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Turn Up the Volume: The Need for "Noisy Withdrawal" in a Post Enron Society

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NOTES

Turn Up the Volume: The Need for “Noisy Withdrawal” in a Post Enron Society

BY RYAN MORRISON*

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I. INTRODUCTION

The Enron scandal of 2001 was an American tragedy. Thousands of Enron employees were left without jobs and pensions when the company collapsed.¹ The shady accounting techniques and ghastly decisions made by Enron executives were widely publicized and met with scathing reprimands from the public.² Sadly, Enron's attorneys also played a key role in the company's collapse.³ Through the Sarbanes-Oxley Act of 2002, Congress sought to curtail unlawful business practices not only through more accounting oversight, but also with new guidelines for attorneys who represented corporations.⁴ Congress, through the Securities and Exchange Commission ("SEC" or "the Commission"), mandated that corporate attorneys who discover fraudulent conduct by managers must report the malfeasance all the way up to the board of directors if necessary.⁵

But the SEC wants to go one step further. If a company's board of directors does not bring fraudulent conduct to an end, the Commission proposes a mandatory noisy withdrawal for outside counsel.⁶ The SEC would require outside counsel to withdraw from serving her corporate client, renounce any work done by the attorney that she deems objectionable, and notify the SEC of these actions.⁷

Critics see the noisy withdrawal as effectively turning the client over to enforcement authorities.⁸ They claim this provision tramples on the

¹ See Greg Hitt & Tom Hamburger, *Skilling Denies He Mised Enron Officials: Former Top Executive Offers a Feisty Defense Brief to Skeptical Senators*, WALL ST. J., Feb. 27, 2002, at A3, 2002 WL-WSJ 3387146.

² See David Wessel, *Capital: When Standards Are Unacceptable*, WALL ST. J., Feb. 7, 2002, at A1, 2002 WL-WSJ 338258; David Wessel, *Capital/Enron and a Bigger Ill: Americans Don't Save*, WALL ST. J., Mar. 7, 2002, at A1, 2002 WL-WSJ 3388002 (asserting that the news of Enron's collapse is so significant that it receives as much attention at the dinner table as in the boardroom).

³ See *infra* notes 64-114 and accompanying text.

⁴ See Michael Schroeder, *SEC to Propose New Financial-Disclosure Rules*, WALL ST. J., Oct. 30, 2002, at A10, 2002 WL-WSJ 3410200.

⁵ See *infra* notes 120-27 and accompanying text.

⁶ See *infra* notes 128-42 and accompanying text.

⁷ See *infra* notes 128-42 and accompanying text.

⁸ See *infra* notes 143-49 and accompanying text.

confidential relationship between a corporation and its attorney.⁹ Mandatory withdrawal with a notification procedure, however, is consistent with ethical principles and necessary to strengthen the integrity of the United States' financial system in the wake of Enron.

II. ENRON¹⁰

In December 2001, Enron, a Houston-based energy corporation, filed for Chapter 11 bankruptcy protection in what was the largest bankruptcy filing in United States history.¹¹ In one year, Enron's market value plummeted from approximately \$77 billion to \$500 million.¹² As the price of Enron's stock fell (from over \$80 to less than \$1 in a year), Enron executives realized capital gains exceeding \$1 billion on the sale of their personal shares, while Enron employees were barred from selling the shares in their company 401(k) pension accounts.¹³ Financial regulators were at a loss as to how such a powerful company could fall so suddenly.¹⁴ Thousands of out of work Enron employees and devastated investors prompted Congress to spring into action.¹⁵ Congress was determined to discover what happened with Enron and address the flaws in the nation's financial system to make sure such a collapse never happened again.¹⁶

A. *"I am incredibly nervous that we will implode in a wave of accounting scandals."*¹⁷

Enron was the top energy dealer in the nation, and it was ruined almost overnight.¹⁸ All of this was due to complex accounting tactics and unethical

⁹ See *infra* notes 143-49 and accompanying text.

¹⁰ Enron's auditor, Arthur Andersen, is arguably as culpable for the fraud as Enron; however, auditor liability is beyond the scope of this Note.

¹¹ See *What's News, Business and Finance*, WALL ST. J., Dec. 3, 2001, at A1, 2001 WL-WSJ 29679584; Michael Schroeder, *Enron Debacle Spurs Calls for Controls*, WALL ST. J., Dec. 14, 2001, at A4, 2001 WL-WSJ 29680795.

¹² See Michael Schroeder & Greg Ip, *Out of Reach: The Enron Debacle Spotlights Huge Void in Financial Regulation, Energy Firm Lobbied Hard to Limit the Oversight of Its Trading Operations, Keeping Ms. Born at Bay*, WALL ST. J., Dec. 13, 2001, at A1, 2001 WL-WSJ 29680609.

¹³ See Schroeder, *supra* note 11.

¹⁴ See Schroeder & Ip, *supra* note 12.

¹⁵ See Schroeder, *supra* note 11.

¹⁶ See Schroeder & Ip, *supra* note 12.

¹⁷ Michael Schroeder & John Emshwiller, *Letter to Lay Prompts Queries to Enron/Law Firm Was Directed Not to Second-Guess Auditor Arthur Andersen*, WALL ST. J., Jan. 15, 2002 at A3, 2002 WL-WSJ 3382961 (quoting Enron executive Sherron Watkins, a main Enron whistle blower).

¹⁸ See Holman W. Jenkins Jr., *Business World: Enron Is History, Says History*, WALL ST. J., Nov. 28, 2001, at A19, 2001 WL-WSJ 29679071.

decisions by Enron's top executives.¹⁹ Enron's implosion centered on its use of a distinctive type of partnership called a Special Purpose Entity ("SPE"). These familiar "off-balance-sheet structures" enabled Enron "to increase leverage without having to report debt on their balance sheet."²⁰ Under accounting rules, the sponsoring company of a SPE may omit the SPE assets and liabilities from its financial statements, while the SPE retains the risks and rewards of the investment.²¹ The exposure of the sponsoring company's assets is off the balance sheet, allowing the company to hide the amount of financial risk it is taking on with those assets.²² As a result, a company can hide debt to protect its credit rating. Enron employed hundreds, possibly thousands of these tactics.²³ But by using these SPEs, Enron went deeper and deeper into a hole that eventually swallowed the company.

Enron's fall started with a 1997 deal with a SPE called JEDI.²⁴ Enron sought to buy a 50% stake in JEDI that a public employee retirement fund held, then turn around and sell that interest to a newly created SPE called Chewco.²⁵ Chewco was independent of Enron in order to conceal several hundred million dollars of debt associated with the JEDI deal from Enron's balance sheet.²⁶

This was a well-designed plan to hide debt, so long as Chewco lived up to certain financing requirements. But the SPE failed. For Chewco to be truly independent of Enron, its capital structure needed to meet minimum outside equity requirements.²⁷ In November of 2001, Enron acknowledged that Chewco never met these standards.²⁸ In doing so, Enron conceded that it had improperly inflated its earnings by \$400 million over four years.²⁹

¹⁹ *Id.*

²⁰ Joe Berardino, *Enron: A Wake-Up Call*, WALL ST. J., Dec. 4, 2001, A18, 2001 WL-WSJ 29679750.

²¹ *Id.*

²² *Id.*

²³ See John R. Emshwiller & Rebecca Smith, *Murky Watters: A Primer on Enron Partnerships/As Details Surface, They Appear Central In Firm's Collapse*, WALL ST. J., Jan. 21, 2002 at C1, 2002 WL-WSJ 3383411.

²⁴ See Ellen Joan Pollock, *Limited Partners: Lawyers for Enron Faulted Its Deals, Didn't Force Issue/Vinson & Elkins Rejects Idea Firm Should Have Taken Doubts to Client's Board/Face to Face With Fastow*, WALL ST. J., May 22, 2002, at A1, 2002 WL-WSJ 3395589 [hereinafter Pollock, *Limited Partners*].

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

Once investors discovered this shell game that hid hundreds of millions of dollars in debt, they started to lose confidence in the company and sold their stock.³⁰

Enron also used SPEs to artificially inflate the value of its assets to make the company appear more attractive. Businesses, like other investors, often invest in other companies to earn a positive return to offset any investment losses.³¹ This technique is called hedging.³² Enron employed this practice as well but failed since it effectively hedged with itself.³³

Few financial experts believe Enron created true investment hedges.³⁴ Instead, Enron hedged its investments by creating SPEs, the most notorious being Condor and the Raptors, to be their independent investors for a hedge transaction.³⁵ The SPEs would go into the market for Enron and negotiate a stock purchase like an outside investor.³⁶ To finance these transactions Enron would lend Condor, for example, \$800 million worth of Enron's own stock to make the trade.³⁷ Enron would record the amount Condor owed it for the loan as a receivable, an asset, on Enron's balance sheet.³⁸ The increase in assets would increase Enron's shareholder equity.³⁹ Thus,

³⁰ Daniel Kadlec, *Who's Accountable? Inside the Growing Enron Scandal: How Evidence Was Shredded and Top Executives Fished for a Bailout as the Company Imploded*, TIME, Jan. 21, 2002, at 28, 31, available at 2002 WL 8385556.

³¹ Michael Duffy, *What Did They Know And . . . When Did They Know It? Meet Sherron Watkins, Who Sounded the Alarm on Enron Long Before its Collapse*, TIME, Jan. 28, 2002, at 16, 2002 WL 8385615.

³² Hedging occurs when a company, seeking to minimize the downside risk of a volatile investment, will pay an outside investor to accept the risk of a negative investment return. Should the investment fail, the outside investor will pay the company the difference between the money loaned and the loss on the investment. Consequently, the company reduces its downside risk of the investment. See Michael L. Fox, *To Tell Or Not To Tell: Legal Ethics and Disclosure After Enron*, 2002 COLUM. BUS. L. REV. 867, 871 (2002).

³³ *Id.* at 873.

³⁴ *Id.* at 871.

³⁵ See Duffy, *supra* note 31, at 20.

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*

³⁹ Recording a stock loan as an increase in account receivables and as an increase in shareholder equity before getting a cash payment for the loan violates generally accepted accounting principles ("GAAP"). Jonathan Weil, *Basic Principle of Accounting Tripped Enron*, WALL ST. J., Nov. 12, 2001 at C1, 2001 WL-WSJ 29677610.

through its SPEs, Enron appeared to have more equity than it actually had by essentially loaning itself money.

