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## Integrity in the Capital Markets

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## INTEGRITY IN THE CAPITAL MARKETS

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This is a fascinating time to be studying securities regulations. There are probably only four or five periods in the last hundred years during which the integrity of the securities markets has been so much under attack, carrying import not only for people who invest in the markets, but for the economy, for society and for the national community at large.

If Enron had been a single instance, it would have been a spectacularly failed business model. It would have been a major accounting scandal. It would have been a significant case study of corporate self-dealing. And it, probably, would have been a good example of what lawyers would do with a failed enterprise. However, when WorldCom failed and companies like AOL Time Warner began to write off tens and tens of billions of dollars at a time—just one of their write offs was over \$40 billion, larger than the market capitalization of most large companies in the economy—when Adelphia failed, when Tyco, Quest and even General Electric begin to be rocked by questions about their accounting, investors begin to lose confidence in the integrity of the capital markets. And when that happens, several things begin to happen in turn.

First, people lose money, and people lose money in an unfair way. One of the things that I want to talk about today is why integrity in the corporate securities markets is important to the average citizen. Why do we care about what happens on Wall Street? One of the reasons we care about what happens on Wall Street is because we, as a society, believe that people ought not lie, cheat and steal. We believe, as a society, that whether you are selling ballpoint pens, books, penny candy, or securities you ought do that in an honest way. And one of the things that has happened is that the basic integrity of the securities markets is now under attack, because people don't believe what they are being told. And when you don't believe what you are being told, you feel that you are being treated unfairly. And you *are* being treated unfairly. And so, the first reason integrity in the securities market is important is because fairness is important. It is a basic value we have in our society. And irrespective of the economic consequences, we would still want

to have integrity in the securities markets just like we want to have integrity in every other market in the country.

However, there is another reason why integrity in the securities markets is critically important. It is because, unlike ballpoint pens and other single items we buy, if the securities markets begin to fail and investors begin to lose confidence in them, then every other market in the country is affected. That is because every market—every major product or service in this country—depends on the securities markets to provide financing. When you look at the difference between developing countries and developed countries, what you see is that the developed countries have well-functioning capital markets. Capital markets provide the financing that is necessary for all kinds of companies to provide the goods and services for what we like to think about as developed society. If you do not have the capital markets functioning effectively, you cannot raise money. If you cannot raise money, you cannot have the kind of investments that you need to make chairs and tables and computers and everything else that is critical to society. So, when the securities markets begin to fail, what happens is not only are people treated unfairly—not only are people cheated—but people in other markets, in every other market, are affected as well.

This is even more so now than it was two or three generations ago. When I was growing up, about fifteen percent of the American people owned securities directly or indirectly at one time. Now more than fifty percent—over half of the country—is invested either directly or indirectly in the stock market. Now, that means several things.

One is that we have greatly broadened the base from which capital can be drawn into commerce; that is a good thing.

The second thing that has happened is that people have a larger stake in the welfare of our economy; that is a good thing, too.

The third thing that has happened is that people have more at risk. People's expectations are at risk. This is particularly true for those of you who are young enough to have never experienced three or four years of down time in the stock market. What is happening now is people are realizing not only that stocks go down, but also that they can stay down for a sustained period of time. One of the reasons for this is that people are losing confidence, have lost confidence, in the integrity of the capital market.

## I. THE IMPORTANCE OF INVESTOR CONFIDENCE

You see people writing about the “Enron Market.” What they mean by that is that people aren't certain what the assets are, what the accounting means. I was hired about nine months ago to come in and represent Tyco who, at that time, was being rocked by a number of allegations about both its

securities compliance and accounting. What we tried to do was restore investor confidence in that company by trying to make clear to both society and investors that the company was going to be honest and candid about all of its problems. Those problems were not fundamental to the company. The company's fundamental businesses were and remain sound. The company's cash flow and earnings are sound. What happened was that when investors lost confidence in their ability to trust the financial statements that the company was putting out, nobody wanted to own that stock. The stock went down not only from its high in the 50's but where it had been in the 20's and 30's to less than \$7 a share. The company didn't change; the assets didn't change; the cash flow actually didn't change very much; the earnings changed a little bit, but not nearly as much as the stock price did. What had happened was that people had lost confidence in the company, and they didn't know what they were buying. When we invest a lot of money, particularly when we are going to invest money that we depend on for our retirements, our savings and our children's education, we tend to be risk averse. Of course we like to see stocks go up, but we particularly do not want to see the stocks go down. The pain of seeing your money being lost in the stock market is far greater than the pleasure of watching your stocks go up. So people start off risk averse. And, when you're risk averse and don't know what you're buying, you tend not to buy. And when you hold it, you tend to sell, which is what happens when stock goes down to less than \$7 a share. As investor confidence has come back, people are now buying the stock, and it is back up to about 14, 15 or 16. And again, it's the same company as it was when it was at \$7. It has the same cash flow. It has the same earnings. But what has happened is that investor confidence is beginning to be restored.

