

# The Enron Debacle - A Primer For NY Lawyers

BY MARY C. DALY

**T**he collapse of the Enron Corporation and the indictment of Arthur Andersen have generated a great deal of communal soul searching about how to establish and maintain an ethical environment in a large business organization. In the public debate and critical appraisal, less attention has been paid to the role of lawyers than to the roles of management or the company's accountants. This article examines the ethical responsibilities of a lawyer who learns of a corporate client's wrongdoing, identifies the three characteristics most commonly found in ethically challenged organizations, and suggests measures that a lawyer can take to foster ethical behavior within a client organization.

The touchstone for all discussion of a New York lawyer's ethical obligations in representing a corporate client is DR 5-109 of the New York Lawyer's Code of Professional Responsibility (Code). It is a fundamental principle of the law of business organizations that a corporation has an independent juridical existence and is separate from its constituents, including its officers, directors, and shareholders. Subsection A. of DR 5-109 incorporates this principle directly into the Code by providing "the lawyer is the lawyer for the organization and not for any of the constituents." It specifically places an ethical obligation on a lawyer to bring this distinction to the constituent's attention if "it appears that the organization's interests may differ from those of the constituents with whom the lawyer is dealing."

## **Beware of "off limits" constituents**

While these precepts are straightforward, acting on them can be difficult, particularly in a corporate environment in which certain key players are supposedly "off limits" and not subject to the same oversight as other employees. Their virtual autonomy often corresponds to the magnitude of their contribution to the organization's fiscal well-being. In the Salomon Brothers' scandal of the early 1990's, for example, the reluctance of the organization's high-level management and its general counsel to investigate a rogue trader's clear wrongdoing could be partially traced to the trader's extraordinary success in generating revenue for the firm. *In the Matter of Gutfreund, Strauss & Meriweather*, Exchange Act Release No. 34-31554 (1992). In other scandals, the "off limits" constituent was the individual who founded the organization and nurtured its growth from a small family-owned entity to a large publicly traded company. *E.g., In re Carter & Johnson*, Exchange Act Release No. 34-17597 (1981); *In Re OPM*, Report of the Trustee Concerning Fraud, etc. (S.D.N.Y., April 25, 1983).

Not all corporate wrongdoing triggers the application of DR 5-109. Two threshold conditions must exist. First, there must be "a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization . . . ." Falling within these two categories respectively are: (1) actions that would constitute a breach of a fiduciary duty, such as usurpation of a corporate opportunity; and (2) actions that would transgress legal obligations, such as noncompliance with environmental and securities laws.

Second, the violation must be "likely to result in substantial injury to the organization." Determining substantial injury is often a more subjective exercise than determining the existence of either of the conditions described above. For example, a \$100,000 fine imposed by a regulatory agency may bankrupt a small business, but it will have no appreciable impact on a Fortune 500 company.

### **The lawyer's options**

If the threshold conditions are found to exist, DR 5-109 requires corporate counsel to "proceed as is reasonably necessary in the best interest of the organization." Among the measures Subsection B. of the Rule suggests are urging reconsideration of the matter, seeking a second opinion, and referring the matter to a higher authority in the organization. If unsuccessful in persuading the corporate client to conform its conduct to the law, the lawyer "may resign," but is not obligated to do so. Of course, if the lawyer's continued representation in the matter will assist the client in illegal or fraudulent conduct, the lawyer must carefully consider whether she is required to withdraw from the representation. See DRs 2-110 & 5-109(C). DR 2-110 defines the circumstances which distinguish permissive withdrawal from mandatory withdrawal. For example, if a lawyer learns that her client, a purchaser of real estate, intends to make the seller "an under-the-table" payment of money in order avoid taxes on the transaction, the lawyer, after remonstrating with the client, must withdraw from the representation and not assist in the closing. N.Y.C. Op. 1994-8 (1994). Though DR 2-110(B) requires the lawyer to withdraw when continued employment will result in her violation of the Disciplinary Rules, DRs 4-101 and 7-102(B) restrict her ability to disclose the client's wrongdoing to anyone outside the organization, including regulators and third-parties who may be injured by the client's conduct. *Id.*

Violations of the law are rarely carried out in broad day light. Often, a lawyer will have only a suspicion of wrongdoing. In these circumstances, there is a natural tendency not to look too hard at the questionable conduct. This is especially true if the actor falls into one of the "off limits" categories - star salesman, company principal or chief executive, personal friend, etc.

