

## **Watchdogs or Whistle-Blowers? The Corporate Lawyer as Gate-Keeper.**

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This paper examines the gate-keeping role of financial lawyers. While much literature examines this from a US perspective, it has received less attention elsewhere. This paper considers the UK position. It assesses the arguments advanced for not following the US lead of the Sarbanes-Oxley Act 2002, and legislating for financial lawyers to act as gatekeepers. These included that the UK system of corporate governance was sufficient to avert an Enron, and that there was little evidence of UK lawyers failing in their duty to corporate clients. Such complacency was not warranted and, while little data is available on the role of UK lawyers in recent instances of corporate misfeasance or in the financial crisis, problems are likely to exist. It examines what lessons can be learned from the UK experience of the money laundering legislation, and lawyers' response to it, and what this may indicate about how and how not to regulate lawyers in gate-keeping/whistle-blowing roles. The paper examines proposals for (i) legislating for up-the-line reporting; (ii) extending whistle-blowing obligations.

The paper's structure is as follows:

- A. No Reform Needed- Enron couldn't happen in the UK
- B. Reform would not work: Lawyers cannot detect corporate misfeasance
  - 1. Structural constraints
  - 2. Cognitive bias
- C. Reform would be Harmful
  - a. Up the Line Reporting
    - i. Chilling communications
    - ii. Costs
  - b. Whistle-Blowing
    - i. Legal Professional Privilege
    - ii. Costs

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## A. Enron Couldn't Happen in the UK

The UK and the US share significant similarities in the structure of their capital markets. As Coffee points out, in both, ownership and control is separated, ownership is dispersed, and shareholders lack the insider information necessary to monitor management effectively. To address this information asymmetry, in both jurisdictions extensive disclosure obligations are imposed on companies. The effectiveness of such a system relies heavily on gatekeepers to monitor and verify the accuracy and quality of disclosures made by management. Consequently in both jurisdictions gatekeepers have a similarly important governance role to play.<sup>2</sup>

Given this and given that a number of the financial scandals which occurred in the US in 2000-2002 were attributed to gatekeeper failure, it might be thought that the UK should have followed the US's lead, and reformed the role of UK gatekeepers. However a view quickly developed that similar events had not materialised in the UK because the regulatory environment differed materially from that in the US. There was therefore no need for the UK to follow the US's lead on gatekeepers, because other mechanisms were working effectively to avert the kinds of catastrophic failures in corporate governance which Enron exemplified. The UK arrived at this more secure position following the financial scandals of the 1980s which led to the Cadbury Report, the Code of Best Practice (now replaced by the Combined Code) and adjustments to the corporate governance regime of publicly listed companies.<sup>3</sup>

However these claims are undermined by the succession of high profile corporate failures and accounting scandals which post-dated these reforms, involving names such as Barings Group, Transtec Plc, SSL International Plc, Independent Insurance Plc, Farepak Food and Gifts Limited, its parent European Home Stores Plc, the Shell Group and Northern Rock. Arguably some of these collapses are a product of determined wrongdoers and no matter how good a corporate governance system is, there will always be those who succeed in flouting the rules undetected. Nevertheless several did involve significant gatekeeper failures, and failure of other corporate governance mechanisms. The collapse of Independent Insurance Plc in 2000, for example, which was described as 'one of the most serious commercial disasters to have occurred in recent years'<sup>4</sup> led to KPMG and Andrew Sawyer, a KPMG audit partner being fined £495,000 plus costs of £1.15 million and £5,000 respectively for audit failures.<sup>5</sup>

On the other hand, there is some evidence that UK managers do behave better than those in the US. One measure of executive (mis)behaviour is the extent of earnings management that managers engage in. Earnings management refers to accounting practices designed to make the financial position of the company appear better than reality warrants.<sup>6</sup> The use of special purpose vehicles to keep debts off the

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<sup>2</sup> J Coffee *Gatekeepers: The Professions and Corporate Governance* (Oxford: Oxford University Press, 2006) p 8, 80-81.

<sup>3</sup> D Kershaw, 'Evading Enron: Taking Principles Too Seriously in Accounting Regulation' (2005) 68 MLR 594 at p 594

<sup>4</sup> *R v Bright* [2008] EWCA Crim 462 unrep 6<sup>th</sup> March 2008 at [4] per Forbes J.