This type of balance sheet manipulation would only work if the stock the SPE invested in became more valuable.⁴⁰ The only way the SPE could pay Enron back for its hedge/loan would be with the capital gains it earned on the investment.⁴¹ Because Enron named itself guarantor in each SPE loan, however, it would be required to issue more of its own stock if the SPE defaulted.⁴² This would be problematic if the SPE investments declined in value along with Enron's stock value.⁴³ If the hedged investments decreased in value along with Enron's stock, it would increase Enron's risk exposure rather than steady it as a proper hedge would.⁴⁴

This became a reality when some of the SPEs' (in particular the Raptors) share holdings began to decline. The Raptor's investments in Avici, a network-equipment supplier, dropped 98% from \$178 million to \$5 million.⁴⁵ Their interest in New Power Co., an energy retailer, went from \$40 to \$6 per share.⁴⁶ Since the Raptors were funded with Enron stock, the cash needed to cover the hedged investment's losses was not available.⁴⁷ In order to keep the Raptors out of bankruptcy, Enron would have to issue the SPEs more of Enron's stock in addition to the \$550 million in stock it gave the Raptors for its initial loan. This is exactly what took place.⁴⁸

Enron could have ended the problem by absorbing the Raptors' losses and booking a loss on its earnings reports, but it did not.⁴⁹ It decided to perpetuate the problem by loaning the Raptors an additional \$800 million in Enron stock, and subsequently recording it as an account receivable asset.⁵⁰ Nevertheless, as the Raptors' investments continued to decline along with the value of Enron's stock, the hedge collapsed.⁵¹ In the end, the manipulation of the Raptors on Enron's financial statements caused Enron's earnings to be overstated by more than \$1 billion.⁵² As an

⁴⁰ See Duffy, *supra* note 31, at 21.

⁴¹ See Fox, *supra* note 32, at 872.

⁴² *Id.* at 873-74; see also Duffy, *supra* note 31, at 21.

⁴³ See Fox, *supra* note 32, at 874.

⁴⁴ *Id.*

⁴⁵ This was a clear conflict of interest investment because one member of New Power Co.'s board of directors was Kenneth Lay, an Enron officer. See Duffy, *supra* note 31, at 19, 21.

⁴⁶ See *id.* at 19, 21.

⁴⁷ See Fox, *supra* note 32, at 874.

⁴⁸ See Duffy, *supra* note 31, at 19-21; see also Fox, *supra* note 32, at 873-74.

⁴⁹ See Fox, *supra* note 32, at 874.

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

investigator for the Enron board of directors described it, “70 percent of Enron’s reported earnings for that period of time did not exist”⁵³ and “[e]ven if the hedges had not failed . . . , the Raptors would have paid Enron with the stock that Enron had provided [to them] in the first place; Enron would simply have paid itself back.”⁵⁴

The fallout from these schemes was catastrophic. Investors across the country saw their retirement savings wiped out as Enron shares went from their \$82 high in January 2001 to just \$0.26 by the end of the year.⁵⁵ Enron’s 21,000 workers saw their \$2.1 billion retirement fund nearly vanish because half of the fund was invested in Enron stock.⁵⁶ Interestingly, when word of Enron’s overstatement of earnings came out in October before the December 2001 bankruptcy filing, some of Enron’s employees considered divesting themselves of Enron stock.⁵⁷ But Enron executives, hoping to postpone a stock market collapse, sent E-mails to the workers to convince them not to sell.⁵⁸ Subsequently, the permitted pension plan or window for the employees to sell their Enron interest closed. The employees had to watch their stock lose thirty-five percent of its value while Enron executives cashed out their holdings for millions.⁵⁹

Enron employees were not the only victims. Many investors lost money through mutual fund holdings that invested in Enron.⁶⁰ Banks such as J.P. Morgan Chase and Citigroup lost approximately \$500 million and \$400 million respectively in unsecured loans to Enron.⁶¹ Enron cost the state pension funds of Ohio \$69 million, New York \$60 million, and California \$45 million.⁶² By the end of 2002, Enron faced 22,000 lawsuits alleging a total of \$400 billion worth of damages.⁶³

⁵³ *Id.*

⁵⁴ *Id.* at 874 n.21 (quoting investigator Chairman Powers).

⁵⁵ Marianne Lavelle & Matthew Benjamin, *The Biggest Bust*, U.S. NEWS & WORLD REP., Dec. 10, 2001, at 34, 36, available at 2001 WL 30366299.

⁵⁶ *Id.* at 36.

⁵⁷ *Id.* at 34, 36.

⁵⁸ *Id.* at 36.

⁵⁹ The Enron executives cashed out their investments in Enron earlier in the year. *Id.*

⁶⁰ In fact, “Alliance Capital, Janus Capital, and Fidelity Investments, plus hundreds of other funds, had substantial positions in Enron.” *Id.* at 34.

⁶¹ Daniel Kadlec, *Power Failure; As Enron crashes, angry workers and shareholders ask, Where were the firm’s directors? The regulators? The stock analysts?*, TIME, Dec. 10, 2001, at 68-69, available at 2001 WL 29385633.

⁶² *Id.* at 69.

⁶³ Daren Fonda, *Enron: Picking Over the Carcass*, TIME, Dec. 30, 2002, at 56, available at 2002 WL 102387136 (“noting the plaintiffs included former employees and investors”).

B. “Where were the lawyers?”⁶⁴

The Houston law firm Vinson & Elkins was Enron’s chief outside counsel.⁶⁵ Enron was the law firm’s biggest client, bringing in approximately \$35.6 million, 7.8% of its revenue, in 2001.⁶⁶ Vinson & Elkins played a large role in creating the partnerships that brought down the energy company.⁶⁷ In spite of this, Vinson & Elkins attorneys did not blindly do the bidding of their client. They expressed reservations about the transactions to Enron’s in-house lawyers.⁶⁸ They did not, however, report their misgivings to Enron’s board of directors or stand up to the chief instigator of the fraudulent transactions, Enron’s Chief Financial Officer Andrew Fastow.⁶⁹ The deals that troubled Vinson & Elkins attorneys were at the heart of the Enron scandal, and the law firm was viewed as a puppet for Enron executives, especially Fastow.⁷⁰ An investigative report for the Enron board “criticized the law firm for an ‘absence’ of ‘objective and critical professional advice’” as to what Enron should have publicly disclosed about its SPE transactions.⁷¹ Presently, Vinson & Elkins, just like its client, faces numerous lawsuits.⁷²

⁶⁴ Kadlec, *supra* note 61, at 69 (quoting John Dingell, ranking member of House of Representatives Energy Committee).

⁶⁵ See Pollock, *Limited Partners*, *supra* note 24.

⁶⁶ *Id.*

⁶⁷ See Fox, *supra* note 32, at 882.

⁶⁸ See Pollock, *Limited Partners*, *supra* note 24.

⁶⁹ *Id.*

⁷⁰ This was the belief of Sherron Watkins in her memo to CEO Kenneth Lay. See Tom Hamburger, *Questioning the Books: Enron Memo Shows Watkins Urged Lay To Restate Earnings*, WALL ST. J., Feb. 14, 2002, at A8, 2002 WL-WSJ 3385930.

⁷¹ See Pollock, *Limited Partners*, *supra* note 24; see also Rebecca Smith & John R. Emshwiller, *Internal Probe of Enron Finds Wide-Ranging Abuses/Unanswered in Board Report Are Some Big Questions Regarding Legal Liability*, WALL ST. J., Feb. 4, 2002, at A3, 2002 WL-WSJ 3384780 (quoting Enron internal investigative report) (stating also that “Vinson & Elkins ‘should have brought a stronger, more objective and more critical voice’ to the issue of what Enron needed to disclose publicly about its partnership-related transactions”).

⁷² Pollock, *Limited Partners*, *supra* note 24; see also Mitchell Pacelle & Ken Brown, *Enron Awaits Andersen-Suit Backlash/Investors Suing Accountancy Likely Will Receive Fresh Support But No Help in Winning Cash*, WALL ST. J., June 19, 2002, at C1, 2002 WL-WSJ 3398270 (Vinson & Elkins, along with other defendants had a suit filed against them “alleging that they participated in a scheme with Enron to defraud shareholders and creditors.”); Kathryn Kranhold & Jonathan

Many members of Congress were bothered that Vinson & Elkins failed to communicate the firm's disapproval of the transactions that brought down the company to the board of directors.⁷³ Nevertheless, Vinson & Elkins's managing partner, Joseph Dilg, told Congress that lawyers may advise, without endorsing, the business decision of their clients as long as the transaction is legal and has been approved by the company's management.⁷⁴ According to Harry Reasoner, Vinson & Elkins's former managing partner, Enron's protocol provided that Vinson & Elkins attorneys should take concerns to Enron's in-house counsel.⁷⁵ Accordingly, Vinson & Elkins did not believe it was obligated to ensure Enron managers met their fiduciary duties to Enron.⁷⁶ Reasoner claims that Enron executives and in-house lawyers were aware of the potential risks of the company's actions, and Vinson & Elkins saw no need to report the transactions to the company's board.⁷⁷

Against this backdrop, Ronald Astin, a partner at Vinson & Elkins, became the firm's primary attorney for Enron and the person the company used to develop its Chewco deal.⁷⁸ When the Chewco deal was proposed, Fastow named himself to manage and be allowed to personally invest in the partnership, which would be categorized as doing business with Enron.⁷⁹ Astin believed this would be a clear conflict of interest and a violation of Fastow's fiduciary duties to Enron.⁸⁰ Initially, Astin took his concerns to

Weil, *Enron Holders' Suit Adds New Defendants/Big Banks, Securities Firms Are Targeted as Plaintiffs Seek to Recoup Losses*, WALL ST. J., Apr. 8, 2002, at A3, 2002 WL-WSJ 3390947.

⁷³ See Ellen Joan Pollock, *Andersen: Called to Account: Enron Lawyers Face Congress Over Their Role*, WALL ST. J., Mar. 15, 2002, at C13, 2002 WL-WSJ 3388729 [hereinafter Pollock, *Andersen: Called to Account*].

⁷⁴ See Pollock, *Limited Partners*, *supra* note 24.

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.* ("The implication that we should have gone around their in-house lawyers and their executives directly to the board, I would say we had no basis for believing such an extraordinary action would have been appropriate or necessary.")

⁷⁸ *Id.*; see also discussion of the Chewco SPE, *supra* Part II.A.

⁷⁹ See Pollock, *Limited Partners*, *supra* note 24.

⁸⁰ *Id.*; see also Emshwiller & Smith, *supra* note 23. One reporter noted that conflict of interest [was Astin's] biggest worry. The [SPE] partnerships did hundreds of millions of dollars of transactions with Enron itself, in some cases buying assets from the company or selling assets to it. The problem is this: Where do the executives' loyalties lie? Are they trying to negotiate the best deal for the company that employs them and the shareholders who own the company, or the best deal for the partnership where they have an ownership stake?

