 and

### B. Risk Taking in a Loss Frame or Gains Frame

Many judgment calls in the practice of law are essentially about evaluating risk. In transactional work, it is thus important for lawyers to understand how a person's risk assessment can be affected by cognitive biases. Calculations of risk are affected by a person's frame of reference.

According to prospect theory, which has been validated by psychological studies, decision-makers tend to be risk-averse when they believe they are deciding between two alternatives that can result in a gain (a "gains frame"), but risk-preferring when they believe they are deciding between two alternatives that can result in a loss (a "loss frame").<sup>54</sup> For example, a person choosing between (a) receiving \$10 and (b) having a one in three chance of receiving \$30 is more likely to take the \$10, whereas someone choosing between (a) a sure \$10 loss and (b) a one in three chance of suffering a \$30 loss is more likely to take his chances. Thus, in the loss frame, reducing the probability of loss altogether becomes the priority, even at the expense of increasing one's exposure to a potentially greater loss. Numerous studies confirm this bias; they show that the nature of a decision, or the "frame" that casts it as a choice between gains or losses, is a critical determinant of decisional outcomes.<sup>55</sup> Expertise in the subject matter of a decision does not mitigate this framing effect.<sup>56</sup> Moreover, this bias influences evaluations as well as decisions.<sup>57</sup>

Prospect theory thus predicts that plaintiffs will likely be risk-averse when weighing settlement offers against their chances for even larger gains in litigation, whereas defendants will likely be risk-preferring when weighing the certain costs of a settlement offer against their

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accompanying text. Persons who violate the law either reject some of those values or subordinate them in importance to their own objectives. Teaching professional responsibility solely from the "critical" view—that professional responsibility rules are designed to preserve privilege within the bar rather than to promote professional ethics—invites students later in life to indulge in the type of rationalization used by Charlie Conroy to justify actions that amount to nothing more than selfish avoidance or even violation of the law.

54. See, e.g., Amos Tversky & Daniel Kahneman, *Advances in Prospect Theory: Cumulative Representation of Uncertainty*, 5 *J. Risk & Uncertainty* 297 (1992); Daniel Kahneman & Amos Tversky, *Choices, Values and Frames*, 39 *Am. Psychologist* 341, 342-44 (1984); Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision under Risk*, 47 *Econometrica* 263 (1979); see also John C. Hershey & J.H. Schoemaker, *Risk Taking and Problem Context in the Domain of Losses: An Expected Utility Analysis*, 47 *J. Risk Ins.* 111, 120-29 (1980) (offering additional empirical support for Kahneman and Tversky's theory).

55. Jeffrey J. Rachlinski, *Gains, Losses, and the Psychology of Litigation*, 70 *S. Cal. L. Rev.* 113, 124 (1996) (citing over a dozen studies confirming this cognitive bias in monetary gambles, life threatening choices, purchasing decisions, and other situations).

56. See *id.* at 124-25.

57. See *id.* at 125 n.52.

chances for even larger liability in litigation.<sup>58</sup> This effect appears in ethical risk taking as well. Taxpayers who owe money are more likely to cheat on their taxes than those who expect a refund.<sup>59</sup> Similarly, defense lawyers, who are told that litigation is going worse than their clients' prior expectations, are more likely to cheat in discovery than defense lawyers whose clients are pleased with better than expected progress.<sup>60</sup>

Prospect theory can also help predict circumstances where participants in closing a transaction are likely to risk violating the securities laws. In the early phases of a securities offering, when disclosure documents are being prepared and deal participants perceive themselves to be in a gains frame from the contemplated transaction, deal participants are usually very cautious. Indeed, lawyers often overstate legal risk when they advise their clients.<sup>61</sup> In addition to risk aversion in the gains frame, rational incentives, social norms, and other cognitive biases further push lawyers toward being more conservative and unwilling to take risks.<sup>62</sup> Clients who view themselves to be in a gains frame may also be prone to take this advice and err on the side of caution in their disclosure documents.