What happened in that one instance is typical of what happens in the economy at large. Had it just been Enron, that would have been an aberration; we would have gotten over that. Some people would have gone to jail, and a lot of people have lost money, but it would not have had the kind of widespread effect on society and on the economy that this current range of corporate scandals has exhibited. But when you add in Enron, WorldCom, Adelphia, Tyco, Quest, General Electric, and AOL Time Warner and many others, what you begin to have is a general loss of confidence in the integrity of the experienced market. And when you begin to have that general loss, not only were people not buying Tyco, now they didn't want to buy stocks, because they weren't sure what they were buying—even if their particular company had not been the subject of a corporate scandal. They were beginning to worry, what was going to come out next, what was there that they didn't know about. Because when you think about these companies, you think about some of the most admired companies in the country. Consider

General Electric; Jack Welch was a corporate icon. The success of General Electric was legendary. For many, many years it was viewed as the most or one of the most admired corporations. AOL Time Warner was supposed to be the corporation of the future—aggressive, intelligent and creative. Tyco was headed by Dennis Kozlowski, who was on the cover of *Business Week* as the most admired corporate executive. Quest was a new type of company, one of the baby bells companies, so admired because it was the local telephone company for big fiber optics. These weren't aberrations. These were not the kinds of companies that trade as penny stocks; nor were they the kinds of companies of which people expected questions. These were the kinds of companies that everybody admired. So when they began to fall, when people began to find that they could not trust the financial statements of these pillar companies, people began to distrust the financial statements of all companies. And when that began to happen, people were less willing to invest their money and a flight of capital, either to bonds or to other forms of investments, resulted. And that was a good thing. Because I think one of the things that has happened through a combination of new legislation, Sarbanes-Oxley, enforcement by the Securities and Exchange Commission (SEC), a number of private lawsuits and corporations taking their responsibilities increasing seriously and making additional disclosures, is that investor confidence is beginning to return.

## II. DECLINE OF THE "ENRON EFFECT": VOLUNTARY COMPLIANCE

It is too early to tell with all the different kinds of effects that impact the stock market whether it is concern with what's happening in Iraq, the war on terrorism, or the economy, but what you are beginning to see is the beginning of the mitigation of the so called "Enron Effect." Admittedly, it has taken well over a year to do that, and it is happening only because people recognize how important the integrity of the market is worth. It is the kind of integrity—like our tax code—that can only be preserved with essentially voluntary compliance. The SEC has fewer lawyers assigned to litigation than some single firms are devoting to single corporate scandals. Davis, Polk & Wardwell has more lawyers on Enron than the SEC has in its entire litigation group. Now, what that says is that if you don't have substantial voluntary compliance, you're not going to succeed in having effective securities law enforcement.

Voluntary compliance has two aspects to it: one is cultural and one is deterrence. Unless you create a culture of integrity in a corporation, you're not going to be able to have the kind of voluntary compliance that our securities markets depend on. And second, unless you have effective deterrence so that people know that there is a penalty, those people who are not motivated

by a culture of integrity are going to cheat. And so, what you have to do within a company is you have to try to create a culture of integrity; and what you have to do from an enforcement standpoint is you have to try to create a culture of deterrence, so that people know that there will be penalties, severe penalties. One of the things that you've seen in Sarbanes-Oxley is an attempt to escalate both responsibility and accountability of companies. You have seen there, among other things, an attempt to say to a corporation's chief financial officer and chief executive officer that they are personally on the line. You have got to certify these financials and if you're wrong, you're personally going to be in trouble. And what they've tried to say to the accountants, and to some extent to the lawyers, is that when you find something out, you must take responsibility to fix it. And if you tell the general counsel, and the general counsel doesn't get it fixed, you have got to tell the chief executive officer; and if he or she doesn't fix it, you've got to tell the board of directors. Now Sarbanes-Oxley stops there. It doesn't say if the board of directors doesn't solve that you've got to go public, but that's one of the issues that is being debated right now. The question is: What is the responsibility of lawyers in the corporate environment to go beyond their clients in the instance of a violation of law. Unless you have that kind of accountability, you've got less pressure both from the top coming down in terms of the chief executive officer and from the side, the accountants and lawyers, to impact the company.

### III. LAW ENFORCEMENT

You also have to have effective law enforcement. You've got to have an SEC for example that lays claim to both the mission and the resources to do the job that has to be done. One of the things that has happened up until the last couple of years is that the budget has been continually cut. It's easy to cut out enforcement. There isn't any real constituency out there saying please have more people trying to enforce the securities laws, and unlike the pressure to have more cops on the beat that comes from public concern for crime on the streets, people are generally not worried about securities fraud. It's something that they don't see, and as long as they don't see it, they don't worry about it. So you don't have a natural constituency trying to increase the resources that are devoted to securities enforcement. What that means is that in normal times when we have budgetary constraints, that kind of budget is one of the easiest budgets to cut, or at least not increase. Consequently, over a period of time during which the importance of the securities markets and the number of people invested in it, directly or indirectly, have increased markedly, the percentage of the budget devoted to enforcing its integrity has declined sharply. And one of the things we're beginning to see is some re-

versal of that, although not nearly as much as you would think. There's still an enormous gap between resources that need to be devoted to enforcement at the public level and resources that are in fact devoted to enforcement at the public level.

In addition, for a number of years, the approach of the legislature and the approach of the people generally was one inconsistent with private enforcement of securities laws. Lawyers gave private enforcement of securities laws a bad name. Part of that was entirely understandable because the way securities law enforcement at the private level essentially worked was you have these class actions by lawyers who didn't have real clients in the sense of somebody telling them what to do. They would bring these actions. They would settle these actions for amounts of money that gave class members a tiny recovery, yet would earn them very large fees. The reason is that when you aggregate millions or tens of thousands of claims together, each of them receives just one dollar, or ten dollars, or fifty dollars, while you secure a pretty big pot out of which attorney's fees can be paid. So, what you saw in the Private Securities Reform Act legislation was an attempt by Congress to make it more difficult to bring those cases. In the antitrust area—which is another arena in which we rely on a large extent of voluntary compliance, public enforcement and private enforcement as sort of the three legs of compliance—you have a lot of things going in favor of private enforcement. You have treble damages. The antitrust plaintiff gets his attorney's fees paid for by the defendant. We have a lot of advantages that are designed to encourage private antitrust enforcement. And that's because, generally speaking, private antitrust litigation has involved real clients with real problems, and the return from litigation can be seen to go to the deserving clients and not to lawyers. Whereas in the securities area what happens is that people perceive this as a way for class action lawyers to get richer, but not to really benefit the class too much. Part of that was an educational problem, inasmuch as one of the things that private securities actions did and continue to do is target enhancement of the deterrence factor. As a result, not only do you have all seventy-five SEC litigators bringing cases, but you have maybe 7,500 class action lawyers looking for securities violations, and that adds the element of deterrence.