Dilg, his supervisor at Vinson & Elkins, and eventually the two attorneys, along with Enron's in house counsel, met with Fastow to discuss the matter.⁸¹ At first, Fastow resisted stepping down as Chewco's director, but eventually relented to the attorneys' pleas. Nonetheless, Fastow simply turned over the reins of the partnership to a lower ranking Enron manager named Michael Kopper who, because of lower management status, was not obligated to disclose his new position to the public.⁸² Vinson & Elkins attorneys still believed that appointing an Enron manager to a partnership that would transact business with Enron was unwise because of the potential personal benefit Kopper would receive from his new role.⁸³ The attorneys' fears were well founded. When the details of the Chewco deal were finally disclosed and Enron's earnings were restated, it was revealed that Kopper earned at least \$10 million from his role in Chewco, \$2 million of which was given to him without an identifiable purpose.⁸⁴

Soon after the Chewco deal was formed, Vinson & Elkins attorneys clashed with Fastow again over matters concerning his fiduciary duties to Enron. But this time Fastow refused to heed their advice not once, but twice. In 1999, Fastow became a general partner of two SPE partnerships, LJM and LJM2, which helped inflate Enron earnings just like the Raptors.⁸⁵ In order to do this, Fastow convinced Enron's audit committee, the body charged with administering the company's code of ethics, to waive Enron's conflicts of interest policy twice.⁸⁶ But the audit committee did not consult Vinson & Elkins when it took this peculiar course of action. In fact, Enron never asked Vinson & Elkins to provide oversight for its ethics policies.⁸⁷ According to Vinson & Elkins, the decision "was presented to [them] as a fait accompli."⁸⁸

Nevertheless, Vinson & Elkins knew it was a breach of Fastow's fiduciary duties to engage in these deals, but the firm did not have the

Id.

⁸¹ See Pollock, *Limited Partners*, *supra* note 24.

⁸² *Id.*

⁸³ *Id.*

⁸⁴ See Smith & Emshwiller, *supra* note 71.

⁸⁵ See Pollock, *Limited Partners*, *supra* note 24.

⁸⁶ See *id.*; Joann S. Lublin, *Inside, Outside Enron, Audit Panel Is Scrutinized/ Links to Company Of Certain Members Are Called Too Cozy*, WALL ST. J., Feb. 1, 2002, at C1, 2002 WL-WSJ 3384720.

⁸⁷ See Pollock, *Limited Partners*, *supra* note 24.

⁸⁸ See *id.* (internal quotations omitted). *Fait accompli* means "a thing accomplished and presumably irreversible." MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 417 (10th ed. 2002).

courage to do anything about it. In 2001, Astin and some Enron in-house attorneys agreed that Fastow must end his conflicted role with the SPEs,⁸⁹ yet they never took these concerns to Enron's general counsel or any chief Enron executive.⁹⁰ Consequently, Enron's management and board relied on Vinson & Elkins's tacit approval of the LJM deals.⁹¹

Additionally, despite his protests, Astin helped conceal Fastow's conflict of interest in the company's 2001 proxy statement. Instead of sticking to his convictions, Astin advised Enron that it was "technically correct" to omit the amount of compensation Fastow earned from the LJM partnerships from the proxy statement.⁹² Jordan Mintz, an Enron attorney who agreed with Astin that Fastow must terminate his role in the partnerships, was unhappy with this decision not to disclose the information in the proxy solicitation and warned Fastow that "the rationale for not making the disclosure might not be applicable in future [SEC] filings."⁹³

Following the bankruptcy filing, an internal investigation for Enron's board reported Vinson & Elkins should have been more aggressive in requiring Fastow to disclose his compensation in order to help the board of directors make an informed decision on its omission in the proxy. The report determined that "[t]he lawyers apparently searched for and embraced a technical rationale to avoid that disclosure" and that Vinson & Elkins "should have brought a stronger, more objective and more critical voice to the disclosure process."⁹⁴ Eventually, Fastow did disclose his interest in the LJM partnerships. But in the end it was discovered that Fastow duped the audit committee and Enron shareholders by personally earning \$45 million from the partnerships.⁹⁵

Before all of this came to light, Vinson & Elkins worked on a number of deals concerning the LJM partnerships in which they stood up to Enron, only to have the company get someone else to do its bidding. The firm's role was writing "true sale" opinions for transactions in which Enron would sell assets to LJM, just to have LJM sell them back to Enron.⁹⁶ The true sale opinions would certify the change in possession of legal title of the

⁸⁹ See Pollock, *Limited Partners*, *supra* note 24.

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² *Id.* (It was "technically correct" to omit the amount of compensation "because not all the LJM transactions were completed and thus the compensation was hard to calculate.")

⁹³ *Id.*

⁹⁴ *Id.* (internal quotations omitted).

⁹⁵ *Id.*

⁹⁶ *Id.*

assets. Astin and other Vinson & Elkins attorneys, however, were not always convinced the transactions met the legal criteria required for such opinions, and Enron developed an attitude that Vinson & Elkins could not be relied on to close deals for it.⁹⁷ Accordingly, Enron turned to another law firm when Vinson & Elkins would not capitulate.⁹⁸

Among the successes and failures of Vinson & Elkins to curtail Enron's questionable activities, the firm's last assignment for the energy company is the most notable. Vinson & Elkins was assigned to investigate the concerns of the vice president for corporate development, Sherron Watkins. Watkins was looking for assets to sell to obtain capital to help support Enron and pull it out of financial trouble,⁹⁹ but she kept running into Enron's off-the-balance sheet SPE transactions, which no one could explain.¹⁰⁰ Regardless, she learned that Enron was losing money on investments backed by company stock, namely on the Condor and Raptors deals.¹⁰¹ Watkins decided to write a letter to the new CEO Kenneth Lay stating that she was "incredibly nervous that [Enron would] implode in a wave of accounting scandals" and that "the business world [would] consider [Enron's success] as nothing but an elaborate accounting hoax."¹⁰² she later met with Lay about the matter and despite her fears of a conflict of interest, Lay appointed Vinson & Elkins to investigate.¹⁰³

Vinson & Elkins' investigation was hindered before it even began. The firm was instructed not to question the accounting techniques of Arthur Andersen, the company's auditor, and not to investigate every transaction.¹⁰⁴ The firm was relegated to conflicts of interests, the impact

⁹⁷ *Id.*

⁹⁸ *Id.* ("[T]here was 'an understanding at Enron that it would be easier to get such an opinion from [Andrews & Kurth] than [Vinson & Elkins] because [Andrews & Kurth] would raise less issues than [Vinson & Elkins].'" (quoting Enron's internal investigative report).

⁹⁹ See Duffy, *supra* note 31, at 19.

¹⁰⁰ *Id.* (reporting that the veil of secrecy was such that at least one person was transferred out of his position when he inquired about the transactions).

¹⁰¹ *Id.*; see also *supra* Part II.A for a discussion of the Condor and Raptors deals.

¹⁰² Jeanne Cummings et al., *Law Firm Reassured Enron on Accounting/Vinson & Elkins Discounted Warnings by Employee About Dubious Dealings*, WALL ST. J., Jan. 16, 2002, at A18, 2002 WL-WSJ 3383123 (internal quotations omitted).

¹⁰³ *Id.*

¹⁰⁴ *Id.*; see also Michael Schroeder & John Emshwiller, *Letter to Lay Prompts Queries to Enron/Law Firm Was Directed Not to Second-Guess Auditor Arthur Andersen*, WALL ST. J., Jan. 15, 2002, at A3, 2002 WL-WSJ 3382961 (House Energy and Commerce Committee Spokesman Ken Johnson stated the Vinson &

of the SPEs on the company's financial statements, the need for public disclosures of the SPEs, and the potential impact of decreased stock value on Enron's financial statements.¹⁰⁵

In every area, Vinson & Elkins deferred to Arthur Andersen and reported to the board that Enron had done nothing wrong. In Vinson & Elkins' mind, " 'further widespread investigation by independent counsel and auditors' was unwarranted."¹⁰⁶ By this time, Fastow had resigned from his positions in the SPE partnerships, and Vinson & Elkins believed the only thing to fear was " 'bad cosmetics' involving the transactions and the decline of Enron's stock [that] posed [a] 'serious risk of adverse publicity and litigation.'"¹⁰⁷ Vinson & Elkins determined that Enron's use of SPEs to hide its debt was "creative and aggressive" and technically proper.¹⁰⁸ The day after the firm's report was given to Lay, Enron disclosed that it incurred a \$618 million loss in the 2001 third quarter. Thereafter the SPE partnerships were exposed as having concealed the company's losses, which led Enron to file for bankruptcy.¹⁰⁹ Dilg, Vinson & Elkins's managing partner, maintained that the firm was confident in its investigation, while alluding to whom he believed to be the true culprit of the scandal (i.e., Arthur Andersen) by stating, "We are not competent to render accounting advice."¹¹⁰

Nevertheless, the transactions Vinson & Elkins performed for Enron and its unwillingness to stand up to top management or go to the board of directors helped the company fall into bankruptcy and cost investors millions. The special Enron committee formed to investigate why the company went bankrupt found Enron overflowing with corruption. The theme of the committee's report was that for each transaction, Enron officers were more interested in creating off-the-balance sheet entities to boost the bottom-line than fulfilling their fiduciary duties to Enron.¹¹¹ The

Elkins investigation "has the appearance of a whitewash.") (internal quotations omitted).

¹⁰⁵ See Cummings et al., *supra* note 102.

¹⁰⁶ See Schroeder & Emshwiller, *supra* note 104 (quoting internal investigative letter Vinson & Elkins wrote to Enron).

¹⁰⁷ See *id.*; Cummings et al., *supra* note 102 (quoting investigative letter Vinson & Elkins wrote to Enron following internal review by the law firm).

¹⁰⁸ See Cummings et al., *supra* note 102 (Max Hendricks III stated that "no one [had] reason to believe that it [was] inappropriate from a technical standpoint.") (internal quotations omitted).

¹⁰⁹ *Id.*

¹¹⁰ *Id.* (internal quotations omitted).