<sup>5</sup> Joint Disciplinary Tribunal Report, Complaints Against KPMG Audit (14<sup>th</sup> May 2008) [http://www.castigator.org.uk/wordfiles/independent2\\_tr.rtf](http://www.castigator.org.uk/wordfiles/independent2_tr.rtf) (last visited 21 July 2008). See also the Joint Disciplinary Tribunal Reports on Barings plc, (13<sup>th</sup> June 2000) at [http://www.castigator.org.uk/wordfiles/coopers\\_tr.rtf](http://www.castigator.org.uk/wordfiles/coopers_tr.rtf) (last visited 12 January 2009) and Transtec Plc (25 November 2006) at [http://www.castigator.org.uk/index.html?transtecpwc\\_tr.html](http://www.castigator.org.uk/index.html?transtecpwc_tr.html) (last visited 21 July 2008)

<sup>6</sup> Financial Reporting Council, *Aggressive Earnings Management* (July 2001) at p 3: <http://www.frc.org.uk/images/uploaded/documents/aggressive.pdf>, (last visited 14 July 2008). There

balance sheet, as occurred in Enron is one such example, but there are numerous others. Earnings management need not be entirely self interested: it may be directed at protecting share price and therefore short-term shareholder interests. Nevertheless, it undermines a key aspect of the UK and US system of corporate governance, namely financial disclosure and transparency. Financial disclosures must be reliable to enable managers to be monitored effectively and to be held accountable where there are problems. Consequently the level of earnings management can be used as a measure of how well this system of corporate governance is working and in this respect, earnings management does, indeed, seem to be less prevalent in the UK than in the US.<sup>7</sup>

Partly this may be due to differences in the structure and composition of boards in the US and UK<sup>8</sup>, the role of outside directors,<sup>9</sup> the use of equity compensation and the level of executive compensation.<sup>10</sup> Research has suggested a positive link between the incidence of earnings management and the CEO being the company's founder, presumably because such CEOs exercise a strong influence over the company's affairs but lack accountability.<sup>11</sup> The link between CEO control and earnings management is significant given that US CEOs are believed to exercise a larger degree of control over their companies than UK CEOs as a result of the position of CEO and chairman being combined, a lack of senior independent directors and a cult of personality around certain CEOs.<sup>12</sup> In contrast, in the UK, the Combined Code requires that the roles of CEO and Chairman be separated<sup>13</sup> and most publicly listed companies comply with this requirement.<sup>14</sup> A failure to comply can lead to public censure of management, and a market response such as a drop in share price.<sup>15</sup> Nevertheless the UK practice of separating the positions of CEO and Chairman is not a sufficient reason for neglecting reform of UK gatekeeper roles. In the case of the Shell Group, the positions of Chairman and CEO were held by two individuals who both knew that Shell's oil and gas reserves had been misstated, and the market misled.

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has been some disagreement over whether earnings management is always a bad thing: W.R.Scott, 'Discussion of "Two Models of Auditor--Client Interaction: Tests with United Kingdom Data"' (1997) 14 *Contemporary Accounting Research* 51.

<sup>7</sup> L Brown and H Higgins, 'Managing Earnings Surprises in the US versus 12 Other Countries' (2001) *Journal of Accounting and Public Policy* 373-398; C Wright, J Riley Shaw and L Guan, 'Corporate Governance and Investor Protection: Earnings Management in the UK and US' (2006) 5 *Journal of International Accounting Research* 25

<sup>8</sup> For a discussion and over-view see A Monks and N Minow, *Corporate Governance*, 3<sup>rd</sup> edition, Malden, MA: Blackwell, 2004 Ch 3.

<sup>9</sup> Though evidence on the impact of outside directors is contradictory and inconclusive: M Mulgrew and J Forker, 'Independent Non-Executive Directors and Earnings Management in the UK' (2006) 13 *The Irish Accounting Review* 35 at pp 36 and 39

<sup>10</sup> L Brown and H Higgins, 'Managing Earnings Surprises in the US versus 12 Other Countries' (2001) *Journal of Accounting and Public Policy* 373-398; J Coffee *Gatekeepers: The Professions and Corporate Governance* (Oxford: Oxford University Press, 2006) p 84-85.

<sup>11</sup> M Mulgrew and J Forker, 'Independent Non-Executive Directors and Earnings Management in the UK' (2006) 13 *The Irish Accounting Review* 35 at pp 39 and 49.

<sup>12</sup> A Monks and N Minow, *Corporate Governance*, 3<sup>rd</sup> edition, Malden, MA: Blackwell, 2004 pp 208-210, 228

<sup>13</sup> The Financial Reporting Council, *The Combined Code on Corporate Governance* (June 2008) Provision A. 2.1

<sup>14</sup> Financial Reporting Council, *Review of the 2003 Combined Code* (January 2006) p 11.

