Restoring Trust in American Business

Edited by Jay W. Lorsch, Leslie Berlowitz, and Andy Zelleke

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Content

Chapter 7

Professional Independence and the Corporate Lawyer

WILLIAM T. ALLEN AND GEOFFREY MILLER

Quickly following the shock and anger engendered by the collapse of the Enron Corporation came the accusations. Directed principally to the senior officers and auditors of the company, the accusations rippled out: "Where was the board?" "Where was the SEC?" As famously put by Judge Stanley Sporkin years earlier, when confronted with the evidence that Charles Keating had operated Lincoln Savings & Loan as a massive fraud, "Where were the lawyers?"

The charge against Enron's auditor was easy to grasp: Arthur Andersen's independence appeared to have been fatally infected, both by the huge audit fee that Enron generated and by the steady and substantial flow of nonaudit services. The auditor was seduced into complicity by large fees. Independence is the *sine qua non* of a public auditor, and when it is gone, the utility of the auditor's service dissipates.

Lawyers are different, and that difference has spared them from much of the criticism that has been directed at auditors. The core duty of a lawyer runs not to the public or to public markets but to the lawyer's client. The conception of the lawyer that dominates all others is that of the "zealous advocate." Under this ideal of undivided loyalty, the attorney is bound to defend the client with every legitimate means at his disposal. This conception of a lawyer's duty has powerfully beneficial social effects.

We value these benefits most keenly in the setting of a criminal prosecution. There the power of the state is arrayed against a single individual, and the liberty or even the life of that single person may stand in the balance. The ideal of pure and energetic loyalty originates with the lawyer in his role of defender of those under attack. As zealous advocates, lawyers are viewed in their most romantic and selfless state (John Adams defending British soldiers for acts at Bunker Hill; the heroic lawyers who stood against racial and ethnic prejudice in the Scottsboro Boys trial, or in the defense of the ill-fated Leo Franks).

But the mentality of the zealous advocate that inspires our admiration in some settings can lead to unprofessional conduct in others. In the litigation setting, the lawyer's imaginative arguments will be tested in a process that provides a range of counterbalances, from the discovery processes and cross-examination to informed counterarguments before a disinterested and expert arbiter. Removed from these safeguards and inserted into the process of the corporate lawyer in advising about prospective actions, this mentality can prove damaging to lawyer and client alike. To be sure, in giving such advice, lawyers are under an ethical constraint. An attorney may assist a client in carrying out a course of action that skirts the edge of the permissible only so long as the attorney believes in good faith that the action is, in fact, legally valid and the client is aware of the legal risks. The effectiveness of this restraint, however, depends largely upon the business lawyer's own willingness to make it effective. Therefore, the conditions under which the business lawyer practices are highly relevant to the profession's ability and willingness to act as a constraint on corporate clients' assuming unreasonable degrees of legal risk. There is good reason to believe that under the profession's present circumstances, busi-

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ness lawyers—those who represented Enron, Worldcom, Tyco, HealthSouth, and their banks—have been forced by circumstances and the zeitgeist to take the narrowest possible zealous advocate view of their duty to the law itself.

We suggest that the evolution of the legal profession over the last half century—from what we call a "club" form to a "market" form of organization—has produced conditions that have (1) atrophied the profession's acknowledgment of a duty to respect the discernible spirit animating the positive law (for this is one way we articulate the duty of good faith) and (2) reduced the leverage of practicing lawyers to influence their clients' willingness to assume unreasonable legal risks. In this summary of a longer piece in process, we outline the changes in the environment that have produced these effects and suggest a few governance modifications, both in corporate clients' governance and in law firm organization, that may restore a bit of the lost ability of business lawyers to act with professional independence. It should be stated, however, that we do not intend for our generalizations concerning the effects of a changing environment on business lawyers' incentives to be understood as a charge against the moral character of business lawyers as a class.

FROM THE CLUB FORM OF ORGANIZATION TO MARKET COMPETITION

Subject to many qualifications to be treated elsewhere, we suggest that the club form of organization displays the following general features. First, significant social and legal barriers to entry produce a profession that is exclusive. Second, members often maintain social associations with one another and with clients outside their business relations. Third, competition is minimized, and when it occurs it is constrained by norms of politeness and courtesy. Fourth, the profession is marked by stable employment with little lateral mobility. Fifth, relations between lawyers and clients tend to be institutional and thus stable over time. Lastly, compensation for services is fixed in a flexible, not a mechanical, way (such as hours expended times a set hourly fee). If we imag-

ine the legal profession circa 1950, it is easy to see each of these features of the club form of organization.