¹¹¹ See Smith & Emshwiller, *supra* note 71.

report found that many deals Enron's management engaged in simply served no other purpose than to provide income for those same managers.¹¹² The report also found that Vinson & Elkins should have done more to persuade Enron executives to disclose more about its off-the-balance sheet transactions.¹¹³ In its defense, Vinson & Elkins replied that it tried to be more assertive and persuade more disclosure, but it was thwarted by one of Enron's investor relations departments.¹¹⁴

III. THE LEGISLATIVE RESPONSE

Congress acted quickly after Enron's fall. The outcry from disgruntled investors was too much to bear.¹¹⁵ Congress knew that it had to prevent another corporate catastrophe, close the loopholes, and prohibit the accounting practices that Enron and Arthur Andersen used to bilk shareholders. The political atmosphere was ripe for regulating the accounting industry with an iron fist, and as a result, Congress passed the Sarbanes-Oxley Act of 2002.¹¹⁶ President George W. Bush signed the bill into law on July 30, 2002 and stated the Act would "deter and punish corporate and accounting fraud and corruption, ensure justice for wrongdoers, and protect the interests of workers and shareholders."¹¹⁷

Congress knew that in order to obtain full compliance from American businesses it would have to increase the duties and options for their corporate attorneys as well. Consequently, the Sarbanes-Oxley Act directed the SEC to develop minimum standards of conduct and an up-the-ladder investigation system for corporate attorneys.¹¹⁸ With this charge from

¹¹² *Id.*

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ See Pollock, *Limited Partners*, *supra* note 24.

¹¹⁶ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

¹¹⁷ See Statement by President George W. Bush Upon Signing H.R. 3763, 38 WEEKLY COMP. PRES. DOC. 1286 (July 30, 2002), *reprinted in* 2002 U.S.C.C.A.N. 543.

¹¹⁸ See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, at § 307 (2002); 15 U.S.C. § 7245.

[T]he Commission shall issue rules, in the public interest and for the protection of investors, setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule—

(1) 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

Congress, the SEC began to develop the rules that would define an attorney's role in the battle against corporate fraud. By the time the SEC was finished, many believed the Commission had overstepped its congressional mandate and turned corporate attorneys into corporate watchdogs.¹¹⁹

A. Up-the-Ladder: Attorney Reporting Requirements

Now that the SEC had its directive, it needed to develop rules that would govern attorneys' behavior for reacting to managerial misconduct. In order to meet its specific mandate from Congress, it used the Act's language with some elaboration. 17 C.F.R. § 205.3(b) states:

(1) If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney *shall report* such evidence to the issuer's chief legal officer (or the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or the equivalents thereof) forthwith

. . . .

(3) Unless an attorney who has made a report under paragraph (b)(1) of this section reasonably believes that the chief legal officer or the chief executive officer of the issuer (or the equivalent thereof) has provided an appropriate response within a reasonable time, the attorney *shall report* the evidence of a material violation to:

- (i) The audit committee of the issuer's board of directors;
- (ii) Another committee of the board of directors . . . ; or
- (iii) The issuer's board of directors. . . .¹²⁰

executive officer of the company (or the equivalent thereof); and
 (2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

¹¹⁹ See Mitchell Pacelle & Michael Schroeder, *Proposed SEC Rules Could Turn Lawyers Into Whistle-Blowers*, WALL ST. J., Jan. 9, 2003, at A1, 2003 WL-WSJ 3956129.

¹²⁰ Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205.3(b) (2003) (effective Aug. 5, 2003) (emphasis added). "The term 'issues' means every

These provisions were in direct response to Vinson & Elkins' failure to report the Enron executives' breaches of fiduciary duties and other objectionable practices up-the-ladder. Section 205.3(b) makes an attorney's duties clear when she is faced with corporate illegalities,¹²¹ but these obligations only arise when an attorney "becomes aware of evidence of a material violation."¹²² A material violation occurs when there is a material violation of "United States federal or state security laws, a material breach of a fiduciary duty arising under [those same laws], or a similar material violation of any federal or state law."¹²³ The SEC sought to make this an objective standard because it believed a requirement of actual knowledge was too high.¹²⁴ Accordingly, if a reasonable attorney believes it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur, then she is obligated to report it.¹²⁵ The Commission opines that for a material violation to be reasonably likely there "must be more than a mere possibility, but it need not be more likely than not."¹²⁶ Nevertheless, the attorney must have credible evidence before she can reasonably conclude there has been or will be a material violation.¹²⁷

Now attorneys had their marching orders from the SEC on what to do when they encountered fraudulent conduct by their corporate client. The new regulations would increase accountability of company managers

person who issues or proposes to issue any security. . . ." Securities Act of 1933, § 2(a)(4), 15 U.S.C. § 77b(a)(4) (2003).

¹²¹ See Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6296, 6306 (proposed Feb. 6, 2003) (to be codified at 17 C.F.R. pt. 205); see also Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 C.F.R. § 205.3(c) (2003) (effective Aug. 5, 2003) (allowing an attorney to report the material violation to the company's qualified legal compliance committee, if there is one, instead of the company's case in chief legal officer).

¹²² 17 C.F.R. § 205.3(b).

¹²³ *Id.* § 205.2(i).

¹²⁴ See Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. at 6302 (proposed Feb. 6, 2003) (to be codified at 17 C.F.R. pt. 205); see also 17 C.F.R. § 205.2(e) (2003) (effective Aug. 5, 2003) ("(e) Evidence of a material violation means credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.").

¹²⁵ 17 C.F.R. § 205.2(e).

¹²⁶ See Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. at 6302.

¹²⁷ *Id.*

because their attorneys were now required to go over their head to report a breach of fiduciary duties, something Vinson & Elkins refused to do. If the reporting attorney was not reasonably satisfied with the findings of the investigative body, she could then go over its head to the company board of directors or a segregate body of the board. But what was an attorney to do if all of these efforts failed and the corporation continued its fraudulent activity?

*B. Noisy Withdrawal: Attorneys Alerting the SEC of their Resignation and Objections to Company Filings*¹²⁸

There is a potential problem after an attorney has complied with the up-the-ladder reporting requirement. Despite an attorney's efforts, a company may ignore his concerns and continue its fraudulent activity. To address this issue, the SEC proposed a noisy withdrawal. The noisy withdrawal would require corporate attorneys to withdraw from serving their client and disaffirm any SEC filing if the company did not cease its threatened or ongoing fraudulent conduct after the up-the-ladder reporting.¹²⁹ Proposed section 205.3(d)(1) states:

Where an attorney who has reported evidence of a material violation . . . [and] does not receive an appropriate response, or has not received a response in a reasonable time, to his or her report, and the attorney reasonably believes that a material violation is ongoing or is about to occur and is likely to result in substantial injury to the financial interest or property of the issuer or of investors:

¹²⁸ This Note focuses on the original noisy withdrawal proposal from the SEC. During the comment period for the new rule, an alternative provision developed that would require an attorney to withdraw from the company and require the company to notify the SEC. If the company did not notify the SEC, then the attorney had the *option* to notify the Commission on his own. For the proposed alternative, see Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. at 6335-36 (proposed Feb. 6, 2003) (to be codified at 17 C.F.R. pt. 205). The author does not believe this is a viable alternative since it depends on the company to notify the SEC. It is wishful thinking to believe a company that is determined to break the law will comply with the notification requirement. Thus, the alternative transforms the original SEC noisy withdrawal into a withdrawal with the option to make noise.

¹²⁹ For past offenses, the noisy withdrawal is discretionary. See Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71,670, 71,690 (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. pt. 205).

- (i) An attorney retained by the issuer shall:
- (A) Withdraw forthwith from representing the issuer, indicating that the withdrawal is based on professional considerations;
 - (B) Within one business day of withdrawing, give written notice to the Commission of the attorney's withdrawal, indicating that the withdrawal was based on professional considerations; and
 - (C) Promptly disaffirm to the Commission any opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the Commission, or incorporated into such a document, that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading.¹³⁰

This was a bold initiative for the SEC, one the Commission thought would be rarely used and one “broadly based” on the American Bar Association’s (“ABA” or “American Bar Association”) Model Rules 1.13 and 1.16.¹³¹ The Commission admitted, however, that this proposal went beyond its express directive from Congress and set a higher standard of compliance than the up-the-ladder reporting.¹³² Nevertheless, the SEC believed that situations involving determined, corrupt corporate managers would be rare, and a high standard requiring noisy withdrawal was acceptable.¹³³

The proposed rule drew criticism in terms of its scope.¹³⁴ Some feared that the proposed rule might require attorneys far removed from securities

¹³⁰ *Id.* at 71,706. The rule for in-house counsel does not require withdrawal. It provides:

- (ii) An attorney employed by the issuer shall:
- (A) Within one business day, notify the Commission in writing that he or she intends to disaffirm some opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the Commission, or incorporated into such a document, that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading; and
 - (B) Promptly disaffirm to the Commission, in writing, any such opinion, document, affirmation, representation, characterization, or the like. . . .

Id.

¹³¹ *See id.* at 71,688.

¹³² *Id.* at 71,689.

¹³³ *Id.*

¹³⁴ *See* Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6296, 6298 (proposed Feb. 6, 2003) (to be codified at 17 C.F.R. pt. 205).

practice to make a noisy withdrawal.¹³⁵ But the SEC put most of those fears to rest when it adopted its final rule defining what it means to appear or practice before the Commission.¹³⁶

¹³⁵ See Pacelle & Schroeder, *supra* note 119.

¹³⁶ See Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. at 6298.

The definition contained in the final rule addresses several of the concerns raised by commentators. Attorneys who advise that, under the federal securities laws, a particular document need not be incorporated into a filing, registration statement or other submission to the Commission will be covered by the revised definition. In addition, an attorney must have notice that a document he or she is preparing or assisting in preparing will be submitted to the Commission to be deemed to be “appearing and practicing” under the revised definition. The definition in the final rule thereby also clarifies that an attorney’s preparation of a document (such as a contract) which he or she never intended or had notice would be submitted to the Commission, or incorporated into a document submitted to the Commission, but which subsequently is submitted to the Commission as an exhibit to or in connection with a filing, does not constitute “appearing and practicing” before the Commission.

As discussed below, commentators also raised concerns regarding the potential application of the rule to attorneys who, while admitted to practice in a state or other United States jurisdiction, were not providing legal services to an issuer. Under the final rule, attorneys need not serve in the legal department of an issuer to be covered by the final rule, but they must be providing legal services to an issuer within the context of an attorney-client relationship. An attorney-client relationship may exist even in the absence of a formal retainer or other agreement. Moreover, in some cases, an attorney and an issuer may have an attorney-client relationship within the meaning of the rule even though the attorney-client privilege would not be available with respect to communications between the attorney and the issuer.