The second thing is that genuine reforms were needed. We needed something that would better align the interests of the lawyer with the interests of the client. We needed things such as greater supervision by judges of those class actions. We needed less willingness from some judges to approve very, very large fees because they knew the lawyers involved. There were a variety of things that really called for reform. The reason that many of us who do defense work as well as plaintiff work were very ambivalent about the Private Securities Reform Act was that those reforms did not really

strike at the abuses. It simply made it more difficult to win this type of case. So, one of the things that needs to happen is that you need to have revitalized *private* securities enforcement; and you are indeed seeing that.

One of the ways you are seeing that is very large institutions have now taken the role of lead plaintiff. As a result, instead of having someone with a very small share and little interest compared to his attorney regarding the outcome of the ongoing case, you now have, for example, California Regents assuming the role of lead plaintiff. California Regents, I think, is the lead plaintiff in Enron. You have very, very large institutions now coming forward and saying we are going to be the real client. We are going to hire somebody, and we are going to have a class action; but we are going to negotiate fees. And the fees, for example, that Regents has negotiated in that Enron case is probably a third or less of the fees that have often been awarded in a percentage arrangement typically associated with these kinds of cases. So what you have now is you have real clients operating in the context of a real negotiation in which the lawyer is still going to make a lot of money. This is still the lawyer's full employment act, the lawyers will still do very well, but what is going to happen is that more of the return is going to go to the actual clients. And you are going to have more receptivity on the part of the courts to these kinds of cases because they will be perceived, not as lawyers winning cases, but as *clients* winning cases. When a large pension fund becomes active things change. For example, the State of New Jersey has a new head of the pension program, and he has made it a priority to make the State of New Jersey a leader both in corporate governance and in the enforcement of securities rights. And because New Jersey is such a large state with so many pensions, they have enormous clout. States such as California, Florida, Texas, New York, New Jersey and Pennsylvania in their pension plans and in their state agencies control huge amounts of capital and are heavily invested in the stock market. They have by and large been passive—CALPERS has been an exception—but they have been by and large bystanders and very, very passive ones. One of the good things that I think is coming out of the Enron and WorldCom scandals is they have been shaken out of that. They are now beginning to take a much more active role. And that's helpful in three respects.

First it is helpful if you are giving additional credibility to private securities law enforcement. I think you are going to see more and more states take that lead role, and more and more attorneys general, like Elliot Spitzer in New York, prepared to do that.

The second effect that this has is that these state agencies, the institutions, have become more interested in corporate governance that is designed to prevent these violations from occurring in the first place. What you find them doing is becoming much more active in exercising their shareholder



rights trying to make sure the board of directors are more independent, for example. This stands in stark contrast to what most large institutions were doing as very, very passive shareholders who generally supported management, except in the most egregious instances, with the rare exception of leaders like CALPERS, trying to improve corporate governance in companies in which it owned stock back in the early 80's.

The third effect is because these are states and, because they are taken seriously in a governmental as well as a share ownership role, they are beginning to use their governmental powers to enforce the securities laws. The states are in a unique position, they are very large owners, but they are also law enforcers. And what you find is that they are now being active both as owners and as law enforcers in a securities action area in a way that they were not before. So what I think you're seeing come out of the Enron and WorldCom scandals is increased private enforcement as well as somewhat increased public enforcement of securities rules, and all those things are good.

Fundamentally, if companies are going to engage in voluntary compliance it is because the people at the very top of the corporation are going to have themselves and enforce in others a culture of integrity. If you are running a corporation, you have enormous power to hide things. And if you are in a situation, like Tyco, where the chief executive officer, the chief financial officer, the general counsel, and the lead director have been indicted, you have a situation in which there is almost nobody left on whom the board can depend. These weren't fly-by-night people. These were leaders in their respective fields. Dennis Kozlowski, the chief executive officer, had been CEO of Tyco since 1992. He was an excellent businessman. He grew that company from \$3 billion to \$36 billion. The share price tripled during that period of time. He was widely admired from both within the business community and outside of it. Mark Schwartz, who was the chief financial officer of the company, was recognized on Wall Street as one of the smartest, most capable, and most direct chief financial officers. He was somebody who people listened to and believed. I dealt with him after I was retained. He was a very persuasive, creative person. Mark Belnick, who is the general counsel, was a distinguished lawyer. He had been a partner at Paul, Weiss in New York. He had been the protégé of Arthur Liman, one of the leading trial lawyers of his generation. He had been a deputy special counsel in the Iran Contra investigation. He was somebody who had all the conventions that were expected. When I was contacted by the board of directors, I asked them why they were contacting me instead of the general counsel making the call? They explained that they were experiencing some problems with the general counsel. I know Mark Belnick, and he is a really terrific guy. Later as the investigation began to uncover things, and documents were requested,

the board decided that he would be suspended. The board came and told me that he had been suspended. I told them that there had to be a misunderstanding, and asked to go talk to him. This was somebody who nobody would have expected to have been engaged in this kind of conduct. Then there was Lee Walsh. Many companies have somebody who is designated as the lead director, to serve as a sort of liaison between the management and the board; that person is in a way first among equals in terms of the board. Mr. Walsh was the former lead director of Tyco. He was independently wealthy. Somebody, again, who prior to revelations of what happened was extremely highly regarded. So these were people whom the board of directors had every right to believe that they could count on. If you can't rely on people with these credentials, the question that every board has to face is who can you rely on?