<sup>15</sup> The Times, 'Standoff over Stuart Rose's executive chairman plan at Marks and Spencer' 30<sup>th</sup> March 2008 at

[http://business.timesonline.co.uk/tol/business/industry\\_sectors/retailing/article3645060.ece](http://business.timesonline.co.uk/tol/business/industry_sectors/retailing/article3645060.ece) (last visited 14 January 2009)

Part of what went wrong was attributed to a failure in the gatekeeper role of in-house counsel.<sup>16</sup> Furthermore, UK companies are not prohibited from combining the roles of CEO and chairman. Where this does occur there is a need for other governance checks and balances.

As for the other factors which are said to materially distinguish the UK position from that in the US, Kershaw has argued that the UK is far more like the US in material ways than this view would suggest. For example, UK CEO pay structures are increasingly similar to those in the US, with increased use of performance based compensation, and this has been linked to a greater risk of earnings management.<sup>17</sup> Kershaw argues that if it was ever true that UK companies were more resistant to corporate governance failures and financial misbehaviour than those in the US, then this is changing.

Another reason advanced for maintaining the regulatory status quo is that the misleading accounting devices used by Enron and Worldcom were permitted in the US, but not the UK. The UK principle based accounting regulation was therefore superior to the US rules based approach in place at the time of Enron and so sufficiently robust.<sup>18</sup> Again, this claim may be false. In contrast to received opinion, both the US and the UK GAAP required auditors to focus on substance and economic reality of transactions rather than allow themselves and others to be misled by form.<sup>19</sup> Furthermore, in relation to the two most controversial aspects of Enron's accounting practice, the use of Special Purpose Entities and Related Party Disclosures, the US GAAP rules were not only very similar to those in the UK, but were also principle based.<sup>20</sup>

Furthermore those factors which caused audit failure in the US may be present in the UK. It has been argued that, when the benefits to US auditors of complying with management accounting practices became significant, because this facilitated the retention or attraction of clients for increasingly profitable non-audit work, and the costs of compliance declined, because there had been a reduction in regulatory oversight and litigation exposure, professional culture was degraded and audit failure increased.<sup>21</sup>

Meanwhile the UK's regulation of auditors was weaker and less invasive than that in the US, and the ratio of non-audit service fees to audit service fees was higher. UK auditors in fact had greater incentives than US auditors to acquiesce to dubious accounting practices.<sup>22</sup> Even now, the risk of auditor capture by client companies has

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<sup>16</sup> See the Davis, Polk and Wardell, *Report to Shell Group Audit Committee: Executive Summary* (March 2004) [http://www.shell.com/home/content/media-en/news\\_and\\_library/press\\_releases/2004/pr\\_announcement1\\_19042004.html](http://www.shell.com/home/content/media-en/news_and_library/press_releases/2004/pr_announcement1_19042004.html) (last visited 18 March 2008).

<sup>17</sup> M J Conyon and GV Sadler, 'How Does US and UK CEO Pay Measure Up?' (2005) at 14; D Kershaw, 'Waiting for Enron: The Unstable Equilibrium of Auditor Independence Regulation' (2006) 33 *Journal of Law and Society* 388 at 401.

<sup>18</sup> D Kershaw, 'Evading Enron: Taking Principles Too Seriously in Accounting Regulation' (2005) 68 *MLR* 594 at p 597-598.

<sup>19</sup> W.W Bratton, 'Enron, Sarbanes Oxley, and Accounting Rules versus Principles versus Rents' (2003) 48 *Villanova Law Review* 1023.

<sup>20</sup> D Kershaw, 'Evading Enron: Taking Principles Too Seriously in Accounting Regulation' (2005) 68 *MLR* 594 at pp 618-624

<sup>21</sup> W.W Bratton, 'Enron, Sarbanes Oxley, and Accounting Rules versus Principles versus Rents' (2003) 48 *Villanova Law Review* 1023, 1036-1038; J Coffee *Gatekeepers: The Professions and Corporate Governance* (Oxford: Oxford University Press, 2006) pp 60-67, 146-163.