When must a lawyer act on her suspicions and advocate investigation of the possibility of wrongdoing? The answer to this question lies along a continuum of possible circumstances. At one end is the vague rumor of wrongdoing that reaches the lawyer's desk in some casual reference by an employee or officer of the company. At the other end are the inexorable signs that something is seriously amiss (*e.g.*, borrowings by a corporate principal not properly reflected on the company's books). One practical solution to the dilemma facing the lawyer who's not sure where the evidence falls on the continuum is to borrow from the disinterested lawyer standard in DRs 5-101 and 5-105 (*i.e.*, what would another disinterested and independent lawyer be likely to do under the same circumstances?). If the lawyer is still not sure how to act, she may resort to the second option in DR 5-109(B) (*i.e.*, "advising that a second legal opinion on the matter be sought for presentation to the appropriate authority in the organization"). So long as the perplexed corporate counsel preserves the secrets and confidences of her client, it is entirely appropriate for her to seek outside guidance on how she should proceed. *See generally* ABA Formal Op. 98-411 (1998).

### **Lessons from the past**

An examination of some of the corporate scandals in the 1970's, 1980's, and 1990's that raised serious questions about lawyers' ethical obligations can also help to identify the tell-tale circumstances that often

surround a corporate client's wrongful conduct. Identifying these circumstances will help the lawyer to determine the appropriate ethical response to conduct along the continuum. The lessons of the scandals are as simple as "A, B, and C:"

"A" stands for corporate abundance. When things are going well, when the business is making money, when profits are high, when bonuses for corporate employees are large, and when the gatekeeper accountants and lawyers are getting paid their fees on time and with little challenge by the client, ethical concerns are often not high on anyone's list - not the company's, not the accountant's, and not the lawyer's. The ethical sensibilities of both the company and its gatekeepers will be dulled when they are called upon to supply imaginative, "creative" solutions to new problems, such as special purpose entities. On the flip side, when abundance begins to evaporate, when the client is having trouble meeting its revenue projections, when sales are down, and when creditors are not being paid on time, clients are more likely to "cook the books." Among the most popular devices are parking goods or services with friendly purchasers and creating documents reflecting phony sales.

"B" stands for "boosterism." Among the facts that stand out in the pantheon of corporate scandals is the pride that the organizations took in their financial prowess and good corporate citizenship. The principals in OPM, for example, were the subject of highly complimentary articles in leading business magazines; so was Charles Keating of S&L infamy. The business communities lionized these men for their financial acumen. The leaders of these ethically-challenged businesses and the businesses themselves often contributed generously to local charities and fine arts initiatives. On the surface, their corporate citizenship was impeccable.

The danger of boosterism is, of course, that at some point the dominant officials in these organizations will begin to believe in their infallibility. They lose a sense of responsibility to the rules imposed by ordinary mortals. There are no moral standards to guide them through the maze of acceptable conduct because they are convinced of their own superior virtue. Boosterism discourages dissent by employees, lawyers, accountants, and even the media.

"C" stands for the culture of excessive corporate closeness. An adequate degree of distance from the corporate client is absolutely essential to the proper performance of a lawyer's gatekeeper function. Distance from influence is essential if the lawyer is to preserve her independent professional judgment. That judgment can be compromised by both financial and relational ties, especially to the officers and to management. A law firm should monitor carefully the percentage of the firm's income that is attributable to each major client. Too great a dependence on a single client will make it difficult for the firm to give the advice that the client clearly does not want to hear. It will also make a firm's decision to withdraw from the representation much harder. These influences also hold true if a law firm has an ownership interest in the organization or if the compensation of in-house lawyers is tied to the organization's profitability.

### **Avoid compromising personalities**

Relational ties can also compromise a lawyer's independent professional judgment. If a corporate client regularly hires its general counsel from the ranks of the lawyers in a particular outside law firm and/or the general counsel hires in-house lawyers from her prior law firm, an unhealthy degree of closeness can

arise that blocks from the lawyer's consciousness signs that something is significantly amiss and needs to be investigated thoroughly.

When SEC Chairman Pitt testified before Congress, he opined that the government could not easily "legislate integrity or ethics." While there is a certain truth to this observation, his statement is far too despairing of a potential solution. It disregards a significant volume of learning that guides us in establishing and maintaining ethical business organizations. In a post-Andersen and post-Enron world, many organizational clients are asking their lawyers to take a hard look at how the organizations promote integrity and ethics. There is a growing body of legal and human resources literature that focuses on compliance programs, ethics manuals, and other responses for encouraging high- principled behavior and limiting and detecting wrongdoing.

The most important single lesson that a lawyer can learn from this literature and communicate to her client is that ethical behavior is taught from the top down. It is management's commitment to ethical standards that sets the tone. No matter how well written a company's code of conduct may be, no matter how elaborate the compliance program is, employees will ignore them unless they are certain that management fully supports - and complies with - the principles they express. Enron had a perfectly persuasive Code of Ethics. It recited piously: "we are responsible for conducting business affairs of the Company in accordance with all applicable laws and in a moral and honest manner." The obvious problem was that no one took the Code seriously.

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