#### IV. CORPORATE GOVERNANCE: THE PROBLEM OF THE BOARD

One of the dilemmas I want to talk about today is how does a board of directors deal with its responsibilities? You have people who are not full time in the company, many of them running their own companies; many are chief executive officers or high officers in other companies. Directors are the ultimate shareholder representatives. They are the people to whom the law gives the real power to hire and fire management. They are ultimately where the buck stops. They hire a chief executive officer. How do they supervise that person? Careful hiring practices is not enough; the boards probably made pretty good decisions when they hired these three people. These people were well regarded, and they did a very effective job managing the company—until something happened and they decided that the company's money could be taken as their own. It wasn't that they made a dumb decision when they hired these people. Once they are hired though, how do you supervise them? How do you make sure they're doing their job? Remember that this is a \$35 billion corporation. It has some 150,000 employees operating in thirty or forty countries around the world. How does a board of directors really know what is going on? One of the things that we found when we did our investigation was that they would acquire a company and they would then reduce artificially the value of the assets just before they acquired it so the new acquisition would come on to Tyco's books with undervalued assets. Those assets could then be increased and the increase recorded as a gain. Similarly, just before a company was acquired they would set up a reserve that would come out of the earnings of the acquired company, but before the acquisition. The acquired had big reserves which some of the people at Tyco treated as a sort of big pile of money, a cookie jar, that they could dip into when they needed a bit more money to meet their tar-

geted earnings before taxes. So this was a way of making Tyco's earnings after the acquisition look better than they actually were. How does the board of directors begin to find that out?

How does the board of directors begin to fulfill its function of ensuring integrity of the companies' financial statements? You have got anywhere from eight to eighteen people on the board of directors. In general, they are pretty savvy people, pretty well educated people, and pretty experienced people in business. Many of them own their own corporations, but they don't have a lot of time and equally important they don't have a lot of help, because everyone they depend on is working for the chief executive officer or somebody who works for the chief executive officer.

How many of you here have ever read a book by John Kenneth Galbraith called *The New Industrial State*? Anybody? Old book and you're too young. Does anybody know who Galbraith was? John Kenneth Galbraith was an economist, and a pretty good economist, and he wrote a number of books. One of the books that he wrote was a book called *The New Industrial State*, and it was published some forty years ago. What he was confronting was the difficulty of regulating business in an era in which so much depends on novel expertise. And the fundamental problem that he was dealing with in *The New Industrial State* was if you have large corporations with hundreds and hundreds of people who have to find out the facts in order to manage the company, how does anybody outside that corporation ever really figure out what is going on? And if you can't figure out what is really going on, how do you ever regulate?

Now there is a sense that what has happened with Enron and WorldCom and Tyco and other companies is really a validation of what Galbraith was concerned about in *The New Industrial State*. Because until something gets so bad that it explodes, nobody knows what is going on internally because nobody has the resources to figure that out. You may find one problem here and one problem there. There is no way to have a broad understanding of what the problems are across companies from the outside. And the problem is not only the company versus enforcement on the outside. It is also a problem within the company when you think of the role of the board of directors. Because Galbraith was thinking of corporations as really unified enterprises, he wasn't thinking about how they relate internally. He was thinking about how they relate to the outside world. How does the government enforce the laws on corporations?

How many of you have heard of Berles and Neads? Even before Galbraith—this goes all the way back to the 30's—they wrote about how managers of companies, and to some extent how boards of directors of companies, but mostly how the controllers of companies really have the power to determine what companies do and to use that power to enrich themselves as

opposed to enriching the shareholders. Because the shareholders are the owners of the company, they are the people that are supposed to benefit from it. And yet, as anybody who studied proxy contests knows, it is almost impossible for shareholders to elect directors. Legally, shareholders elect directors, and directors select management. In fact, the way it works is the management selects the directors, and the shareholders almost uniformly vote in whomever management recommends. So what happens is rather than having directors that are representatives of the shareholders controlling management, you instead have the management selecting the directors, and consequently the directors are beholden to the management they are supposed to control.

One of the things that has happened in a variety of reforms is to try to break the relationship between management and the boards of directors and re-establish a relationship between boards of directors and shareholders. One of those changes is in Sarbanes-Oxley. Another one of those changes is the New York Stock Exchange rules that require certain committees of the board, such as the nominating committee that selects new members of the board and the compensation committee that determines the amount of compensation, to be independent or outside directors. A board of directors usually includes some people who are members of management. Some companies—Microsoft, for one, for a long time were totally dominated by inside directors. Other companies, Tyco was one, were almost totally dominated by outside directors. Tyco demonstrates the fact that even if you have a majority of outside directors—people with no management position in the company—that is not the ultimate safeguard. The ultimate safeguard is *how* those board members interact with management. One of the things that the Stock Exchange rules do is say that there have to be outside directors. The second thing the Stock Exchange rules will do is begin to set up procedures by which those outside directors fulfill their responsibilities.

Another thing that's come out goes back to what I was talking about earlier in terms of increased activity and activism by states and other large shareholder institutions. They have begun to say that they want to nominate somebody. They want to put somebody on the board that management hasn't even had a vote on. Someone that even other board members haven't had a vote on. They want to put somebody on the board who is going to be their representative. And savvy institutions are saying that that they want to change that representative every few years so that they don't get corrupted by other members of the board; so you have got somebody on there who is prepared to dissent. In democratic institutions, you very rarely find the legislature voting unanimously for anything because you have got different points of view. You must look to the non-democratic regimes to find people voting unanimously.