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58. See *id.* at 128-30; see also Chris Guthrie, *Better Settle Than Sorry: The Regret Aversion Theory of Litigation Behavior*, 1999 U. Ill. L. Rev. 43, 45 (discussing Rachlinski's framing theory of litigation).

59. See Rachlinski, *supra* note 55, at 124 n.50 (citing Henry S.J. Robben et al., *Decision Frame and Opportunity as Determinants of Tax Cheating: An International Experimental Study*, 11 J. Econ. Psychol. 341 (1990)).

60. See *id.* at 142.

61. Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. Cal. Interdisc. L.J. 375, 379 (1997).

62. See *id.* at 377-78. Agency problems explain part of this risk aversion. See Donald C. Langevoort, *The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior*, 63 Brook. L. Rev. 629, 655 (1997) ("A lawyer loses far more by giving the go ahead to a course of action that is later subject to legal sanction than she gains from advice that is not challenged. On the other hand, there is frequently no reputational penalty from too much caution because the client lacks the knowledge and expertise to second-guess the lawyer's judgment. In sum (and subject to some predictable exceptions), lawyers are motivated to overstate legal risk."). The importance of caution as a sociological norm of the legal profession could also be a factor. See Langevoort & Rasmussen, *supra* note 61, at 413-19 (discussing caution as a norm in the legal profession and the possibility that overstating legal risk could be a technique to influence clients toward caution). Psychological biases also might cause lawyers to overestimate risk. See *id.* at 423-26 (discussing "defensive pessimism" or the tendency to over-weigh negative outcomes); *id.* at 426-28 (discussing "accountability" bias or the tendency toward caution when it is known that the evaluation will itself likely be evaluated later); *id.* at 428-30 (discussing self-interest-ego bias or the tendency to find risk when the evaluator benefits from its presence). Other psychological biases, however, may cause a lawyer to underestimate risk. *Id.* at 422-23 (discussing three such biases: "cognitive conservatism," which causes people to ignore new law or facts contradicting a prior schema that is likely to be constructed around the client's intended course of action; "commitment" bias, which induces people to stick with a schema even in the face of adverse law or facts; and bias toward overoptimism).

Prospect theory, however, predicts that clients and other participants in a closing, including investment bankers, accountants, and lawyers, can get themselves into trouble once an endowment effect builds up around the transaction, leading participants to believe it is "theirs to lose" if the deal is called off.<sup>63</sup> If bad news surfaces shortly before the closing, risk-preferring behavior becomes more likely, as demonstrated in *National Student Marketing*. It suddenly becomes a no-win situation not only for the client, but also for the investment bankers, who will probably lose their fees if the deal collapses, as well as the lawyers, who may lose a client and possibly a portion of their fees. Decision-making in such a loss frame is further affected if decision-makers conceal risk-preferring behavior from themselves by adjusting their estimates of risk artificially downwards to make themselves believe they are making risk-neutral or risk-averse decisions when, in fact, they are not.<sup>64</sup> Lawyers, investment bankers, or accountants who fall prey to this fallacy may convince themselves that the facts or the law are different than they really are.

This is exactly what happened to the investment bankers and their counsel at the CCC closing. Loss of the CCC deal would have put First Hudson in the red for the year,<sup>65</sup> a result they were loath to live with even though the alternative of closing the sale of the debentures without changing the prospectus would have exposed them to the even worse fate of being sued by the purchasers.<sup>66</sup> "Rational" underwriters in these circumstances presumably should be risk-averse because federal securities laws impose on underwriters liability up to the full amount of the offering,<sup>67</sup> even though they may only take a fraction of the proceeds of the offering in commissions. "Rationality," however, does not prevail with First Hudson or their counsel. In anticipation of the substantial fee from closing the deal, Harry Hatch and his underwriter clients evaluate the deal in a loss frame in which the underwriting fee could disappear.<sup>68</sup> Consequently, they view the risks in the deal a lot more favorably than does Ordway:

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63. Once again, other cognitive biases may also come into play. See Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry into Lawyers' Responsibility for Clients' Fraud*, 46 Vand. L. Rev. 75, 101-11 (1993) (positing that lawyers may not be good monitors of their client's conduct because they are motivated by a number of biases to see their client's activities as permissible).