The Commission intends that the issue whether an attorney-client relationship exists for purposes of this part will be a federal question and, in general, will turn on the expectations and understandings between the attorney and the issuer. Thus, whether the provision of legal services under particular circumstances would or would not establish an attorney-client relationship under the state laws or ethics codes of the state where the attorney practices or is admitted may be relevant to, but will not be controlling on, the issue under this part. This portion of the definition will also have the effect of excluding from coverage attorneys at public broker-dealers and other issuers who are licensed to practice law and who may transact business with the Commission, but who are not in the legal department and do not provide legal services within the context of an

Despite the *noisy* part of the withdrawal, the Commission sought to maintain the confidential relationship between an attorney and his client. As discussed above, after all attempts to end illegal activity have failed, the outside counsel is required to withdraw from serving his corporate client.¹³⁷ Thereafter, the attorney must notify the commission but only state that the withdrawal was for *professional considerations*.¹³⁸ Subsequently, the rule provides that the attorney must disaffirm responsibility for “any opinion, document, affirmation, representation, characterization, or the like in a document filed with or submitted to the Commission, or incorporated into such a document, that the attorney has prepared or assisted in preparing and that the attorney reasonably believes is or may be materially false or misleading.”¹³⁹ If an attorney fails to comply with the noisy withdrawal provisions, he will be subject to civil and/or disciplinary action by the SEC.¹⁴⁰

The SEC believes these mandatory actions will be a “powerful incentive” for corporate boards to eliminate internal corruption.¹⁴¹ Because of the certainty of an investigation by the Commission upon the attorney’s withdrawal, the rule will act as a deterrent to corporate fraud. Accordingly, the Commission believes noisy withdrawals will be rare and in the best interests of the investing public.¹⁴²

attorney-client relationship. Non-appearing foreign attorneys, as defined below, also are not covered by this definition.

Id. at n.10.

¹³⁷ See Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. at 71,689.

¹³⁸ See *id.* The Commission believed:

Use of the phrase “professional considerations” to explain the withdrawal keeps confidential the particular facts underlying the withdrawal while signaling that the withdrawal reflects substantially more than a disagreement about the best legal strategy or a dispute over the cost of representation. A purely silent withdrawal would be likely to assist an issuer in carrying out an ongoing or intended violation.

Id.

¹³⁹ *Id.*

¹⁴⁰ An attorney who fails to comply with the regulation is liable to the SEC for civil damages. If the attorney appears or practices before the Commission, then the attorney may also be disciplined by either being temporarily or permanently barred from practicing before the Commission. See 17 C.F.R. § 205.6(a)-(b) (2003) (effective Aug. 5, 2003).

¹⁴¹ See Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. at 71,689.

¹⁴² *Id.*

IV. OPPOSING VIEWS

Opponents of the noisy withdrawal proposal have two key arguments. Opponents contend, and the SEC acknowledges,¹⁴³ that the noisy withdrawal goes beyond the Commission's express directions from Congress.¹⁴⁴ Furthermore, opponents argue that the noisy withdrawal will transform attorneys into corporate watchdogs and cause management to exclude them from meetings where confidential information is discussed.¹⁴⁵ The ABA believes a noisy withdrawal could breach the duty of confidentiality and "risk destroying the trust and confidence many [corporations] have up to now placed in their legal counsel, creating divided loyalties."¹⁴⁶ As a result, corporate clients will not feel as free to discuss matters with their attorneys.¹⁴⁷ Additionally, an attorney runs the risk of remaining unemployed by complying with a required noisy withdrawal.¹⁴⁸ This problem can be avoided if the attorney is left with the discretion to warn the SEC.¹⁴⁹

V. THE CONSISTENCY OF NOISY WITHDRAWAL WITH THE ABA MODEL RULES OF PROFESSIONAL RESPONSIBILITY AND ETHICAL THOUGHT

Many objections to the noisy withdrawal requirement rest on concerns of maintaining client confidentiality.¹⁵⁰ It is true that noisy withdrawal touches on confidentiality, but it also involves several other provisions of the ABA Model Rules of Professional Conduct ("Model Rules"). Therefore, it is important to see how noisy withdrawal complies with the principles that govern attorneys' professional conduct.

The Model Rules have been criticized for not going far enough to protect the public from client fraud.¹⁵¹ For that reason, it is significant to

¹⁴³ See *supra* note 132 and accompanying text.

¹⁴⁴ See Pacelle & Schroeder, *supra* note 119.

¹⁴⁵ See Richard B. Schmitt, *Pitt Falls: Changes at the SEC: SEC Rules May Face Noisy Dissent/Lawyers Could be Required to Stop Representing Clients They Suspect of Misconduct*, WALL ST. J., Nov. 7, 2002, at C12, 2002 WL-WSJ 3410993.

¹⁴⁶ *The ABA and Corporate Governance*, ABA WATCH (The Federalist Soc'y for Law and Pub. Policy Studies), Feb. 2003, at 9 (internal quotations omitted).

¹⁴⁷ See Michael Schroeder, *Deals & Deal Makers: Some at SEC Rethink Lawyer Rules*, WALL ST. J., Jan. 21, 2003, at C7, 2003 WL-WSJ 3956996.

¹⁴⁸ See 1 GEOFFREY C. HAZARD, JR. & W. WILLIAM HODES, *THE LAW OF LAWYERING* § 9.31 (3d ed. Supp. 2003).

¹⁴⁹ *Id.*

¹⁵⁰ See Schmitt, *supra* note 145.

¹⁵¹ *The ABA and Corporate Governance*, *supra* note 146, at 7.

point out where the Model Rules are lacking and how the SEC's noisy withdrawal resolves the deficiency while remaining consistent with other ethical standards in the Model Rules. This section will analyze the germane sections of the 2002 version of the ABA Model Rules and their 2003 amendments to determine if the SEC's noisy withdrawal is consistent with an attorney's ethical duties. It will also look at how the Commission's provision closes the gap in the Model Rules.¹⁵²

A. Model Rule 1.6(b)(1)

An attorney has the duty of confidentiality to her client for any matter related to the client's representation.¹⁵³ Generally, this means an attorney cannot reveal her client's confidences. This is done, among other things, to foster complete trust between attorney and client.¹⁵⁴ There are times when this policy is superseded by higher societal values. In August 2003, the ABA amended Model Rule 1.6(b)(2) and (3) to state:

(b) A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

....

(2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services; [or]

(3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services.¹⁵⁵

Accordingly, an attorney may disclose information that is adverse to the client if it is necessary to protect the financial interests of another and when the client has used or is using the attorney's services to commit a fraudulent act.

¹⁵² The 2002 Model Rules and their 2003 amendments are virtually brand new and have not had time to be absorbed into the rules of professional conduct among the states. As such, most of the commentary on the rules refers to the Model Rules adopted in 1983.

¹⁵³ See MODEL RULES OF PROF'L CONDUCT R. 1.6(a) (2002).

¹⁵⁴ *Id.* at cmt. 2.

¹⁵⁵ *Id.* at R. 1.6(b)(2), (3) (2003).

The exceptions are in line with the traditional view of client confidentiality. Ethical standards for attorneys were first developed in 1908 with the ABA Canons of Professional Ethics.¹⁵⁶ The Canons were developed to ensure public confidence in the American judicial system.¹⁵⁷ Canon 37 set out standards and limits for the lawyer's duty of confidentiality.¹⁵⁸ It provided that "[t]he announced intention of a client to commit a crime is not included within the confidences which [the attorney] is bound to respect. [The attorney] may properly make such disclosures as may be necessary to prevent the act or protect those against whom it is threatened."¹⁵⁹ Thus, the initial rules of professional conduct valued the protection of third parties to the detriment of client confidences in broader circumstances. The 1908 standards controlled until the Model Code was developed in 1970.¹⁶⁰ The Model Code continued the Canons' policy of allowing attorneys to reveal confidential information in order to stop a client from committing a crime.¹⁶¹

Dissatisfied with the Model Code, the ABA set out to reform it through the creation of the Model Rules of Professional Conduct.¹⁶² The Model Rules were developed by the Commission on Evaluation of Professional Standards which became known as the Kutak Commission.¹⁶³ The Kutak Commission sought to go beyond the Model Codes with consideration of the ethical debates that were present in the 1970s.¹⁶⁴ With this in mind, the Kutak Commission continued the preference for the prevention of unlawful conduct of a client over the duty of confidentiality. The Commission's

¹⁵⁶ See MODEL CODE OF PROF'L RESPONSIBILITY, pmbl. (1908), *reprinted in* THOMAS D. MORGAN & RONALD D. ROTUNDA, MODEL RULES OF PROFESSIONAL CONDUCT AND OTHER SELECTED STANDARDS 677 (2003) [hereinafter MORGAN & ROTUNDA, MODEL RULES].

¹⁵⁷ *Id.*

¹⁵⁸ *Id.*

¹⁵⁹ *Id.*

¹⁶⁰ *Id.* at n.*.

¹⁶¹ MODEL CODE OF PROF'L RESPONSIBILITY DR 4-101(c)(3) (1981) provides: "A lawyer may reveal: . . . (3) The intentions of his client to commit a crime and the information necessary to prevent the crime." (footnotes omitted).

¹⁶² See MODEL RULES OF PROF'L CONDUCT Preface (Discussion Draft 1980); THOMAS D. MORGAN & RONALD D. ROTUNDA, CALIFORNIA RULES EDITION OF THE 1980 STANDARDS SUPPLEMENT TO PROBLEMS AND MATERIALS ON PROFESSIONAL RESPONSIBILITY 67-68 (1980) [hereinafter MORGAN & ROTUNDA, CALIFORNIA RULES].

¹⁶³ MORGAN & ROTUNDA, CALIFORNIA RULES, *supra* note 162, at 67-68.

¹⁶⁴ *Id.*

proposed version of Rule 1.6(b) allowed an attorney to reveal what he “reasonably believe[d] necessary” to prevent a criminal or fraudulent act or to “rectify the consequences of a client’s criminal or fraudulent act” in which the client used the attorney’s services to commit.¹⁶⁵ This proposal was ultimately rejected. The ABA adopted Model Rule 1.6(b)(1) in 1983 without the crime or fraud provisions and allowed an attorney to disclose a client’s information only when it would prevent an act “likely to result in imminent death or substantial bodily harm.”¹⁶⁶

Opponents of the Kutak Commission’s proposal had the same concerns as the opponents of the SEC’s noisy withdrawal provision. They believed the Kutak Commission’s proposal “transformed the lawyer into a ‘policeman’ over a client,”¹⁶⁷ and this provision needed to be changed to place an attorney in a better position to give advice to her client while maintaining her ability to make a quiet withdrawal.¹⁶⁸ Supporters of Rule 1.6 believed that limiting disclosure to the prevention of death or serious bodily harm “struck the proper balance between the client’s right to have confidences protected and the public’s right to be protected from criminal acts by the client.”¹⁶⁹

Ultimately, the Kutak Commission’s vision would prevail. In 1991, there was an attempt to amend Model Rule 1.6 to the Kutak Commission’s proposed version, but it failed.¹⁷⁰ Again, in 2002, the ABA refused to extend the exception to include acts of client fraud.¹⁷¹ Because of Enron, the ABA reversed course in 2003 and amended Model Rule 1.6 to include the crime or fraud exception.¹⁷²

The 2003 repentance of the ABA brings Rule 1.6 in line with contemporary ethical thought. Thirty-seven states already give attorneys the option to disclose information to prevent a client from committing a criminally

¹⁶⁵ STEPHEN GILLERS & ROY D. SIMON, REGULATION OF LAWYERS: STATUTES AND STANDARDS 81 (2002) (1982 Draft of Model Rule 1.6(b)).