One of the problems with the board of directors is that decisions are almost always unanimous. There is almost never a fight at the end. There are often spirited debates. Very, very often you find spirited debates. But ultimately, consensus rules. In part, this is the product of everyone's desire to maintain a certain level of collegiality, a very important ingredient to the proper function of a corporation. But when that goes too far, and you are left without anyone prepared to stand up and actually continue to fight even after they have lost, situations develop where nobody is left pushing the company at the final analysis to do what they have to do in order to properly fulfill their obligations. One of the things that is going to come out of the current ferment is to see large institutions putting their representatives on boards of directors. The great advantage of the Congress of the United States is that the members have to come back to the voters every two years and every six years. They have got to come back to the people who elected them. And they have got to run against opponents. That doesn't happen in corporate democracy, and as a result you get the same kind of consistency you find in most one-party states. When you have an absence of real contested elections for boards of directors and you have the voters—in this case the shareholders—essentially playing a passive role, you don't get people on the board who are thinking as intently about the interests of the people they represent as if they knew they faced an impending election. Now, admittedly, if they did have to run for election, most of these people wouldn't serve; so that is one of the things that must be debated.

For most members of the board of directors today they have got other things to do with their lives. This is not where they are going to make most of their money. It has become a tremendous headache. It has also become a tremendous source of potential liability, because at the same time the liability increases the opportunity for what you call directors and officers insurance—insurance that guarantees that somebody else will pay if the person gets sued—is being reduced. And so, while insurance opportunity is increasing, potential liability is increasing. As a result, lots of the very best people don't want to serve on boards of directors at the present time anyway. The question boils down to: How do you mix the desirability of having a really good board of directors with a board of directors that is going to be responsive to shareholder interests. And then once you have got the right board of directors, how do you get them the information that they need in order to operate properly? How do you make them something other than a rubber stamp for a corporation?

If you were all members of a board—this would be a pretty large board—of a large corporation, how do you make sure that the chief executive officer, the chief financial officer, and the general counsel are doing their jobs right?

[Student: You could hire independent auditors to look at your corporation. They are supposed to tell you exactly what's going on from an independent stance.]

## V. THE INDEPENDENT AUDITOR

Every public company has independent auditors. Tyco, for example, has Price, Waterhouse audit their books. Those independent auditors are paid by the management. The board of directors is presented with a proposal to hire Price, Waterhouse. How does the board of directors decide if they want to hire Price, Waterhouse or Ernst and Young or somebody else? How does the board of directors make sure that Price, Waterhouse, for example, is doing its job right? For example, you have read in the papers about how auditing firms do a lot of consulting for the companies that they audit. They can make a lot of money that way. They may even make more money for that kind of work than they do for their auditing work. That consulting work is all given to them by the management of the companies. How does a board of directors figure out whether the auditors are really performing their function?

[Student: They should hire, like Tyco did, outside investigators.]

Now that is one solution. One solution is to hire, for example, an outside law firm that comes in and, in effect, audits the company separate from the general counsel. And, similarly audit committees of boards of directors could bring in a separate auditing firm to help give advice. Now where do you draw the line? In other words, it is fine to bring Boies, Schiller & Flexner in to work for the company for six to twelve months, do an investigation and provide some recommendations. But at some point, the company needs to get back to business. Do you really want two parallel structures? Do you really want a parallel legal structure or a parallel auditing structure? It would certainly be very expensive. For a company the size of AOL Time Warner or Tyco, it is probably expensive but not crippling. For a smaller company, you are going to eat up large chunks of shareholder earnings, if what you are doing is duplicating the structure. On the other hand, I think the point that each of you is making is that trying to secure some independent advice is the right path to take.

The question is: Where do you draw the line? How do you figure out how much advice you really need to get your job done without sort of having wasteful duplication? Any ideas about that?

[Student: Should board committees be very careful with their pre-approval of non-consulting services? Maybe they really need to weigh whether they are going to allow them to do it at all, weigh whether it's worth putting at risk the independence of their auditors. At least, the board should

meet separately—without management being there—with the auditors to determine whether or not to pre-approve any non-audit work.]

I think that is a very critical step. I think that what you need to do is you need to convert the auditors—the normal corporate auditors—into an arm of the board, as opposed to an arm of management. And I think that ensuring that anything paid to the auditors be approved, thought about and focused on by the board is a critical step. Because what you're trying to do is you're trying to make the auditors people that want to please the board, not people who want to please the management. And I think the step of having the audit company meet independently of management and the step of making the audit committee approve any consulting contracts helps. I also think that the step of increased exposure is an important element of that. Because one of the things that boards are now feeling is their own exposure—the exposure of their own savings and assets—and in that particular context, it makes them much more aggressive in dealing with auditors. They become much more determined to be sure that the auditors have explained every issue to them. And so I think that if you have the separate meetings, you have the separate approval, you have the incentive, you have some of the ingredients that are necessary to convert the auditors from people who think of themselves as working for the company to people who are working for the board. And that, of course, is an entire bureaucracy that already exists. You are not duplicating a bureaucracy here. And I think that is one of the most important steps.

I also think that another step is to rotate auditors. Auditors, and this may be true for most professionals, but there's a certain animalistic quality about large auditors, love to come in and find problems that their predecessors did not. So if you rotate your auditors, the board knows two things. First, they know they're going to get a fresh pair of eyes coming in at some point and pointing out all the problems that existed. And second, because their existing auditors know that that's going to happen, that their work is going to be audited by somebody else, they become more cautious and careful while they are doing the work. So, that if you have a context in which every five years or so you are going to rotate your auditors, you are going to get new people coming in and setting out to find problems and the existing auditors know that that's going to happen, and will consequently be much more cautious.