64. See Rachlinski, *supra* note 55, at 134-35 (discussing how subjects in litigation settlement negotiation simulation studies overestimate their chances of winning and therefore perceive their own risk-preferring reservation prices to be risk-averse) (citing George Loewenstein et al., *Self-Serving Assessments of Fairness and Pretrial Bargaining*, 22 J. Legal Stud. 135 (1993)).

65. See Solmssen, *supra* note 9, at 325.

66. See 15 U.S.C. § 77k (1994).

67. *Id.*

68. It is not clear that Harry Hatch's firm would necessarily have lost its legal fee if the First Hudson underwriters lost their underwriting fee. Nevertheless, because underwriters often use the same outside law firm to represent them on many transactions, the lawyers representing them may identify strongly with the interests of

Harry Hatch's first reaction had been an icy stare: "I take it you know something we don't?"

"No, you have all the facts we have, Harry. I'm just drawing a different conclusion."<sup>69</sup>

Fortunately, the accountants and Ordway remain risk-averse,<sup>70</sup> either because they have not built up an endowment effect in their minds around the pending transaction or because they are able for other reasons to overcome cognitive bias towards taking risk in a loss frame.

The lesson from this story for a professional responsibility class is clear: a lawyer who understands that judgment can be affected by frames of reference—such as whether a decision-maker believes himself to be in a gains frame or a loss frame—should be able to recognize situations in which frames of reference change, and to evaluate more critically both his own and other people's judgments.

### C. Other Cognitive Biases

Cognitive biases other than risk preferences can contribute to an issuer's concealment of material information from investors.<sup>71</sup> These biases may become more entrenched in people's minds as the closing approaches. Professor Langevoort has observed, for example, that "cognitive conservatism and decision simplification" can lead decision-makers to develop simplified explanations of occurrences, or "schemas," that tend to resist change.<sup>72</sup> This tendency, as illustrated by *The Comfort Letter*, is exacerbated in group settings where stress comes from challenging commonly held beliefs.<sup>73</sup> Once Darby Turbine's officers convince themselves that the limestone scrubbers are going to work, it becomes difficult for them to change their minds. In the group setting around the closing table, there is enormous

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the underwriters, thus increasing their "commitment" bias to their clients. See generally Langevoort & Rasmussen, *supra* note 61, at 422-23; Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. Pa. L. Rev. 101 (1997) [hereinafter Langevoort, *Organized Illusions*] (discussing commitment bias). Furthermore, in some cases the law firm may have an informal understanding with their underwriter clients that they will write off a substantial portion of their fee in unsuccessful deals in return for charging a premium in deals that are successful.

69. Solmssen, *supra* note 9, at 325.

70. See *id.* at 282, 325.

71. See Langevoort, *Organized Illusions*, *supra* note 68, at 157.

72. *Id.* at 135-39.

73. Sara Kiesler & Lee Sproull, *Managerial Response to Changing Environments: Perspectives on Problem Sensing from Social Cognition*, 27 Admin. Sci. Q. 548, 549 (1982); Langevoort, *Organized Illusions*, *supra* note 68, at 135-39, 136 n.118 (citing Dennis A. Gioia, *Pinto Fires and Personal Ethics: A Script Analysis of Missed Opportunities*, 11 J. Bus. Ethics 379 (1992) (discussing how Ford Motor's product-recall personnel missed danger signs associated with the Pinto's on-road performance because of a "normalcy" schema that refused to admit that there were problems with the car's design)).