¹⁶⁶ MODEL RULES OF PROF’L CONDUCT R. 1.6(b)(1) (1983).

¹⁶⁷ AMERICAN BAR ASSOCIATION, THE LEGISLATIVE HISTORY OF THE MODEL RULES OF PROFESSIONAL CONDUCT: THEIR DEVELOPMENT IN THE ABA HOUSE OF DELEGATES 48 (1987) [hereinafter THE LEGISLATIVE HISTORY OF THE MODEL RULES].

¹⁶⁸ *Id.*

¹⁶⁹ *Id.* at 49.

¹⁷⁰ See MORGAN & ROTUNDA, MODEL RULES, *supra* note 156, at 196-97 n.*.

¹⁷¹ *Id.*

¹⁷² See MODEL RULES OF PROF’L CONDUCT R. 1.6(b)(2)-(3) (2003); Judith Burns, *Attorneys Face a Paradox in the SEC’s Conduct Rules*, WALL ST. J., Aug. 19, 2003, at C1, 2003 WL-WSJ 3977309.

fraudulent act and four states require the attorney to disclose in such a situation.¹⁷³ Moreover, in July 2002, the ABA's own Task Force on Corporate Responsibility advised the ABA to extend Rule 1.6 to allow attorneys to reveal confidential client information to prevent fraud.¹⁷⁴ Apparently, the ABA realized that the Kutak Commission's proposal and the principles of the original ethical rules were a better approach to client confidentiality than their obstinate limitation. These approaches to client fraud also give a foundation in the rules of ethics for the SEC's noisy withdrawal requirement.

Facially speaking, a noisy withdrawal is consistent with Model Rule 1.6 because the withdrawal is *not* a disclosure.¹⁷⁵ Professor Geoffrey Hazard maintains, "withdrawals do not reveal the *content* of information the lawyer has gained in the course of the representation. By the same token, it does not reveal the *reasons* for the withdrawal being announced."¹⁷⁶ In theory, an attorney could withdraw from representing a client, disaffirm an SEC filing, and notify a third party of the withdrawal without disclosing any information.¹⁷⁷ The only requirement is that the attorney must have withdrawn from representing her client before she gives notice of the withdrawal.¹⁷⁸ Indeed, even the ABA Standing Committee on Professional Ethics and Responsibility indicated in Formal Opinion 92-366 that after withdrawing, an attorney may have a duty to notify a third party of the withdrawal and to disavow documents in order to prevent the attorney from assisting with the client's fraudulent activity.¹⁷⁹ The Committee "urged that where the only effective way to avoid further 'assistance' is to rectify the situation by 'waving a flag,' then rectification may be made even at the cost of betraying client confidences."¹⁸⁰

Interestingly, there is a noisy withdrawal option for attorneys who desire to obstruct a client's fraudulent conduct and still be within the 2002 version of Model Rule 1.6. Comment 14 of Rule 1.6 provides:

¹⁷³ See MORGAN & ROTUNDA, MODEL RULES, *supra* note 156, at 166 (Appendix A, Ethics Rules of Client Confidences § 2 Chart of Ethics Rules of Client Confidences).

¹⁷⁴ *The ABA and Corporate Governance*, *supra* note 146, at 3, 6-7.

¹⁷⁵ See 1 HAZARD & HODES, *supra* note 148, § 9.30 (3d ed. Supp. 2002).

¹⁷⁶ *Id.*

¹⁷⁷ *See id.*

¹⁷⁸ *See id.*

¹⁷⁹ *See id.* § 9.31 (The Opinion "generated significant controversy, however, and even provoked a rare (and quite caustic) dissent.").

¹⁸⁰ *Id.*

Neither this Rule nor Rule 1.8(b) nor Rule 1.16(d) prevents the lawyer from giving notice of the fact of withdrawal, and the lawyer may also withdraw or disaffirm any opinion, document, affirmation, or the like. Where the client is an organization, the lawyer may be in doubt whether contemplated conduct will actually be carried out by the organization. . . .¹⁸¹

Thus, the comment allows attorneys to make a noisy withdrawal just like the SEC's proposal. Even though this action would indicate something is improper, it would not constitute a disclosure of confidential information.¹⁸² This provision is ironic considering the ABA's long-standing rejection of any rule allowing proactive conduct to prevent fraudulent acts in the development of the Model Rules.¹⁸³ According to Hazard, this provision "could create an exception broader than any proposed by the Kutak Commission and rejected by the [ABA]."¹⁸⁴ The ABA, however, deleted this comment in its 2003 amendment to Rule 1.6.¹⁸⁵

B. Model Rule 1.2(d)

Model Rule 1.2(d) is designed to prevent an attorney from participating in a client's unlawful activity. The Rule states:

A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.¹⁸⁶

The Rule essentially seeks to prevent an attorney from giving legal services to clients who are going to engage in unlawful behavior with the attorney as their accomplice.¹⁸⁷

¹⁸¹ MODEL RULES OF PROF'L CONDUCT R. 1.6 cmt. 14 (2002); *see also* MODEL RULES OF PROF'L CONDUCT R. 1.6 cmt. 15-17 (1983) (The 2002 version combined all three comments.). This comment is the codified version of the original comments. *See* MODEL RULES OF PROF'L CONDUCT R. 1.6 cmt. 14-16 (1983).

¹⁸² *See* NATHAN M. CRYSTAL, PROFESSIONAL RESPONSIBILITY: PROBLEMS OF PRACTICE AND THE PROFESSION 514 (2d ed. 2000).

¹⁸³ *See* 1 HAZARD & HODES, *supra* note 148, § 9.30.

¹⁸⁴ *Id.*

¹⁸⁵ *See* MODEL RULES OF PROF'L CONDUCT R. 1.6 (2003).

¹⁸⁶ MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2002).

¹⁸⁷ *See* 1 HAZARD & HODES, *supra* note 148, § 5.2.

Hazard maintains that “while a lawyer may discuss, explain, and predict the consequences of proposed conduct that would constitute crime or fraud, a lawyer may not counsel or assist in such conduct.”¹⁸⁸ If after providing services, the attorney discovers those services have aided a client’s unlawful activity, the attorney must cease providing services for the client.¹⁸⁹ To do otherwise would be to act with the knowledge that the attorney is assisting in the unlawful conduct.¹⁹⁰ If a client demands assistance with unlawful activity, the attorney must withdraw from serving that client.¹⁹¹

The question remains as to whether withdrawing alone is sufficient for an attorney to evade an accusation of participation in a client’s fraudulent act or whether the attorney must do so noisily to warn the client’s intended victim.¹⁹² The attorney that makes a noisy withdrawal protects herself from liability. The ABA appears to take this position in Formal Opinion 92-366, which states that when the attorney continues to serve the client on another matter that is not related to the fraudulent transaction,¹⁹³ she otherwise vouches for the client’s conduct through her continued assistance as the client’s attorney.¹⁹⁴ Of course, an attorney could also warn the victim and protect herself through the newly amended Rule 1.6(b), but that would require the disclosure of confidential information.¹⁹⁵

C. Model Rule 1.13

Model Rule 1.13 sets the ethical standards for an attorney representing a corporation. It was amended in August 2003 to respond to the Enron catastrophe.¹⁹⁶ The Rule requires the attorney to view her representation as serving the entity and not the individuals that direct the entity.¹⁹⁷ Additionally, it allows up-the-ladder reporting comparable to the SEC’s regulation and allows disclosure of confidential information. If an attorney discovers that a manager intends to engage or is engaging in a breach of fiduciary duties or other fraudulent conduct, the Rule provides that the attorney:

¹⁸⁸ See 1 *id.* § 5.12.

¹⁸⁹ See 1 *id.* § 5.16.

¹⁹⁰ See 1 *id.*

¹⁹¹ See 1 *id.* § 5.12.

¹⁹² See 1 *id.*

¹⁹³ See 1 *id.* § 5.16.

¹⁹⁴ See 1 *id.*

¹⁹⁵ See MODEL RULES OF PROF’L CONDUCT R. 1.6(b)(2)-(3) (2003).

¹⁹⁶ See Burns, *supra* note 172.

¹⁹⁷ See 1 HAZARD & HODES, *supra* note 148, § 17.2 (3d ed. Supp. 2003).

- (b) . . . shall refer the matter to higher authority in the organization, including, if warranted by the circumstances, to the highest authority that can act on behalf of the organization as determined by applicable law.
- (c) . . . if despite the lawyer's efforts . . . the highest authority that can act
- (1) on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action or a refusal to act, that is clearly a violation of law, and
 - (2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization, then the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.¹⁹⁸

Model Rule 1.13 operates almost exactly like the SEC's up-the-ladder provision.¹⁹⁹ When an attorney discovers fraud within her corporate client, she is required to look out for the best interests of the entity and prevent harm to it. This is done by "refer[ring] the matter to higher authority in the organization," even all the way up to the board of directors.²⁰⁰ During the referral process, the attorney must take steps to minimize the risk of disclosure to persons outside of the entity.²⁰¹ But, unlike the SEC's provision, the Model Rule states if the entity's "highest authority insists upon or fails to address threatened or ongoing" unlawful conduct, the attorney is allowed to disclose confidential entity-client information to prevent substantial injury to the entity-client.²⁰²

In view of the foregoing, it is important to note that the Kutak Commission's proposed language was significantly different from the adopted 1983 version of Model Rule 1.13. Part (c) of the Kutak Commission's proposal provided for the disclosure of confidential information if the corporation's highest authority insists on continuing unlawful action.²⁰³ It permitted an attorney to take remedial action in such a situation, including "revealing

¹⁹⁸ MODEL RULES OF PROF'L CONDUCT R. 1.13(b)-(c) (2003); *see also id.* R. 1.13(d) (2003) (stating that section (c) does not apply when an attorney is hired "to investigate an alleged violation of law, or to defend the organization . . . [for an] alleged violation of law").

¹⁹⁹ *See Burns, supra* note 172; *see also supra* Part III.A (discussing the SEC's up-the-ladder reporting requirements).

²⁰⁰ MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2003).

²⁰¹ *Id.* cmt. 4.

²⁰² *Id.* cmt. 6.