<sup>22</sup> D Kershaw, 'Evading Enron: Taking Principles Too Seriously in Accounting Regulation' (2005) 68 *MLR* 594 at p 600-603.

not been removed. Professional guidelines only require that audit firms resign from acting for a client where audit and non-audit fees received from a listed client regularly exceed 10% of a firm's annual fee income (15% for non-listed companies). Where the figure is between 5-10%, the firm does not have to resign but the audit partner must report the matter to the ethics partner who must consider whether appropriate safeguards for auditor independence are in place.<sup>23</sup> As Kershaw notes, under these guidelines the level of income derived from non-audit services will continue to be of a sufficient level to provide an incentive to the individual audit partner to acquiesce with management accounting practices.<sup>24</sup> At the same time, the costs of acquiescence are not high: in *Caparo Industries Plc v Dickman*<sup>25</sup> the House of Lords limited auditor liability to third parties in respect of negligently audited accounts, and arguably it will be rare for auditors to be found liable to the company itself.<sup>26</sup> Costs have been further reduced through the introduction of limited liability partnerships which remove the risk of unlimited liability arising out of the conduct of fellow audit partners,<sup>27</sup> and by the introduction in the Companies Act 2006 of provisions allowing auditors to agree limitations of liability with audit clients in respect of audit failure.<sup>28</sup>

In summary, there seems little reason for complacency. Arguably it does not follow that reforming the role of lawyers would address the deficits in the UK system of corporate governance. Many corporate scandals are purely accounting scandals.<sup>29</sup> UK lawyers are even less capable than their US counterparts of recognising and reacting to such frauds.<sup>30</sup> Basic accounting is not taught in UK law schools and, in any event, accounting fraud is often highly sophisticated.

However, not all corporate scandals are solely accounting scandals. Sargent has identified five types of lawyer failure associated with US corporate scandals: wilful refusal to recognise misfeasance, particularly where this would jeopardise a profitable relationship; providing advice and opinions on, and structuring deals of questionable legality; inadequate inquiry into questionable transactions; negligent failure to alert boards of risky transactions from which managers would profit; acting where there was a clear conflict of interest.<sup>31</sup> While it is true that there is little data indicating that UK lawyers have played a part in recent corporate debacles, there seems little reason to think that this is because UK lawyers behave better than their US counterparts. The absence of such data can be more realistically attributed to, firstly the rarity of public investigations into corporate failures; secondly legal professional privilege, which shields communications between a lawyer and a client from external view; thirdly the failure by regulators to take formal disciplinary action against corporate lawyers. The view that UK lawyers are not more virtuous than those

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<sup>23</sup> Auditing Practices Board, *Ethical Standard 4* paras 23, 24 and 27 (2004).

<sup>24</sup> D Kershaw, 'Waiting for Enron: The Unstable Equilibrium of Auditor Independence Regulation' (2006) 33 *Journal of Law and Society* 388 at 396.

<sup>25</sup> [1990] 2 AC 605.

<sup>26</sup> D Kershaw, 'Waiting for Enron: The Unstable Equilibrium of Auditor Independence Regulation' (2006) 33 *Journal of Law and Society* 388 at pp402-407.

<sup>27</sup> The Limited Liability Partnerships Act 2000

<sup>28</sup> Companies Act 2006 sections 534-538, though the Act provides broad and discretionary grounds for setting aside these agreements: section 537.

<sup>29</sup> S Bainbridge, C Johnson, 'Managerialism, Legal Ethics and Sarbanes-Oxley Section 307' (2004) *Michigan State Law Review* 299, 323.

<sup>30</sup> For the US position see L A Cunningham, 'Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows' 57 *Business Lawyer* 1421, 1429 and 1439.

<sup>31</sup> M Sargent, 'Lawyers in the Perfect Storm' 43 *Washburn Law Journal* 1 at 31-32 (2003)

in the US is supported by evidence from DTI company investigations in the late 1980s and 1990s. These confirm firstly that, while some scandals do raise purely accounting issues, others involve managers engaging in legally risky conduct, such as avoiding or seeking to avoid, disclosure obligations, entering into transactions in which they have a conflict of interest or otherwise breaching their fiduciary duty, and claiming transactions are at arms length when in fact they are related party transactions.<sup>32</sup> Assessing whether these amount to corporate misfeasance lies well within the realm of lawyers' professional expertise. Secondly the reports illustrate that corporate lawyers did behave in problematic ways which exposed them to criticism. Even where no criticism was warranted, the reports frequently raised pertinent ethical questions, such as the extent to which lawyers should facilitate arguably legal conduct.<sup>33</sup> While these reports cover events long since past, pre-Cadbury and pre-Combined Code, there is little reason to think that the issues they raised have been resolved, or that lawyer behaviour has changed. This further undermines the argument that it is not necessary to consider whether reform of UK corporate lawyers' roles is desirable.