A critical feature of this world was the absence of a strongly competitive market for legal services. In this stable world, law firms had both economic and social levers to influence or constrain clients (or, more accurately, the officers who represented corporate clients). Economically, the deep knowledge that each law firm had concerning its client's business gave to each counseling firm a certain degree of market power vis-à-vis its client. Replacement would be cumbersome and costly. Socially, each officer of the firm, including the CEO, had had relations with the firm's lawyers for a significant period, starting in his training and junior years. In these relationships, dignity, respect, and trust were developed. Lawyers were not outside providers of commodity services. Of course, both of these sources of power could be used to extract economic rents, but they could also be used, if necessary, as a source of leverage in constraining a corporate officer who was willing to take excessive legal risk.

If we compare the characteristics of elite legal representation in the 1950s with the situation today, we observe a dramatic contrast in nearly all the elements that we have identified. The general paradigm for corporate practice has evolved from a club form of organization to a competitive form. From the huge growth in the number of lawyers (owing to a range of factors beyond the scope of this summary), to the removal of legal constraints on competition, to the emergence of national and international firms that engage in active marketing of services, the world of lawyers in private practice now looks radically different. Restraints on mobility have eased. Today it is not uncommon for attorneys to move from firm to firm several times during a career, sometimes taking clients with them.

Almost certainly, the most significant development respecting the ability of business lawyers to exercise constraining force on clients comes from the rationalization of the legal function within client firms and the development of large internal law departments. In a sense, the mission of the internal law department is to destroy the social and economic base that permitted outside

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counsel both to extract economic rents and to exercise useful constraint on aggressive corporate officers or employees. Internal law departments have this effect in a number of ways. First, lawyers (henceforth "outside" counsel) will be less likely to develop informal relations and the degree of trust and familiarity with senior officers that arose naturally under the prior system. (These relations may be replaced by inside lawyers, of course, but as we note below, these lawyers are structurally far less likely to constrain aggressive risk taking). Second, the informational advantage of counsel is diminished through a program of "spreading the work." This may arise as a method to control costs. Specialist firms and beauty contests appear. Because the charge is to monitor costs, corporate clients grow more price-sensitive and begin to demand closer supervision of charges for services. Competitive bidding for legal work comes onto the scene.

The evolution in the patterns within which business lawyers practice their profession has reduced their practical power to influence the conduct of their clients and has reduced, as well, their incentives to do so. The first result is a natural outgrowth of more competitive markets and is not the only effect of this change. In our longer paper, we will discuss how lawyers in the current environment may have less access to client information, may lack economic incentives to restrain clients or monitor others in the firm, and often face clients (officers and employees) with stronger incentives to "play for the sidelines" rather than "center court." The development of all of these points must await a fuller discussion.

CORPORATE LAWYERS' DUTY OF INDEPENDENCE

The foregoing points out some of the ways in which business lawyers and others who facilitate the design and effectuation of corporate transactions and disclosure have become less independent of their clients. This erosion in the external protections from client control and pressure can be expected to reduce the capacity and the willingness of corporate lawyers to act as an unwelcome constraint on the activities initiated by clients' officers. Such

lawyers will tend, more likely, to comply with clients' wishes. Some may ask, "What is wrong with compliant lawyers, so long as they do not facilitate law breaking?" Ah, therein lies the rub. In a world in which all legal commands were unambiguous and all clients were motivated to obey the law, being a compliant lawyer would be an unalloyed virtue. But real life is complicated both by pervasive ambiguity in legal standards and by the existence of clients (or managing agents of clients) who sometimes seek to graze on pastures intended by lawmakers to be fenced off. In this world, a compliant lawyer can be an instrument of social injury. Thus, it is important that business lawyers recognize that the duty energetically to facilitate a client's lawful wishes must be supplemented with a duty, to the law itself, of independence. This is a duty to exercise independent (good faith) judgment concerning whether a proposed action falls within the law. We suggest that in representing clients in negotiating or structuring transactions, or in otherwise assisting clients in their ongoing efforts to do business within the law, lawyers are obliged to strive to advance, and not to thwart, the discernible spirit animating the law. The existence of an obligation to advance the discernible spirit that animates the law may seem controversial in some contexts. We leave for another day, or for other voices, the question of the duty of the lawyer conducting formal adversary proceedings, civil or criminal.