pressure to affirm Darby Turbine's confidence in the technology, and to dismiss dissenters, such as Alex Morrisson, Darby's chief engineer, as disgruntled complainers.<sup>74</sup>

Another phenomena pointed out by Professor Langevoort is "overoptimism," or the tendency of organizations to promote an optimistic frame of reference in order to promote hard work and long-term commitment by employees, even though this mindset deflects or rationalizes evidence of negative developments.<sup>75</sup> Although much of what entrepreneurs believe about themselves and their businesses may in fact be myths, some of the entrepreneur's "success may actually be due to the *presence* of such myths and illusions."<sup>76</sup> Charlie apparently used over-optimism to inspire subordinates when he built his business empire from a nearly bankrupt sheet and tube company, and he now tries to use that same strategy to bluff his way out of his present difficulty:

I returned just as the second act began. Charlie Conroy, Bernard Bromberg and Justin Silverstone were at the table now, and the underwriters were crowding back into the room.

"All right, is the fire out?" demanded Charlie. He seemed completely recovered.<sup>77</sup>

Every person in the room, except Ordway and the accountants, appears to have joined Charlie in rationalizing or deflecting the bad news, and is ready to close.<sup>78</sup> While over-optimism is a useful tool for building confidence and enhancing performance in a business,<sup>79</sup> it has a dark side that should be recognized—over-optimism has the potential to distort good judgment in the face of suddenly learned and decidedly negative facts.

Decision-makers are also vulnerable to "commitment" bias. Once people make a commitment to a person or course of conduct, they may consistently adhere to that commitment even if later confronted with facts suggesting that the commitment is a bad choice.<sup>80</sup> This

74. Jack Renfrew: "Shoulda gotten rid of [Alex Morrisson] years ago. . . . Alex is a holdover from the old gang, from before Charlie got control, he's got a chip on his shoulder because other people have been put on top of him, and underneath him too." Solmssen, *supra* note 9, at 283.

75. Langevoort, *Organized Illusions*, *supra* note 68, at 139-41, 140 nn.133 & 135 (citing Martin E.P. Seligman, *Learned Optimism* 100-12 (1991), and Edward J. Zajac & Max H. Bazerman, *Blind Spots for Industry and Competitor Analysis: Implications of Interfirm (Mis)perceptions for Strategic Decisions*, 16 *Acad. Mgmt. Rev.* 37 (1991)).

76. Donald C. Langevoort, *Taking Myths Seriously: An Essay for Lawyers*, 74 *Chi.-Kent L. Rev.* 1569, 1581 (2000) [hereinafter Langevoort, *Myths*] ("Myth-making is stable in an evolutionary sense even among the 'fittest.'").

77. Solmssen, *supra* note 9, at 300.

78. *See id.* at 322-23.

79. Langevoort, *Myths*, *supra* note 76, at 1581.

80. *See* Langevoort, *Organized Illusions*, *supra* note 68, at 142-43, 142 n.142 (citing Barry M. Staw, *The Escalation of Commitment to a Course of Action*, 6 *Acad. Mgmt.*

behavior is demonstrated by the underwriters, their counsel Harry Hatch, and Charlie, who have all committed themselves to completing the debenture offering, despite the fact that they may be violating federal securities laws. Ordway is committed to Charlie, his client, and Charlie appeals to this commitment in his attempt to persuade Ordway to go along with closing.<sup>81</sup> Ordway, however, stands firm in not allowing this commitment to sway his judgment.<sup>82</sup>

When there is sufficient ambiguity in a situation, people also may sometimes infer "self-serving facts" that do not threaten their self-esteem or career prospects.<sup>83</sup> Charlie's self-esteem, ever threatened by the snobbishness of Philadelphia's elite, seems to depend on his closing this deal. The underwriters' self-esteem also seems to depend on the deal, which will determine their year-end bonuses. Fortunately, Ordway's self-esteem is distanced enough from this transaction that he can view the "self-serving facts" professed by the others for what they are.