## VI. THE INDEPENDENT LAW FIRM: ROLE AND RESPONSIBILITIES

I think you also want to think about changing—and this entails more difficulty—the person or people at the very top of a corporation's legal structure every five years or so. With auditors, a corporation essentially subcon-

tracts out its auditing function to an independent firm. Most corporations do not do that with respect to law. They have their internal general counsels; I think that's a very good trend. When I started practicing law, most large corporations did not. Most large corporations had very skeleton, if any, internal lawyers. They relied on outside law firms. And I think it is a healthy trend in the main. But one of the problems is that you now get people who are in there for a very long period of time, and you do not get anybody in there auditing them. The general counsels hire the lawyers. The lawyers want to please the general counsel, because the general counsel is the person that gives the lawyers business. Now part of the answer may be to have a committee on the board that is able to hire law firms, is able to meet separately with law firms, and is able to develop a relationship with outside law firms akin to relationship that the audit committee has with outside auditors.

What you need to have is some mechanism by which the board has a supervisory check on what is happening from the legal standpoint. Probably five years ago, certainly ten years ago, I think most lawyers would have said you do not really need that, because CEO's may move on, CFO's may move on, and the managers of the businesses may move on, but lawyers have integrity. And, you can count on the general counsel. The general counsel may not be the best lawyer in the world, may not always get everything right, but you can count on the general counsel to have integrity. I think one of the lessons we have learned from the last several scandals, is a lesson that we relearn every thirty years, which is, that despite our best efforts to make law a unique profession, we have not completely succeeded. The mere fact that somebody has a law degree, and is in a legal position, does not necessarily insulate them from all the kinds of pressures that lead these people to do improper things. So I think that we are a little less willing now—I think society is a little less willing now—to say that the board doesn't need the same kind of oversight of its internal lawyers as it does its internal auditors. One of the things that we have seen is we have seen lawyers not doing their job. We have seen lawyers not reporting on the illegal conduct of others. We have also seen lawyers engaging in improper conduct themselves. And so, I think one of the challenges facing us is how to deal with this phenomenon.

[Student: Interestingly, what the SEC called the qualified legal compliance committees—what the SEC wants boards to consider having in terms of reporting illegal conduct—is a committee of the board that the lawyer would go to, go up the ladder to that committee on the board. If you could expand that legal committee structure somewhat and say they also have to supervise, rotate and hire the general counsel, then it fits right in that committee's structure.]

Yes, it does. What it would do is it would say to the board: You need to do the same thing to your legal function as you do with your auditing



function. And when you think about it, both functions really are designed to find problems, to find and deal with problems. What you are saying is you want to be sure that the board has control over the legal function as well, so that the outside suppliers—be it legal or auditing—think of the *board* as their client.

If you ask a lawyer, “Who is your client?,” the lawyer will always say the company. But, in fact, an awful lot of lawyers think of their client as the person who hires them and the person who is going to hire them next time. And an awful lot of lawyers—and particularly in a time in which legal fees are so large and law firms fixed costs get very high—begin to think about marketing, as well as practicing law. You begin to think not how am I going to serve this client, but how am I going to make sure that I’ve got a client next year. And those kinds of business pressures can lead you in both subtle and non-subtle ways to begin to think of the person who is hiring you and paying you as the person that you want to please. That person historically has not been the board of directors. Indeed most general counsels are a little uncomfortable having outside lawyers actually talk to the board of directors. They want to be the filter. They want to receive all this advice, figure out what to do, and then present it to the board of directors. That is a natural human desire. Most people like control of their lives. So it is not at all unusual, if that is the way they want to operate. And typically, they want to operate like that for entirely legitimate reasons. Not that they want to cover up something; they just want to make their lives easier. They want to go in, they want to figure out what to do, they want to tell the board of directors and they want the board of directors to understand or ask a few questions, but they don’t want to have conflicting points of view presented. And in the standard case, the only cost of that is maybe the board doesn’t get the best advice possible. But in the Tyco or Enron or WorldCom situations, the result is the board is not getting essential information. So, I think the first step is to deal with the auditors. And I think the second step is to deal with the legal function. And that is to make the outside law firms responsive to the board of directors and to make the board of directors know who those lawyers are, have an opportunity to meet with them and make decisions as to hiring and firing.

It would be a very different world. It would be a much less comfortable world. It would be a much less comfortable world both for the general counsel and for the lawyers. In the present environment a law firm develops a relationship not only with the general counsel, but with the deputy general counsel, and with the people five or six levels down from the general counsel. And, in a large corporation, inside lawyers three, four, five or six levels down from general counsel have the capacity to assign a lot of business. So they become your client. What happens is you have very interrelated and

tight relationships after a few years between the law firm and these inside lawyers, and none of that relationship is with the board of directors. It is very comfortable, because you have got a continuous stream of work coming in. And, I think that the client gets better service because of that kind of continuing relationship. I think there are many advantages to that. The problem is that you need to have some mechanism for bringing that back to the board of directors—bringing back the fact that you are representing the shareholders of the companies, not the people who hired you. You are being paid by one person, but your real obligation, as a lawyer, is to serve other people. In most cases, the interests of the people who are paying you are the same as the interests of the people you are serving. But there are enough cases where that is not so that there needs to be some improved mechanism to deal with that. One of the ways the SEC is moving—and I think a lot of people in the legislature are moving—is to try to impose on lawyers some of the same obligations to come forward with things they find out in the securities area that the auditors have. If an auditor finds something, the auditor has an obligation—there’s no auditor/client privilege—to make that public. What a lot of people are saying is that lawyers when they find something illegal in the securities area, they ought to have the same kind of obligation to come forward. How many of you think that would be a good rule? How many of you think that lawyers should have the same obligation in effect as auditors? That is, if they find something illegal that is going on in the company, they go to the head of the company they say you are breaking the law, you have got to stop; now, if the company says no we are not going to stop, what obligation, if any, should the lawyer have at that point?