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STRENGTHENING THE PROFESSIONAL INDEPENDENCE OF CORPORATE LAWYERS: GOVERNANCE CONSIDERATIONS

The Role of the General Counsel

Corporations are the primary clients of corporate lawyers, and for most engagements a member of the internal legal team is the

agent representing the client to the lawyer. Earlier, we cited the growth of large in-house legal departments as one of the signal developments that has reduced the leverage of private lawyers. The critical role played by inside lawyers today makes the incentives and controls of the inside general counsel and his or her staff highly salient to a consideration of the incentives facing practicing business lawyers.

In thinking about ways to enlist general counsel and internal lawyers in an effort to provide corporations with independent legal advice from outside corporate lawyers, we focus on three features of the general counsel's office: first, on the hiring, firing, and reporting process with respect to the general counsel personally; second, on the system of compensation of in-house lawyers; and, lastly, on the conception of the job. Slightly modifying existing practices along these lines would help to align the incentives of all general counsel with the long-term corporate interests of their firms, which we believe would, on balance, reduce excessive legal risk taking. Such general counsel would more likely adopt the norm that sees lawyers as agents seeking the realization of the spirit of the law.

Hiring, Firing, and Reporting of the General Counsel. Corporate governance principles and practices have not sufficiently focused on the critical role of the general counsel in assuring the corporation's compliance with law. Such attention would be less necessary in a world in which senior management of the enterprise had interests that were perfectly compatible with the long-term interests of the corporation. In fact, it is quite difficult to create management incentives that perfectly align these interests. Ordinarily, the CEO has incentives that are either oriented excessively toward risk avoidance (because his or her valuable human capital is invested solely in his or her employer) or oriented to excessive risk preference (due to substantial incentive compensation in the form of options that are more valuable the more volatile the stock, short of bankruptcy). This is, of course, a problem that can most effectively be dealt with through better design of incentive compensation programs. But for technical as well as political reasons, this is a difficult thing to do. In recent

years, the dominant problem with senior management incentives appears to have been aggressive option compensation programs that created incentives for excessive risk taking or financial statement manipulation. Directors, on the other hand, rarely have significant incentive compensation. Thus, they have little or no economic interest in either taking on excessively risky projects or manipulating financial statements to pump up the stock price. From the point of view of incentives, the board is the better situated agency to assess risk policies of the firm. But boards have less relevant information than does the management team, usually less expertise, and certainly less time to evaluate courses of action.

As we focus our attention on the governance of legal risk, we see the same pattern. Senior management (when incented with options) has a greater incentive than the independent members of the board to allow financial statement "spin" or to "aggressively" manage earnings. Famously, in the late 1990s those incentives, coupled with dependent auditors infused with an advocacy mentality, produced massive manipulation. Congress's answer was to force boards to be more engaged and to try to shore up the independence of the professional advisors. A similar response is appropriate with respect to a risk of noncompliance with regulatory law.

While there are obvious and important differences, in some respects the general counsel can be analogized to the independent auditor. Every board of directors has a duty to exercise reasonable care to see that the corporation complies with the law.[1] The board may rely upon the CEO to assure compliance, but that reliance must be reasonable.[2] In our opinion, recognizing the inevitable imperfections in the incentive system facing the CEO, and the importance to the corporation that it take reasonable steps to be in compliance with the law, it ought not to be deemed satisfactory for the board to permit a CEO to act as its sole or primary channel of communication with the general

[1] *In re Caremark International, Inc. Derivative Litigation*, 698 A. 2d 959 (Del. Ch. 1996).
[2] See, e.g., 8 Del. C. Sec. 141.

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counsel. Thus, direct contact and reporting from the corporation's chief legal officer is one way the board can show that it was appropriately active and informed in meeting this duty. An appropriate committee of the board should supervise the relationship between the general counsel and the corporation. This would entail being involved in hiring and firing decisions (e.g., conducting exit interviews) and exercising prudent oversight by direct, periodic communication with the general counsel. The appropriate board committee or lead director should insist upon direct and private access to the corporation's general counsel at any time and periodically.