## **B. Reform Would Not Work**

### **1. Structural Constraints**

The relationship between external law firms and their clients has changed. Companies spread their work amongst several law firms. Even where a company only employs one firm, the trend towards specialisation amongst lawyers means that the company's work would, most probably, be carried out by different lawyers from different departments. External lawyers' knowledge about a company client is therefore splintered, narrow and incomplete. As a result, it is argued that they are unlikely to have a sufficient overview of the business to be able to detect wrongdoing.<sup>34</sup> The manner in which the legal affairs of Mirror Group Newspapers Plc (MGN), and other companies in the Mirror Group were conducted is a paradigm example of this problem and its consequences.<sup>35</sup>

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<sup>32</sup> H B H Carlisle and M G Lickiss, *Milbury plc, Westminster Property Group Ltd; investigations under Sections 432(2) and 442 of the Companies Act 1985* (DTI) (London : Stationery Office, 1988) p299-313; R M Owen and P D Powell, *The Milford Docks Company: investigation under Sections 432(2) of the Companies Act 1985* (DTI) (London : Stationery Office, 1992) pp44-46 and 52; R G B McCombe and J K Heywood, *Norton Group plc investigation under Sections 432(2) of the Companies Act 1985* (DTI) (London : Stationery Office, 1993) pp189-190; Sir Roger Thomas and R Turner, *Mirror Group Newspapers plc: investigations under Sections 432(2) and 442 of the Companies Act 1985* (DTI) (London : Stationery Office, 2001).

<sup>33</sup> See H Brooker QC and H G C Aldous QC, *House of Fraser Holdings plc: investigation under Sections 432(2) of the Companies Act 1985* (DTI) (London : Stationery Office, 1988) Ch 23 and Ch 25; M Crystal and D Spence, *County NatWest Limited, County NatWest Securities Limited: investigations under Sections 432(2) of the Companies Act 1985* (DTI) (London : Stationery Office, 1989); H Heilbron and M Boohan, *Blue Arrow plc investigation under Sections 432(2) of the Companies Act 1985* (DTI) (London : Stationery Office, 1991); M H Arden and G N Lane, *Rotaprint plc: ; investigations under Sections 432(2) and 442 of the Companies Act 1985* (DTI) (London : Stationery Office, 1991).

<sup>34</sup> J Coffee *Gatekeepers: The Professions and Corporate Governance* (Oxford: Oxford University Press, 2006) pp 347-348.

<sup>35</sup> Sir Roger Thomas and R Turner, *Mirror Group Newspapers plc: investigations under Sections 432(2) and 442 of the Companies Act 1985* (DTI) (London: Stationery Office, 2001) p 61 FN e, p 114 FN 4 and p 206 FN (a) which reveals that Maxwell 'did not like lawyers...knowing things'. Enron was another example: see D A DeMott 'The Discrete Roles of General Counsel' (2005) 74 *Fordham Law Review* 955 at 977-978.

Nevertheless, the problem of information deficit may not always be as great as the argument suggests. There is a trend for some companies to reduce the number of law firms used, precisely because they want the law firms to have a better understanding of the company's business.<sup>36</sup> Meanwhile, companies are increasingly using external law firms to conduct internal investigations, for example to determine whether employees are engaged in market abuse and, if so, to decide what action is required. In-house counsel expect the number of such investigations to increase and for external lawyers to have greater involvement'.<sup>37</sup> These investigations provide law firms with detailed knowledge of the client's business. This does not, admittedly, mean that individuals who subsequently handle a company's legal affairs will have a better understanding of the company's business and be better placed to detect misfeasance. It may still be the case that the detailed knowledge acquired from investigations is dispersed within the law firm where the fee-earners who subsequently act for the company are not be those who conducted the investigation. However this could be addressed by ensuring that, as far as possible, at least some of those who handle the enquiry supervise or conduct subsequent legal work for the company.

The problem of information deficit and fragmentation could be addressed in other ways. Coffee, for example, has suggested a form of legal audit whereby external lawyers would be required to carry out due diligence on a company's periodic filings with the SEC and review and certify the accuracy of the company's disclosures on an on-going basis.<sup>38</sup> Bainbridge has criticised this suggestion on the basis that, in the US context, a considerable amount of corporate misconduct escapes detection by auditors and by lawyers carrying out due diligence exercises. It is unclear therefore that an extended due diligence role would materially improve lawyers ability to detect problems, and there is a risk that the costs of such a reform would outweigh any benefits.<sup>39</sup>

In-house lawyers may also suffer from fragmented and incomplete knowledge about their company client, though to a lesser degree than external lawyers. Much will depend on the status and role of the in-house lawyer within the company. The Report into the Shell earnings restatement demonstrates that even a large and respected in-house legal team can be deprived of the information it needs to detect and deal with major problems. The Report reveals that: the CEO of Shell did not perceive the need to consult the legal department when he realised that the Group's approach to booking its oil reserves did not comply with SEC disclosure rules;<sup>40</sup> there was no liaison between the legal department and the internal reserves auditor;<sup>41</sup> the governing body of the Group, the Committee of Managing Directors ('CMD') discussed disclosure issues, but did not seek the advice of securities lawyers; the Legal Director did not

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<sup>36</sup> In fact, at the time of writing Tyco Plc uses Eversheds LLP as its sole provider, although it has reserved the power to allocate work on certain transactions (probably the larger corporate transactions) to other providers.