It is important to remember that in a closing for a major transaction, these biases, when they appear, do so against a background of considerable stress. Lack of sleep in the days leading up to a closing is common, particularly for the more junior lawyers and investment bankers. This stress and fatigue, coupled with cognitive biases, may further cloud the judgments of the participants in the deal.

#### IV. COMFORT ON A CONTINGENCY?

*The Comfort Letter* also provides a good opportunity to discuss with a professional responsibility class how compensation arrangements affect people's incentives and judgments. The different ethical rules imposed on auditors and lawyers with respect to compensation arrangements reflect the different roles of these two professions in transactions. The particular compensation arrangement chosen among the range of ethically permissible alternatives, however, can also influence how these roles are carried out.

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Rev. 577, 584 (1981)).

81. Charlie remarks:

We run into a few problems and the Messrs. Conyers & Dean develop cold feet. Oh, they don't mind collecting two or three hundred grand in fees every year, even from the gardener's son—it's all money, after all—but when we get down to the nitty-gritty, when the client really has his balls in the wringer, then Messrs. Conyers & Dean suddenly develop very high ethics—.

Solmssen, *supra* note 9, at 323.

82. *See id.*

83. *See* Langevoort, *Organized Illusions*, *supra* note 68, at 143-46, 144 n.149 (citing Dennis A. Gioia, *Self-Serving Bias as a Self-Sensemaking Strategy: Explicit vs. Tacit Impression Management*, in *Impression Management in the Organization* 219, 230-33 (Robert A. Giacalone & Paul Rosenfeld eds., 1989)).



Auditors are prohibited from charging a contingent fee<sup>84</sup>—an arrangement that could invite auditors to look the other way when problems of the sort uncovered at Darby Turbine arise. In order to earn the fee, some auditors would be tempted to provide a comfort letter despite their lack of comfort with the transaction. Although liability under § 11 of the 1933 Act should encourage auditors to think twice before providing false comfort in a registered offering,<sup>85</sup> the SEC and the auditing profession have both expressly rejected contingent-fee arrangements for auditors.<sup>86</sup>

Perverse incentives from an ownership interest are not as powerful as those from a contingency fee, because it would be more difficult for auditors with an ownership interest to take their money and run. Nonetheless, auditors are still prohibited from having an ownership interest in their clients.<sup>87</sup> While the auditor-owner would usually suffer with the other stockholders if material information were concealed, an auditor's ownership interest in a client might not coincide perfectly with the interests of other shareholders. For example, auditors might accept securities with different liquidation, dividend, or voting rights than the securities an issuer sells to the public, or they might sell their shares before other investors are told about a problem in the issuer's financial statements.<sup>88</sup> Such

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84. Auditors who certify an issuer's books and records may not be compensated by contingent fees. American Institute of Certified Public Accountants (AICPA) Code of Prof'l Conduct R. 302.01, at <http://www.aicpa.org/about/code/et302.htm> (last visited Oct. 24, 2000). The AICPA Rule defines a contingent fee as "a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service." *Id.* In addition, the SEC has proposed rules that extend this prohibition to contingent fees paid to the auditors' firm for other services. Revision of the Commission's Auditor Independence Requirements, SEC Release Nos. 33-7870, 34-42994, 35-27193, 2000 SEC LEXIS 1389 (June 30, 2000). Proposed rule 2-01(c)(5) states that an accountant is not independent under the SEC's standard if the accountant provides any service to an audit client or an affiliate of an audit client for a contingent fee. *Id.*

85. Auditors are specifically mentioned in § 11 as potential defendants with respect to the portions of the registration statement for which they are responsible, namely the audited financial statements. *See* 15 U.S.C. § 77k(a) (1997).

86. *See supra* note 84.