Compensation of the General Counsel. Considered from a governance perspective, the corporate general counsel must be considered a lawyer first and a corporate officer second. Unless the general counsel is a competent lawyer, he or she cannot effectively fill the corporate office held. It is therefore the essence of the position that the general counsel exercise (or supervise an organization of lawyers who can be expected to exercise) legal judgment in a manner that reflects independent expert professional judgment. This is a difficult task, in part because inevitably the general counsel is a member of the management "team," and the familiar human instinct to cooperate will be felt by inside lawyers. This instinct, however, is often exacerbated by inclusion of the general counsel in option compensation programs. For this reason, it is unwise, in our judgment, to include general counsel in option compensation programs. Restricted stock grants are less problematic than options. *Ex post* bonus payments tied to measures unrelated to stock price would form a safer way to compensate unusually good performance, and would protect the general counsel to some extent from pressure to approve legally marginal strategies. Boards should impress on the general counsel his or her role as an independent force in the organization, responsive toward the corporate goals and plans determined by others, but responsible for law compliance to the board and his or her own independent professional judgment.

Conception of the General Counsel's Task. The board of directors should define the general counsel's charge, or pass upon the

CEO's charge to the general counsel. Of course, included within that charge should be the management of the corporation's costs of legal representation, but that ought not to be the central focus of the charge. Rather, the core responsibility of the inside legal department should be seen as providing reasonable assurance that the corporation is complying with applicable law, that its assets are appropriately protected, and that its rights are appropriately defended. Because of a series of dramatic events (moving at least from the Salomon Brothers treasury trading scandal through the charges of complicity in Enron's financial duplicity brought against Citigroup and J. P. Morgan Chase), the role of general counsel in financial institutions is coming to reflect a conception of the general counsel's mission in which supervising the firm's use of legal services is subsidiary to the overarching responsibility of assuring legal compliance with regulatory law and disclosure. Surely, the economical provision of these functions is an important feature of the general counsel's task; but just as the reduction of the independent auditor's fee is not the main mission of the audit committee, the general counsel's responsibilities extend far beyond minimizing the expense of legal counsel.

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These corporate governance matters relate to our topic of lawyer independence in a rather obvious way. To the extent lawyers within firms are protected by boards from pressure to take overly aggressive legal positions when giving prospective legal guidance, there will be reduced pressure on outside corporate lawyers to do so as well.

The Organization of Law Firms

As we noted above, the characteristic setting for corporate lawyers in private practice today is the very large firm, offering a very broad range of legal services, with offices in many cities or countries. We have also noted the evolution of compensation

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structures in such firms. Often these firms must devise a system that attempts to gear compensation to individual productivity, somehow measured. And because the risks of such firms are difficult for individual lawyers to know about and to control, such firms permit individuals to protect themselves by adopting a limited liability structure for their participation.

Incentive Pay for Partners. Productivity-driven compensation always involves the problem of designing the incentives by selecting measures and according weights. When reasonably well designed, these are highly useful organizational tools. But they can never be perfectly designed. The more compensation is determined by some measure of individual productivity, the greater the reduction in the incentive for individuals to engage in activities that do not serve as markers of productivity. Thus, consulting with a partner about a difficult problem, which makes perfect sense when compensation is on a lockstep basis, may under an incentive compensation system look like a waste of time or a gift. It is striking that the modern firms with the greatest earnings per partner engage in little incentive compensation. In giving up some forms of incentives, they gain some measure of team involvement.

Incentive compensation within law firms often has another perverse consequence. As a partner's compensation depends more on his own production, his personal income will become less diversified (i.e., he will become more dependent on his client's fees). The resulting problem is particularly apparent when a lawyer spends most of his time on the work of a particular client. No matter what the firm's compensation practices, that lawyer will be under some additional pressure to keep that client happy. But that pressure will become intense in a system in which his compensation is directly tied in a material way to the fees that the lawyer produces. In that circumstance, given just the average amount of human weakness, such a lawyer's likelihood of trying, where appropriate, to constrain a very aggressive client will be markedly diminished. Incentive pay schemes for law partners are quite complex; in most instances, they risk reducing the professional independence of lawyers.

Limited Liability for Partners. Limited liability for lawyers is a modern innovation that both arises from and facilitates the growth of very large multicity law firms. If a firm is relatively small and located in only one city, monitoring of lawyers by their partners occurs more or less naturally and effectively. But if there are two or more degrees of separation between a partner in New York and a firm lawyer in London or Shanghai, it is quite easy to understand the incentive for partners to adopt a structure for their own participation that limits their vicarious liability. Allowing lawyers to protect their assets in this way, however, also reduces their incentives to see that other lawyers in the firm do not engage in liability-risking behavior. By reducing the incentive to monitor others, this structure in effect increases the risk that lawyers will allow themselves to be driven by client interests and demands to bless transactions or structures that violate the discernible spirit of law when a nonfrivolous account of compliance can be imagined.