<sup>37</sup> N Pettifer, 'Corporate Counsel Poll' (2008) *International Financial Law Review* (July)

<sup>38</sup> J Coffee *Gatekeepers: The Professions and Corporate Governance* (Oxford: Oxford University Press, 2006) Ch 10.

<sup>39</sup> S Bainbridge, 'Managerialism, Legal Ethics and Sarbanes-Oxley Section 307' (2004) *Michigan State Law Review* 299,325.

<sup>40</sup> See the Davis, Polk and Wardell, *Report to Shell Group Audit Committee: Executive Summary* (March 2004) p 5 [http://www.shell.com/home/content/media-en/news\\_and\\_library/press\\_releases/2004/pr\\_announcement1\\_19042004.html](http://www.shell.com/home/content/media-en/news_and_library/press_releases/2004/pr_announcement1_19042004.html) (last visited 18 March 2008).

<sup>41</sup> *Ibid* p 12

attend meetings of the CMD and other group boards on a regular basis; there were no clear lines of reporting from lawyers within the group to the Group Legal Director, and so no one internal lawyer had an overview of the regulatory and disclosure risks within the Group.<sup>42</sup>

Nevertheless the problem of information deficit does not defeat the case for assigning further gate-keeping or whistle-blowing duties to lawyers. Measures can be put in place to alleviate or resolve difficulties. In addition, despite information constraints, both internal and external lawyers can, and do, manage to detect misfeasance, and it is necessary to consider what their response should be when this occurs.<sup>43</sup>

## 2. Cognitive Bias

It has been argued that even if lawyers were able to access information revealing corporate misfeasance and had the professional expertise to interpret that information, they would remain hampered from recognising that corporate misfeasance had occurred as a result of cognitive bias.

To explain, in order for people to interpret their social world, and to cope with and make sense of the noisy amounts of information which surround them, they need to construct models or mental maps. These mental maps incorporate heuristic devices to filter, weigh and give meaning to that information. However these devices and models may well be based on erroneous assumptions and, where this is so, people will not interpret the information they receive correctly. For example, lawyers who are approached by a new client are likely to make positive assumptions about that client unless there are obvious danger signs, not least because a new client is generally good news for the lawyer.<sup>44</sup> Once a person constructs a mental map about a person, client or situation he or she will be slow, and subconsciously reluctant, to alter it. As a result, in the example given, where danger signs emerge after the lawyer has formed a positive view of the client, there is a real risk that the lawyer will discount them. This is particularly likely to be the case if everyone else is behaving as if nothing is wrong, thus reinforcing the lawyer's positive view. There is nothing sinister about this-as Langevoort points out, it would be impossible and undesirable to possess a completely open mind which constantly reviewed and reworked its view of the world.<sup>45</sup> It does mean though, that a lawyer may not react to initial signs of wrongdoing.

Lawyers can be provided with incentives, in the form of liability exposure for example, which counteract and overcome these cognitive tendencies. However, the theory of social cognition argues that such incentives may be ineffective in the

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<sup>42</sup> The full Report was never published but these conclusions are clear, or can reasonably be inferred from Davis, Polk and Wardell, *Report to Shell Group Audit Committee: Proposed Remedial Measure* p7 (March 2004) p 5 [http://www.shell.com/home/content/media-en/news\\_and\\_library/press\\_releases/2004/pr\\_announcement1\\_19042004.html](http://www.shell.com/home/content/media-en/news_and_library/press_releases/2004/pr_announcement1_19042004.html) (last visited 18 March 2008).

<sup>43</sup> See for example R G B McCombe and J K Heywood, *Norton Group plc investigation under Sections 432(2) of the Companies Act 1985* (DTI) (London : Stationery Office, 1993) pp 85-88; Sir Roger Thomas and R Turner, *Mirror Group Newspapers plc: investigations under Sections 432(2) and 442 of the Companies Act 1985* (DTI) (London : Stationery Office, 2001).at 114-115.

<sup>44</sup> D C Langevoort, 'Where Were the Lawyers? A Behavioural Inquiry Into Lawyers' Responsibilities For Clients' Fraud' 46 *Vanderbilt Law Review* 75 (1993) at pp 98-99.