87. Such an ownership interest is perceived to destroy the independence of an accountant with respect to the client. *See* Codification of Financial Reporting Policies § 602.02(b), Fed. Sec. L. Rep. (CCH) ¶ 73,258, at 62,886 (1988); AICPA Codification of Statements on Auditing Standards No. 1, AU § 220.03 ("[A]n auditor with a substantial financial interest in a company might be unbiased in expressing his opinion on the financial statements of the company, but the public would be reluctant to believe that he was unbiased."); *see also* Revision of the Commission's Auditor Independence Requirements, SEC Release Nos. 33-7870, 34-42994, 35-27193, *supra* note 84 (proposing clarification of SEC rules on ownership interests in clients held by partners of auditing firms).

88. If the auditors were caught, they might be liable for insider trading if they knew about the problem when they sold their shares. *See generally* Selective Disclosure and Insider Trading, SEC Release Nos. 33,7881, 34-43154, 2000 WL

temptations are too great for the SEC and the auditing profession to feel comfortable with, even though an equity stake, unlike a contingent fee, might align the auditors' financial interests more closely with those of the investors who purchase securities in a public offering.<sup>89</sup>

In sharp contrast, lawyers are permitted to earn compensation from clients under a wide range of arrangements. Lawyers, for example, can take an ownership interest in a client, either in lieu of, or in addition to, a cash fee.<sup>90</sup> Today, both practices are increasingly common.<sup>91</sup> Indeed, the ABA Standing Committee on Ethics and Professional Responsibility recently approved of equity-in-lieu-of-cash fee arrangements in a Formal Opinion.<sup>92</sup> Such arrangements must be "fair and reasonable" under Model Rule 1.5, and the stock ownership must not sway the lawyer's independent judgment in advising the client under Model Rule 2.1.<sup>93</sup> Both standards, however, are so subjective that they are difficult to enforce.

It is uncertain how an equity stake in a client may affect a lawyer's judgment, if at all. If Ordway had an equity stake in CCC, he might have been tempted to go ahead with the closing on the theory that selling the debentures was good for CCC's shareholders because the debenture holders would take on undisclosed, and hence uncompensated, risk. Such an approach, however, would be shortsighted because a subsequent lawsuit from the debenture holders for securities fraud probably would have done more damage to CCC's share price than cancellation of the debenture offering. Alternatively, an equity stake in CCC might have made Ordway even more likely to stand up to Charlie's irrational decision-making. Finally, regardless of his equity stake, Ordway might have observed Model Rule 2.1 and not allowed his personal stake in CCC to affect his independent judgment on behalf of his client.

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1239722, 2000 WL 1201556 (Aug. 15, 2000) (final rules effective Oct. 23, 2000) (promulgating Rule 10b5-1, which imposes liability on insiders who trade while in "knowing possession" of material nonpublic information).

89. See *supra* note 87.

90. See generally Debra Baker, *Who Wants to Be a Millionaire?: Law firms investing in hot high-tech IPOs are making a fortune, but some critics worry the stock craze is clouding ethics matters*, 86 A.B.A. J. 36 (Feb. 2000).

91. See *id.*

92. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 00-418 (2000); see also Model Rules of Professional Conduct R. 1.7(b) (1987) [hereinafter Model Rules] ("A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless . . . the lawyer reasonably believes the representation will not be adversely affected . . . [and] the client consents after consultation." (emphasis added)).

93. Model Rules, *supra* note 92, R. 2.1 ("In representing a client, a lawyer shall exercise independent professional judgment and render candid advice.")