[Student: I think they should have an obligation, but I wonder in that regard shouldn’t the organized bar be doing more that perhaps it is doing at the present time? Shouldn’t the bar enunciate standards of professional conduct that would establish a minimum platform of responsibility that lawyers would know from the start, from the get go, that would be imposed upon them if they served as corporate counsel or in one of those situations?]

I think they should, and I think they should for two reasons. One, I think they should because I think it’s the right thing to do. Because I think the profession needs that kind of guidance, and I think the profession needs those kinds of standards. The second thing is because if the profession does not do it themselves, at some point the SEC or the legislature is going to do it. We very much value, and I personally very much value, the attorney/client privilege. I believe the attorney/client privilege serves very important public purposes. However, society is not going to be prepared to have the attorney/client privilege be an absolute bar to the revelation of illegal conduct when you are hired to represent the company in their ongoing affairs. It is one thing to say if you are a criminal defense lawyer you ought to

be able to have completely candid conversations with your client, and they ought to be able to tell you whatever it is and you can't repeat it. But it is another thing to say that a lawyer, be it an inside lawyer or an outside lawyer, whose function is, in part, to advise the company as to illegal conduct—what's legal and what's illegal—who finds illegal conduct and advises against it, and the company just continues to do what it has been doing all along, that there is not some kind of obligation to come forward. Again, I think the great difficulty is going to be where to draw those lines.

[Student: Do you think there would be a need for the attorney to be a whistleblower?]

The proposal has been for what is called noisy withdrawal, which is that if a lawyer finds a client is breaking the law, the lawyer has the obligation first to try to take it up the chain and then if the board ultimately fails to stop the activity for the lawyer to withdraw and to withdraw with some kind of statement, although not specific about what the lawyer found. Nevertheless, it is a red flag to something wrong going on. I suspect that some kind of noisy withdrawal kind of rule unless somebody comes up with something better is reasonably possible. As I said, I think people in this round have focused more on the auditors than on the lawyers. I think that that is, in part, because of the Arthur Anderson prosecution. I think it is, in part, because of the function of the auditors and in part because lawyers still have a reservoir of respect in the community. But I think that as time goes on and people understand more and more of the multiple roles lawyers play in a corporation, there is going to be more and more pressure imposed on lawyers to face some kind of obligation when they find illegal conduct.

[Student: Do you think that it is realistic for an attorney involved in a noisy withdrawal in a real setting to still feel that she can possibly get a job again?]

I think that it depends in large part on how accepted that responsibility is. If that is a very accepted responsibility, one of two things will happen. Either there will be a lot of noisy withdrawals, in which case a lot of lawyers are in that same position or there will be only a very, very few, and the impression, I think, will be that it was a problem with that particular client, not with the lawyer. I think that there is also a sense that if a lawyer makes a noisy withdrawal and it later turns out that the company was actually violating the law in a serious way, I think that lawyer and the law firm gains a certain amount in terms of credibility. What boards are interested in—and this gets back to what we talked about before in terms of how much control you give the board or directors—is having credibility and integrity on the part of their advisors, both in their auditor advisors and their legal advisors. Now, management is probably interested in that and also probably interested in a more quiet life. They don't want lawyers who are going to be causing prob-

lem. But even many managers are going to place the quality of integrity very, very high in their selection of counsel. And I think one of the reasons that our firm was hired by Tyco was because they knew we would give them a very candid and complete report. We were not going to airbrush anything out. I think one of the reasons why when we go to court judges will listen is because I think we go in with that level of credibility. So I think there are advantages and disadvantages for the law firm. But it is never easy, I mean because even though other people may hire you, you nonetheless just lost a big client, and big clients are important. Every large law firm has large fixed costs; they are paying a lot of money to lawyers that are fixed, they pay a lot of money for rent, for computers, and the way a partnership works is you don't have any retained earnings, so every year you pay out all your money to the partners. So you don't have the kind of cushion of retained earnings that large corporations have. That puts a lot of pressure—economic pressure—on not losing clients, which is why standards have to be widespread, they have to be enforced and they have to be well respected. That is why I think it goes with what you suggested earlier—that having the bar do it is by far the best way to do it. That is the way to get the broadest range of acceptance. I think having rules imposed from the outside is bad, not only because you may get told by people who know less about the profession and the rules may consequently be less effective and more obtrusive than they need to be, but also I think it garners less respect within the profession.

[Student: Why didn't Sarbanes-Oxley require the noisy withdrawal—or more—from the lawyers?]

One of the problems with Sarbanes-Oxley is that a lot of the people who were supporting Sarbanes-Oxley wanted to write into Sarbanes-Oxley the noisy withdrawal, and the legal profession did a good job of killing that. In part because there was a lot of time pressure to get something enacted and the feeling was that the noisy withdrawal issues could be handled later. You now have the SEC approaching it from an administrative standpoint. I believe that you will see Congress revisit it when it has got a little more time to do that and doesn't have the time pressure of having to get something enacted. I think that there's a sense in which Sarbanes-Oxley in this respect stepped back. I think you are going to see this revisited in the legislature. The best way for the legal profession to keep control of this would be to be proactive and to come up with some kind of procedure, mechanism and standard that everybody would support. If you don't do that, then I think you are going to see that handled by Congress, and if it is not handled by Congress, then it is going to be handled by the SEC. I think the SEC does a very good job of enforcing the securities laws. I do not think that the SEC is the right body to be determining what the legal standards are. So, I really think we are

much better off in following this as a profession than we are forcing the government to impose rules.