²⁰³ *See MORGAN & ROTUNDA, MODEL RULES, supra* note 156, at 216 n.*.

information otherwise protected by Rule 1.6” if the attorney reasonably believes the highest authority is seeking personal benefits adverse to the entity-client and disclosure is in the best interests of the corporation.²⁰⁴ Such a provision would go beyond the SEC’s proposed noisy withdrawal.²⁰⁵ Nevertheless, the ABA initially adopted Rule 1.13(c) to allow only a quiet withdrawal from the representation of an entity-client in the face of its fraudulent acts,²⁰⁶ but the fallout from Enron persuaded the ABA to reverse course and allow disclosure if the entity’s highest authority did not cease its fraudulent conduct.²⁰⁷ Additionally, some attorneys thought that by amending the rule to require attorneys to report up-the-ladder, it might keep the SEC from forcing attorneys to “report out” to the SEC.²⁰⁸

It seems, however, that if the client is the entity and the highest authoritative servants of the entity are reaping personal benefits contrary to the interests of the entity, then a mandatory rule is more appropriate. Model Rule 1.13 gives an attorney the ability to look out for the entity-client’s interests. Vinson & Elkins operated under a permissive disclosure rule and it was unable to stop Enron’s renegade management.²⁰⁹ Therefore, if the entity is the true client, then going over the entity’s highest authority to disclose otherwise confidential information to a regulatory body is the only way to protect the entity.²¹⁰ The SEC’s noisy withdrawal accomplishes this without full disclosure.

Furthermore, the ABA appears hypocritical by holding an entity-client’s confidential information more sacred than the secrets of a criminal defendant.²¹¹ The Model Rules allow an attorney to disclose an entity-client’s confidential information to prevent fraud, but under the Model Rules’ candor to the tribunal provisions, criminal defense attorneys are required to disclose a client’s perjury to the court.²¹² Consequently, corporate attorneys are better equipped than criminal defense attorneys to

²⁰⁴ *Id.*

²⁰⁵ For the discussion of noisy withdrawal, see *supra* Part III.B.

²⁰⁶ See MODEL RULES OF PROF’L CONDUCT R. 1.13(c) (1983).

²⁰⁷ See MODEL RULES OF PROF’L CONDUCT R. 1.13(c) (2003).

²⁰⁸ See Burns, *supra* note 172.

²⁰⁹ See TEXAS RULES OF PROF’L CONDUCT R. 1.05(c)(7) (Texas allows attorneys to disclose clients’ “criminal or fraudulent” acts.).

²¹⁰ See 1 HAZARD & HODES, *supra* note 148, § 17.12.

²¹¹ Richard H. Underwood, *What I Think That I Have Learned About Legal Ethics*, 39 IDAHO L. REV. 245, 261-62 (2003).

²¹² See *id.* at 262; see also MODEL RULES OF PROF’L CONDUCT R. 3.3(a)(3) and cmt. 12 (2002).

serve their clients and are allowed to hold their client's interests above the public's interest.²¹³

Additionally, as a matter of self-defense, and as discussed with Model Rule 1.2(d) above, an attorney may have to make a noisy withdrawal to avoid liability as a participant in the fraudulent conduct.²¹⁴ Hazard states:

[If a] lawyer became convinced that the entire hierarchy of an organization was engaged in a serious and ongoing fraud, the lawyer would be *required* to withdraw from the representation under Rule 1.16(a) . . . and might in addition be permitted to reveal the reasons for withdrawal to successor counsel or to the victims.²¹⁵

Clearly, this point of view is in line with the SEC's noisy withdrawal.

D. Model Rule 4.1(b)

Model Rule 4.1(b) speaks to what an attorney must do in order to avoid assisting a client's illegal activity.²¹⁶ The Rule identifies an attorney's obligation to third parties to avoid assisting clients in their unlawful acts. It provides: "In the course of representing a client a lawyer shall not knowingly: . . . (b) fail to disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6."²¹⁷ As stated, the attorney must have knowledge of the client's unlawful acts before her obligation arises. Knowledge is defined as actual knowledge, but knowledge may be inferred from the surrounding circumstances.²¹⁸ Therefore, the attorney who unwittingly participates with a client and fails to correct the situation is not responsible.²¹⁹

It is important to note the interaction of Model Rule 4.1(b) with Model Rules 1.2(d) and 1.6. It can be said that the literal language of Rule 4.1(b) is not consistent with the latter provisions.²²⁰ This is most readily seen in

²¹³ See Underwood, *supra* note 211, at 261-62.

²¹⁴ See 1 HAZARD & HODES, *supra* note 148, § 17.12.

²¹⁵ *Id.* § 17.11.

²¹⁶ 2 *id.* § 37.2.

²¹⁷ MODEL RULES OF PROF'L CONDUCT R. 4.1(b) (2002).

²¹⁸ See AMERICAN BAR ASSOCIATION, ANNOTATED MODEL RULES OF PROFESSIONAL CONDUCT 390 (4th ed. 1999).

²¹⁹ See 2 HAZARD & HODES, *supra* note 148, § 37.2 (3d ed. Supp. 2002).

²²⁰ See 2 *id.*

the potential for an attorney to assist a client's fraudulent activity, prohibited by Rule 1.2(d), through silence allowed under Rule 1.6.²²¹ In order to harmonize these rules, Hazard maintains that Rule 1.2(d) must be viewed as an exception to Rule 1.6 by forcing the attorney to disclose when "not disclosing client confidences is the fraud."²²² Thus, Rules 1.2(d), 1.6, and 4.1(b) present a circular problem.²²³ For when "silence assists client fraud; the lawyer must therefore speak; she may not speak *if* prevented from doing so by Rule 1.6; but *Rule 1.6 does not prevent her from speaking, for she is required by law—Rule 1.2(d)—to speak.*"²²⁴ The permissive disclosure of client fraud in Rule 1.6 mitigates this problem.²²⁵ As the Attorneys' Liability Assurance Society maintains, "Rule 4.1(b) . . . clearly *requires* a certain amount of flag-waving that will alert even the most naive citizen to the fact that the lawyer's client has probably concealed or misrepresented material facts."²²⁶

The SEC's noisy withdrawal requirement answers the problem presented by Rule 4.1(b). An attorney need not worry about failing to disclose a material fact, furthering client fraud, or breaching the duty of confidentiality under the SEC provision. The withdrawal and renunciation of documents discloses all the material facts necessary to alert a client's victim of impropriety and keeps the attorney from aiding the client in the fraudulent act. Withdrawing for professional considerations also removes the attorney from the client's service without disclosing any confidences. Clearly, the noisy withdrawal puts an end to the wild carousel ride of Rule 4.1(b).

VI. SUGGESTED COURSE OF ACTION

How attorneys should respond in the face of corporate fraud is not a new problem. Attorneys have allowed their corporate clients to defraud the public before. In the 1990s the federal government collected over \$100 million in settlements from law firms who assisted the savings and loan industry in fraudulent activity.²²⁷ With the apparent reprise of history in the

²²¹ 2 *id.* § 37.5.

²²² 2 *id.*

²²³ 2 *id.* § 37.6.

²²⁴ 2 *id.*

²²⁵ See MODEL RULES OF PROF'L CONDUCT R. 1.6(b) (2003).

²²⁶ See MORGAN & ROTUNDA, MODEL RULES, *supra* note 156, at 161 n.*, 167-68 n.3 (Appendix A, Ethics Rules on Client Confidences).

²²⁷ See Michael Orey & Richard B. Schmitt, *Enron Entangles Lawyers/Cases Linked to Energy Giant Offer Behind-the-Scenes Look at Quandaries Attorneys Face*, WALL ST. J., May 8, 2002, at B1, 2002 WL-WSJ 3394087.

fall of Enron, there is a need for government intervention to prevent this from happening again.

When Model Rule 1.6 was developed, some wanted to give attorneys more discretion to disclose client confidences just as the Model Code did.²²⁸ Drafters of the Rule found no evidence that the Model Code's disclosure provisions had interfered with the attorney-client relationship.²²⁹ Supporters of a Model Code approach believed that after withdrawal, attorneys might be subject to various sanctions for a client's unlawful acts unless they were allowed to disclose confidential information.²³⁰ The ABA finally relented to these arguments in August 2003.²³¹ Hazard maintains:

It is preferable directly and openly to face the tension between preserving confidentiality on the one hand and, on the other hand, avoiding involvement in a client's fraud and rectifying the harm that the client has caused by using the lawyer as an innocent dupe. A rule that openly acknowledged the possibility of the disclosure would provide an occasion for frank dialog between lawyer and client at an early stage, when candid advice backed up with a threat to withdraw (and disclose) might still cause the client to change course.²³²

Certainly the Enron fallout caused the ABA to change its mind. But corporate attorneys in a majority of states were already under permissive disclosure rules.²³³ Therefore, the ABA's amended disclosure rules will have little effect. To create the frank dialogue between lawyer and client that Hazard envisions, a mandatory noisy withdrawal is needed.

While client confidentiality is an important ideal, a mandatory noisy withdrawal furthers higher social values. Supporters of noisy withdrawal believe that client confidentiality should be subservient to the prevention of fraud.²³⁴ There is already a provision in the Model Rules for an attorney to withdraw from serving a corporation after an attempt to remedy an

²²⁸ See *supra* Part V.A, notes 153-85 and corresponding text.

²²⁹ See THE LEGISLATIVE HISTORY OF THE MODEL RULES, *supra* note 167, at 49.

²³⁰ *Id.*

²³¹ See MODEL RULES OF PROF'L CONDUCT R. 1.6(b) (2003) (allowing permissive disclosure of confidential client information when a client commits fraud).

²³² See 1 HAZARD & HODES, *supra* note 148, § 9.30 (3d ed. Supp. 2003).

²³³ See MORGAN & ROTUNDA, MODEL RULES, *supra* note 156, at 166 (Appendix A, Ethics Rules of Client Confidences § 2 Chart of Ethics Rules on Client Confidences).

²³⁴ See Schroeder, *supra* note 147.

unlawful situation.²³⁵ The SEC simply seeks to make it mandatory. Supporters maintain:

If the recent scandals and those of the past have taught us anything, it is that the boards of some companies are either kept in the dark by management or are reluctant to oppose management actions that are or may be illegal. In those situations, illegal conduct will be stopped or rectified if everyone knows that the company's attorneys will have to exit noisily. On the other hand, if everyone knows that all an attorney can do, if the board persists, is to exit quietly without any signal to anyone, the illegal conduct may continue indefinitely and cause irreparable harm to the company, its shareholders and investors.²³⁶

Indeed, the fall of Enron generated an atmosphere of public distrust of corporations. A 2002 poll of potential jurors found that at least seventy-five percent distrust corporations, up from an historical benchmark of fifty percent in such polls.²³⁷ In fact, an ABA task force on corporate governance found "that a disturbing series of recent lapses in corporations involving false or misleading financial statements and alleged misconduct by executive officers has compromised investors' confidence in both the quality and the integrity of public company governance."²³⁸ The ABA report found "the system of corporate governance at many public companies has failed dramatically. Moreover, the [ABA report] acknowledges that attorneys representing and advising corporate clients bear some share of the blame for this failure."²³⁹

Therefore, the ability of a corporation to abuse the duty of confidentiality must end. The *Restatement (Third) of the Law Governing Lawyers* recognizes the virtues of client confidentiality but understands that "con-

²³⁵ See 1 HAZARD & HODES, *supra* note 148, § 17.3 (3d ed. Supp. 2002).