<sup>45</sup> D C Langevoort, 'Where Were the Lawyers? A Behavioural Inquiry Into Lawyers' Responsibilities For Clients' Fraud' 46 *Vanderbilt Law Review* 75 (1993) at pp 100-101.



presence of certain factors which cause individuals not just to discount information, but to overlook it. This suppression of information is not a conscious process, but again a result of cognitive bias. Given that these factors include the level of a person's commitment to their original point of view, the amount they have invested in that view being correct, and the presence of high levels of egotism in the opinion holder, it is perhaps not surprising that lawyers may be particularly prone to having blind spots about their clients.<sup>46</sup> Lawyers are expected to have a high level of commitment to their clients, and successful lawyers are not always modest and self-effacing. Again, reacting to wrong-doing could lead to the loss of the client and, since the economic structure of law firms penalises lawyers who are unable to retain clients, this would have a detrimental impact on the lawyer's career and income.<sup>47</sup> Lawyers therefore have a great deal at risk if their original positive view of their client is inaccurate and has to be revised. Lawyers' tendency to identify with management further impairs lawyers' ability to recognise flaws in management's decision-making, or leads them to minimise it.<sup>48</sup> As Coffee notes, 'rationalization is a skill that lawyers have honed to a fine edge', and lawyers have every reason to exercise the skill in this context.<sup>49</sup> Furthermore, when things go wrong, lawyers are unlikely to learn from mistakes since this process of rationalisation leads to them to blame others and to down-play their own involvement.<sup>50</sup> In particular, although corporate lawyers may have advised on a transaction, or drafted the documentation, they view decisions to pursue a course of conduct as management's responsibility.<sup>51</sup> This process of rationalisation, and tendency to turn a blind eye to corporate misconduct, is likely to be encouraged where lawyers adopt the standard conception of legal ethics, which emphasises neutrality, partisanship and non-accountability.

It is important, however, not to overstate the implications of the research on cognitive bias. First of all its findings are based upon laboratory experiments, which may not mirror real life. Secondly, it demonstrates only that cognitive bias may reduce lawyers' ability to perform gatekeeping /whistleblowing roles rather than eliminate it.<sup>52</sup> Furthermore it should be recalled that the effects of cognitive bias may be off-set through incentives or other reforms. Before the Proceeds of Crime Act 2002, and the Money Laundering Regulations 2003, came into force in the UK, solicitors had been criticised for making only 1% money-laundering reports to the regulators, and were said to 'see only what they want to see'.<sup>53</sup> Following the

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<sup>46</sup> D C Langevoort, 'Where Were the Lawyers? A Behavioural Inquiry Into Lawyers' Responsibilities For Clients' Fraud' 46 *Vanderbilt Law Review* 75 (1993) at pp 101-104.

<sup>47</sup> J Fisch and K Rosen 'Is There a Role for Lawyers in Preventing Future Enrons?' (2003) 48 *Villanova Law Review* 1097, 1123; J Coffee *Gatekeepers: The Professions and Corporate Governance* (Oxford: Oxford University Press, 2006) 213, 227-229.

<sup>48</sup> D Langevoort "The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior" (1997) 63 *Brooklyn Law Review* 629, 655-656

<sup>49</sup> J Coffee *Gatekeepers: The Professions and Corporate Governance* (Oxford: Oxford University Press, 2006) 223; see also S Bainbridge, C Johnson, 'Managerialism, Legal Ethics and Sarbanes-Oxley Section 307' (2004) *Michigan State Law Review* 299, 321.

<sup>50</sup> R Able, *Lawyers in the Dock, Learning from Attorney Disciplinary Proceedings* (Oxford University Press, 2008) p ?.

<sup>51</sup> R C Cramton, 'Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues' 58 *Business Lawyer* 143 at p 174 (2002).

<sup>52</sup> D C Langevoort, 'Where Were the Lawyers? A Behavioural Inquiry Into Lawyers' Responsibilities For Clients' Fraud' 46 *Vanderbilt Law Review* 75 (1993) at pp 110.