Lawyers also may take a legal fee that is contingent upon closing.<sup>94</sup> Until recently, contingent fees were charged primarily in litigation by lawyers representing plaintiffs, a practice that has generated considerable controversy.<sup>95</sup> In the 1980's, "performance fees" based in part on outcome became more common in mergers and acquisitions.<sup>96</sup> The New York law firm Cravath Swaine & Moore broke new ground in 1999 when it charged a \$35 million fee to Time Warner, contingent upon the successful closing of Time Warner's merger with AOL.<sup>97</sup> Although the fee arrangement, negotiated by Time Warner's General Counsel, a former Cravath associate, compensated Cravath for a portion of the time billed by its associates regardless of results, the lion's share of Cravath's fee depended upon the merger successfully closing.<sup>98</sup>

To anyone who has read *The Comfort Letter*, the risk inherent in contingent-fee-for-closing arrangements is obvious. The contingent fee gives the lawyer an enormous incentive to cave in to client pressure and close the deal regardless of the consequences. As already pointed out, CCC's investment bankers viewed the risks inherent in the transaction more favorably than Ordway, and there is a reason why:

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94. See *id.* R. 1.5(c) ("A fee may be contingent on the outcome of the matter for which the service is rendered.").

95. See Richard W. Painter, *Litigating on a Contingency: A Monopoly of Champions or a Market for Champerty*, 71 Chi.-Kent L. Rev. 625 (1995) (describing the incentives that can arise out of a contingent fee arrangement and the prospect of overcharging); Richard W. Painter, *The New American Rule: A First Amendment to the Client's Bill of Rights*, Civ. Just. Rep. 1 (March 2000), at [http://www.manhattan-institute.org/html/cjr\\_l.htm](http://www.manhattan-institute.org/html/cjr_l.htm) (recommending that contingent-fee lawyers be required to choose for each case, and then disclose to the client a dollars-per-hour limit on how high the contingent fee can go).

96. See Daniel Hertzberg & James B. Stewart, *Contingency Legal Fee for Merger Breaks Ground, Stirs Controversy*, Wall St. J., Oct. 24, 1986, at 31 (discussing "performance fee" charged by Wachtell Lipton and Skadden Arps).

97. See Krysten Crawford & Karen Hall, *High Rollers*, Am. Law., Feb. 2000, at 19; Krysten Crawford & Karen Hall, *AOL-Time Warner Merger A Big Gamble for Firm*, The Legal Intelligencer, Jan. 21, 2000, at 4.

98. According to the New York Law Journal:

The \$35 million is all-inclusive, said one person familiar with the fee arrangement; it covers "everything touching getting this deal done." There is one exception. While no partner time—neither litigation nor corporate—will be paid if the deal dies, Cravath negotiated a cushion that allows it to recover fees for associates' time spent on document production. Cravath has agreed not to bill Time Warner for the first \$1 million of work on the deal. Beyond that and up to \$5 million, Time Warner will pay half of the associates' billings. Associate hours spent on document production in excess of \$5 million will be paid in full. That could cover thousands of billable hours spent producing documents in connection with regulatory filings as well as shareholder suits. "What that tells me," said one M&A expert, "is that Cravath was not willing to assume the risk of an eternal battle."

Krysten Crawford & Karen Hall, *Cravath's \$35 Million Fee Wager; Time Warner M&A on Contingency*, N.Y. L.J., Jan. 20, 2000, at 1.

Every eye in the room focused on me. The Frenchman had his sunglasses on again, but it seemed to me that I could see his eyes right through them.

One of the brokers, *sotto voce*: "That's the ballgame. We're in the red for sixty-nine. Bye-bye bonus."

"Bye-bye Conroy," whispered his neighbor.<sup>99</sup>

One can only imagine the pressure that Ordway would have been under to "shut up and close" had he stood to lose not only CCC as a client but also a multimillion-dollar contingent fee.

### CONCLUSION

*The Comfort Letter* is an excellent introduction to the business and legal issues, as well as the psychological pressures, that can accompany a closing. While CCC may not be the typical issuer, nor Charlie the typical client, issuers and the people who manage them often are not "typical." Each closing will bring its own issues to the table. Lawyers who have been taught in law school and later in law practice to think for themselves, and who try to understand as much as possible how other people think, are well positioned to successfully anticipate and confront important issues in a closing before they become crises.

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99. Solmssen, *supra* note 9, at 325.

*Notes & Observations*