²³⁶ Susan P. Koniak et al., Comments on Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys 4 (Dec. 17, 2002), available at <http://www.law.virginia.edu/home2002/pdf/SECletter.pdf>.

²³⁷ See John Gibeaut, *FEAR and LOATHING in CORPORATE AMERICA: Big Business's Public Tribulations Have Led to Skeptical Juries, New Laws and In-House Lawyers Working to Tighten Compliance*, 89 A.B.A. J. 50, 52 (2003).

²³⁸ See Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6324, 6325 (proposed Feb. 6, 2003) (to be codified at 17 C.F.R. pt. 205) (footnotes and internal quotations omitted).

²³⁹ *Id.*

fidentiality can also be exploited to violate the law.”²⁴⁰ It appreciates the value of frank communication between an attorney and client, but acknowledges that exceptions are needed to prevent abuse.²⁴¹ Like Rule 1.6, the *Restatement* asserts that an attorney may disclose a client’s confidential information to prevent fraud if certain conditions are met.²⁴² An attorney may reveal a client’s confidences if the fraud “threatens substantial financial loss” and either the client or his agent intend to commit the fraud with the aid of an attorney.²⁴³ The *Restatement* and Rule 1.6 maintain that when a client uses his attorney to perpetrate a fraud this exception is justified on the principle “that the client is not entitled to the protection of confidentiality when the client knowingly causes substantial financial harm.”²⁴⁴ The *Restatement* also recognizes that the ability to take this course of action could lessen “some clients’ willingness to consult freely with their lawyers.”²⁴⁵ Nevertheless, the *Restatement* maintains that “[t]he social benefits of allowing a lawyer to prevent, mitigate, or rectify substantial financial loss to intended victims of [a client’s fraud] warrant incurring [this] additional risk.”²⁴⁶

Before an attorney may take this action, the *Restatement* and Model Rule 1.6 require him to “make a good-faith effort to persuade the client not to act” and to disclose only as a last resort.²⁴⁷ Thus, if the SEC up-the-ladder reporting fails, it is a *prima facie* case of an attorney’s inability to persuade a client away from fraudulent conduct. The *Restatement* declares an attorney must notify the client of his ability to disclose confidential information under these conditions.²⁴⁸ An attorney “may also withdraw or disaffirm opinion letters, affidavits, and other legal documents that had been prepared for the client,” which have been used to further the

²⁴⁰ See RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS ch. 5, introductory note (2000).

²⁴¹ *Id.*

²⁴² *Id.* § 67(1).

²⁴³ *Id.* § 67(1)-(2). Generally speaking, subsection (2) removes the issue of whether the fraud has occurred or has yet to occur, since the attorney may disclose under either condition.

²⁴⁴ *Id.* § 67 cmt. b. See also MODEL RULES OF PROF’L CONDUCT R. 1.6 cmt. 7 (2003) (noting that “abuse of the client-lawyer relationship by the client forfeits the protection” of Rule 1.6).

²⁴⁵ RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 67(1)-(2) (2000).

²⁴⁶ *Id.*

²⁴⁷ *Id.* § 67(3) and cmt. j; see also MODEL RULES OF PROF’L CONDUCT R. 1.2(d) (2002); MODEL RULES OF PROF’L CONDUCT R. 1.6(b)(2) (2003).

²⁴⁸ RESTATEMENT (THIRD) OF LAW GOVERNING LAWYERS § 67(3) (2000).

fraudulent acts.²⁴⁹ Accordingly, the SEC noisy withdrawal is in line with the *Restatement*.

While the Model Rules and the *Restatement* approaches to disclosure are similar to the SEC's noisy withdrawal requirement, there is a significant difference. Under the Model Rules and the *Restatement*, an entity-client waives the duty of confidentiality when it uses an attorney's services for a fraudulent act.²⁵⁰ Fundamentally, the SEC's proposed noisy withdrawal provision does not go this far. It only requires an attorney to wash his hands of the client and notify the Commission.²⁵¹ However, the Commission's noisy withdrawal is more effective than the Model Rules and *Restatement* approaches by giving an attorney leverage with a company's managers to persuade them from fraudulent acts that harm the entity and the public.

The ABA maintains that the SEC's noisy withdrawal provision will "risk destroying the trust and confidence many [corporations] have up to now placed in their legal counsel, creating divided loyalties and driving a wedge into the attorney-client relationship."²⁵² But a survey of 1200 in-house attorneys found that forty-nine percent reported being "kept out of the loop on some important financial and accounting" matters.²⁵³ This indicates that there is already a wedge in the attorney-client relationship on the matters that caused Enron's fall, even though the noisy withdrawal has not yet been implemented.²⁵⁴ Furthermore, the ABA cannot ignore the findings of its own task force on corporate governance that found the public's faith in corporate governance is in decline.²⁵⁵ Attorneys have been practicing under various state versions of the ABA Model Rules for decades and cannot effectively restrain corporate fraud under their permissive guidelines.²⁵⁶ Indeed, the ABA Task Force on Corporate Responsibility "concluded that the Model Rules should be amended so as

²⁴⁹ *Id.* § 67 cmt. j.

²⁵⁰ *Id.* § 67 cmt. e.

²⁵¹ *See supra* Part III.B.

²⁵² Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6324, 6329 n.35 (internal quotations omitted).

²⁵³ *See Gibeaut, supra* note 237, at 55.

²⁵⁴ One could argue that a noisy withdrawal could make matters worse. Nevertheless, attorneys and corporations have had ample opportunity to voluntarily police themselves and have failed. Action must be taken. Short of complete disclosure, the SEC noisy withdrawal requirement is the best option available.

²⁵⁵ *See* Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. at 6325.

²⁵⁶ *The ABA and Corporate Governance, supra* note 146, at 7.

better to protect the public from criminal or fraudulent conduct using a lawyer's services, better to serve the interests of [entity-clients], and better to guide lawyers in complying with their ethical obligations when serving [entity-clients]."²⁵⁷ The permissive amendments to Model Rules 1.6 and 1.13 were in direct response to this conclusion.²⁵⁸ However, Vinson & Elkins operated under permissive disclosure rules and were not able to restrain Enron's management.²⁵⁹ In fact, Vinson & Elkins buckled under pressure from Enron executives when the firm knew it could disclose what was going on at Enron.²⁶⁰ Therefore, mandatory responsibilities are needed for corporate attorneys to prevent client fraud.

Without a mandatory noisy withdrawal, corporations will continue fraudulent conduct despite the advice of their attorneys. A study commissioned by the United States District Court for the Northern District of Illinois found that in a fraud case against Spiegel, Inc. prosecuted by the SEC, "the absence of a 'noisy withdrawal' requirement allowed Spiegel to keep investors and the SEC in the dark" to the company's fraudulent conduct.²⁶¹ Spiegel was charged with failing to file periodic reports with the SEC and fraudulently withholding information about the financial health of the company.²⁶² The report found that, like Enron, "Spiegel's desperate financial difficulties were compounded by a string of material accounting irregularities lurking beneath the surface of its public disclosure."²⁶³

Spiegel's principal outside counsel, Kirkland & Ellis, advised the company's audit and board committees to make the appropriate disclosures.²⁶⁴ Kirkland & Ellis maintained that it "repeatedly advised Spiegel to file its SEC reports, repeatedly told Spiegel that failure to file was a serious matter, gave its advice 'loudly and clearly,' and reported 'up the line.'"²⁶⁵ But the district court report found that "this was a case where reporting 'up the ladder' was not enough."²⁶⁶ Kirkland & Ellis believed

²⁵⁷ *Id.*

²⁵⁸ See MODEL RULES OF PROF'L CONDUCT R. 1.6, 1.13 (2003).

²⁵⁹ See TEXAS RULES OF PROF'L CONDUCT R. 1.05(c)(7) (allowing attorneys to disclose confidential information to prevent client fraud).

²⁶⁰ See Pollock, *supra* note 24.

²⁶¹ See *Spiegel Examiner Says Noisy Withdrawal Would've Helped Bring Wrongdoing to Light*, 19 ABA/BNA LAWYERS' MANUAL ON PROFESSIONAL CONDUCT, No. 20, at 542 (Sept. 24, 2003).

²⁶² *Id.*

²⁶³ *Id.* at 542-43.

²⁶⁴ *Id.* at 542.

²⁶⁵ *Id.* at 543 (quoting Jack Levin, a senior partner at Kirkland & Ellis).

²⁶⁶ *Id.* at 542.

“that at a certain point Spiegel decided very clearly that they were not going to follow [the firm’s] advice.”²⁶⁷ Since Kirkland & Ellis were not required to make a noisy withdrawal, they did not do so.²⁶⁸

The district court’s report stated “that if the SEC’s proposed noisy withdrawal rule had been in effect, the SEC would have been alerted to take action sooner and investors would have been kept abreast of developments at the company.”²⁶⁹ The report concluded, “[t]he lack of such a requirement enabled Spiegel to hide the truth from investors and the SEC.”²⁷⁰

The SEC’s noisy withdrawal is a device that could diminish or even eliminate the possibility of another scandal like Enron. With a mandatory provision, attorneys will have the necessary leverage to direct corporate managers to comply with their legal and fiduciary duties. Additionally, the rule will act as a deterrent. Use of noisy withdrawal will be kept at a minimum because if the attorney is forced to notify the SEC of his withdrawal, it is an absolute certainty that the SEC will initiate an investigation. Had Vinson & Elkins been required to make a noisy withdrawal, thousands of retirees’ pensions, investor portfolios, and the stock market as a whole could have been preserved.

VII. CONCLUSION

In light of the Enron collapse, new standards for attorneys are needed to prevent another corporate failure from happening. Congress provided the SEC with the power to create the tools it needed to prevent another Enron scenario. One of those tools is noisy withdrawal. While controversial, the noisy withdrawal provision is consistent with ethical responsibilities of attorneys. In an atmosphere of corporate corruption there is a need for the noisy withdrawal requirement to protect the interests of the investing public.

²⁶⁷ *Id.* at 543.

²⁶⁸ *Id.*

²⁶⁹ *Id.*

²⁷⁰ *Id.*