Once a limited liability structure is adopted, the incentive for a lawyer to monitor the quality of the legal work of others in his or her office is reduced because he or she will be put at less economic risk by their actions. A lawyer protected by a limited liability structure would, of course, be exposed to loss caused by his own actions; but with respect to liabilities occasioned by the acts of another in the firm, his potential liability would be limited to his interest in the firm's assets. In most cases this will be a substantial and mind-concentrating loss—but it certainly will often be a substantial reduction from the partnership default of joint and several liability for all liabilities.

These are but a few of the concrete reforms that might be implemented to help guard against the risk that lawyers will sacrifice their professional independence in order to serve the short-term goals of high-ranking corporate officers, especially when those goals are at or beyond the line of the legally permissible. A number of other reforms are possible, but space does not permit us to explore them here. We plan to develop these ideas further in later work.

POSTSCRIPT: ON "THE DIS ANIMATING THE LAW"

Central to our notion that, dentiality and zealous advo accept a duty to the integri assertion that that duty ma "the discernible spirit anim (which perhaps still means ing such an obviously deba be highly problematic. Wha a discernible one) is obviou tified. It will often be the s murkiness of this core idea sional self-regulation could

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POSTSCRIPT: ON "THE DISCERNIBLE SPIRIT ANIMATING THE LAW"

Central to our notion that, in addition to their duties of confidentiality and zealous advocacy, lawyers should acknowledge and accept a duty to the integrity of the legal system itself, is the assertion that that duty may be adequately conceived as a duty to "the discernible spirit animating the law." But for legal positivists (which perhaps still means for most of us), the idea of employing such an obviously debatable, if not ephemeral, concept will be highly problematic. What can it mean? A spirit (perhaps even a discernible one) is obviously not something that can be objectified. It will often be the subject of honest debate. Does not the murkiness of this core idea mean that no actual system of professional self-regulation could incorporate such an obligation?

We do not think so. First, this concept is no less coherent than many legal doctrines usefully deployed every day in our legal order (consider "reasonable cause," for example, or "reasonable care"). Second, the search for the animating spirit of positive law (whether in statutes, regulation, or written contract) has long been conventionally understood as the guiding polestar of legal interpretation. Words themselves are imperfect and ambiguous symbols, and the human imagination that shapes them into legal commands is inevitably unable to foresee all of the contexts in which the problem addressed will later arise. Thus, as Learned Hand said many years ago in construing a statute, "There is no surer guide . . . than its purpose when that is sufficiently disclosed; nor any surer mark of oversolicitude for the letter than to wince at carrying out that purpose because the words do not formally quite match with it."[3]

Finally, criticism of the nonobjective nature of the discernible spirit standard would misunderstand the thrust of our suggestion. We do not suggest that business lawyers should be subject to sanction by licensing bodies for failure to counsel a client to comply with the discernible spirit animating applicable law. In this work, at least, we are concerned primarily with a profession-

[3] *Federal Deposit Insurance Corp. v. Tremaine,* 133 F.2d 827, 830 (2d Cir. 1943).

al's *self*-regulation, in the sense of individual professionals internalizing norms of behavior and regulating their conduct in accordance with such norms. In part, it is the power to control one's own actions that gives dignity to those activities that we deign to designate as professional undertakings. Thus, we have in mind a world in which business lawyers, in advising and assisting business clients to plan and accomplish transactions, ask themselves, and honestly answer for themselves, the question, "What is the purpose sought to be achieved by this (apparently ambiguous) regulatory scheme?" When a lawyer can discern with confidence the answer to that question, we suggest that he or she should feel bound by the professional norm of independence to advise the client accordingly and to limit his or her zealous advocacy.

Thus, for us, the fact that individuals—even those not driven by an advocacy mentality—might disagree about whether there is a "discernible spirit animating the law" in a particular setting is not problematic. For it is for individual business lawyers to make this determination and to be guided by it. What is required, in our view, is for the profession to acknowledge that to act in this way is consistent with the highest aspirations of the profession.

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[1] Ron Chernow, *The House of Morgan Modern Finance* (New York: Atlantic

[2] Renee Deger, "Law Professors Led 2, 2002).