If we assume the lawyer will have some sort of obligation, the question then is when should that obligation take effect? In other words, what is the trigger, what is the standard that triggers that obligation? Putting aside the procedure of how you go up the ladder, what is the substantive trigger? For example, if you find out that the chief executive officer, chief financial officer, and general counsel are just stealing money out of the till and you tell them to stop, and they say they're not going to stop, then that's pretty easy. But suppose what you do is you say I think that these reserves that you are setting up are not appropriate. And they say we think these are entirely appropriate and in fact they produce a general counsel who says yes, these are entirely appropriate. How convinced do you have to be that it is a violation of law and how objectively clear does that violation have to be before you decide to do something. Suppose you are the outside lawyers—not someone brought in to do an internal investigation. Rather, suppose this is just the normal client of mine, and in the course of representing them and defending a securities lawsuit, I see a number of reserves that they have set up, and I conclude that those reserves were improperly set up. I conclude that there is no basis for setting them up. Suppose further that what they are doing is they are drawing down those reserves the last five days of every quarter to make their earnings numbers. And I say those are improper reserves, you are violating the securities laws by doing this, and misleading investors. You need to disclose this. You need to stop. And they say no, we think these are entirely appropriate reserves. We think the reserves were set up for legitimate purposes. We think the draw downs are okay. Yes we draw them down at the end of the quarter, but we can draw them down anytime, and if it's appropriate draw down it does not make any difference when it takes place. And then they go out and go to another law firm and get an opinion from the other firm saying those reserves are entirely appropriate. Now do I have any obligation?

[Student: What if you don't believe the other law firm is right? What if you don't think the firm's opinion is well reasoned?

The difficulty is that if you get another respected law firm that gives you a contrary opinion, what are the circumstances, if any, in which objectively it would be not unreasonable to conclude that there is a problem. For me, I think that once you conclude on a subjective level that what your client is doing is illegal, then I think that you have got an obligation to do something—an obligation at a minimum of withdrawal. Whether it has to be a noisy withdrawal at that point, I'm still trying to figure that out. How much of that should be a subjective test, how much of that should be an objective test? Obviously, there are some lawyers who are convinced that when they

are right, they are right, and nobody else can change their mind. But is that enough to subject a client to a noisy withdrawal? I think what you need is both sort of subjective determination that this is something that the client should not be doing, and you need to be sure that you are being reasonable in that position. The “it is not unreasonable” standard is confusing. What I think is if you conclude that your client is doing something illegal and won’t stop and you conclude that your position is reasonable, that is that you are not just being pigheaded, but you really think that this true, I think then you have got an obligation to withdraw and probably ought to have some obligation to at least raise the issue. Remember you are not indicting the company. You are not the prosecutor. All you are doing is raising a red flag.

[Student: This sounds similar to the due diligence standard of both a reasonable—objective—belief and a subjective belief; is it similar?]

It is exactly that approach, and it borrows from what we deal with all the time in terms of due diligence. What it does is it imposes on the lawyer in this context the kind obligation that would be imposed on anybody, lawyer or non-lawyer, doing due diligence.

[Student: Shouldn’t the lawyer just go back to his or her firm and speak to his partners and get their take on what they think? Wouldn’t that minimize subjecting the company to an unreasonable—subjective—noisy withdrawal?]

I think that a lawyer of this context ought to and really has an obligation both to his firm, as well as to the client, to go to his partners and say, look, this is the dilemma I’m in. Remember these things don’t happen every day. Fundamentally, American corporations, 99% of the time, try to do what is lawful. They don’t necessarily always try to do what is right, but they do try to do what is lawful. And so the occasional times that you have to go to your client and say this isn’t proper and it shouldn’t be done, they will take that very seriously in my experience. So the number of times where you really have this kind of conflict is a fraction of 1% of your practice; and it’s a big deal. You are going to go back and talk to your partners and think about it, worry about it. When a lawyer concludes that their client is violating the law, and they have got to do something about it, this is a very, very big step after a lot of consultations. And, I think that is a lot of protection. You are not going to have a lot of lawyers running around accusing their clients without care. There are too many economic disincentives for doing that. This is going to be where the bar is already set very high, which gives me a lot of comfort to know that there is going to be a very limited intrusion into what I think of as the privilege arena—the frontiers of privilege protection. It is something this is not going to necessarily intrude very far.

[Student: Do you think that with this rule that the company can say okay, we are breaking the law, we didn’t know that and we will stop, and

then the company will just go to another law firm for the opinion it wants? We have read in our articles that it is often not just one firm doing all the deals. One firm does one part then another firm does another and put together it is illegal. Should this all go back to the board of directors?]

I think that is exactly the answer to your question. That is why it is so important to have—on issues like this—the board of directors involved. The danger is that a lawyer goes to the general counsel and says there is a problem, and the general counsel says don't worry about it, we are going to fix it. Then, that lawyer just doesn't get called again. However, if you've got that board of directors level, that is not likely to happen. Remember that the board of directors has less incentive to cover up illegal conduct than the management does. As long as the board acts properly to reveal it, the board isn't losing their job, and they are protecting the shareholders' interests. So it comes back to the board. It brings us back full circle. You know because the theme of this all centers on the fact that the culture has to start with the board. Enforcement within the company has to start with the board. The board has to have the mechanisms to do it. In short, what we are really talking about is how you implement that.