<sup>53</sup> R E Bell, 'The Prosecution of Lawyers for Money Laundering Offences' (2002) 6 *Journal of Money Laundering Compliance* p 17 at p 18. Both sets of legislation expanded the duties of solicitors to report suspicious activities-the Proceeds of Crime Act 2002 extended the meaning of proceeds of crime to all

introduction of the Act, in 2004, the numbers of suspicious activity reports made by solicitors shot up to 19,000, though this dropped to 9,600, following clarification of the law as it related to solicitors.<sup>54</sup> From October 2006 until September 2007, there were 11,300 reports from solicitors.<sup>55</sup> The most recent survey for 2007-2008 has shown a drop in the number of reports to 6,460 but this has been attributed to factors such as the movement of one particular body which made a large number of reports out of the jurisdiction and the downturn in the economy rather than disengagement by the profession from the reporting process. Solicitors remain the seventh highest reporters of suspicious activity by their clients.<sup>56</sup>

This response to the money laundering legislation reveals that where solicitors themselves are vulnerable to criminal sanctions, cognitive bias in favour of the client does not cause them to overlook potential problems. On the contrary, solicitors have been conscientious whistle-blowers. It also reveals that the rigour of the incentives set will affect their efficacy in off-setting cognitive bias and a cultural disinclination to blow the whistle. Generally lawyers in the UK are far more likely to make reports than lawyers in other jurisdictions and it is thought that this is linked to the fact that the UK's money-laundering regime is extremely strict compared to that in other jurisdictions in the EU.<sup>57</sup> This does suggest that a strong enough regulatory regime will counteract cognitive and cultural bias against disclosure, though too onerous a regime could result in over-reaction.<sup>58</sup>

There are other incentives and mechanisms which could counteract cognitive bias. For example, fear of losing the client could cause the lawyer to co-operate in, or overlook, questionable practices, but it could also have the reverse effect. A lawyer may fear that if such practices come to light and the lawyer is perceived by incumbent management as being implicated, he is likely to lose the client in any event.<sup>59</sup> Those directors uninvolved in the wrongdoing are unlikely to continue to entrust company business to a lawyer who is perceived as being too close to the wrongdoers or the wrongdoing. Again the presence of teams of lawyers working on a transaction may also work to off-set the effects of cognitive bias since, with the exception of the client partner, the team will not have the same vested interest in dismissing adverse information about a client and may therefore be more likely to detect danger signals. Admittedly this discounts the pressures on junior lawyers to conform and avoid challenging those more senior than them, and also overlooks the effect of group-

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crimes, with no *de minimis* rule, while the regulations extended the range of solicitors who had to comply with the money-laundering rules.

<sup>54</sup> Namely *Bowman v Fels* [2005] EWCA Civ 226; [2005] 1 W.L.R. 3083 (CA): which clarified the reporting duties of solicitors advising clients in the course of litigation and confirmed that privileged information should not be disclosed Sir Stephen Lander, *SARS Review* (2006) para 26

<sup>55</sup> SOCA, *The Suspicious Activity Report Annual Review 2007* (20 March 2008) p 29.

<sup>56</sup> SOCA, *The Suspicious Activity Report Annual Review 2008* (2009) p 16 and 40; The Law Society *Soca-Suspicious activity report annual review* (27 November 2008)

<sup>57</sup> European Commission Staff Working Document SEC (2006) 1793 para 39. At present lawyers on the continent provide, on average, only 10 reports per year: The Law Society *Soca-Suspicious activity report annual review* (27 November 2008)

<sup>58</sup> Sir Stephen Lander, *SARS Review* (2006) at para 52, who noted defensive reporting.

<sup>59</sup> As seems to have occurred in *Blue Arrow* where the non-executive directors instructed new lawyers from those who had been instructed by the CEO: H Heilbron and M Boohan, *Blue Arrow plc investigation under Sections 432(2) of the Companies Act 1985* (DTI) (London: Stationery Office, 1991)

think.<sup>60</sup> Nevertheless, there will be times when more junior lawyers detect and react to problems that their more senior colleagues have developed a blind spot for, or wish to consciously ignore.<sup>61</sup>

In-house lawyers are perceived as being particularly vulnerable to cognitive bias and to pressure to comply with management practices, due to their lack of independence from the client.<sup>62</sup> External lawyers have several clients and are unlikely to be instantly dismissed from their job if they challenge management behaviour. In contrast, in-house lawyers have only one client and are highly vulnerable to severe reprisals from disgruntled management.<sup>63</sup> These are strong influences which may cause them to consciously or sub-consciously overlook wrongdoing. Coffee argues that it would therefore be unsafe to rely on in-house counsel to perform effective gatekeeper (or whistle-blowing) roles. Nevertheless, there is evidence that in-house lawyers can exercise independence in circumstances where external lawyers are more supine and less questioning. The MGN Inquiry, for example, revealed such behaviour demonstrated by the in-house group legal advisor to the Maxwell companies. Upon discovering that there had been a failure to disclose material information to the shareholders of one of the Maxwell companies, when she was advised by external lawyers that disclosure had to be made, she sought twice to arrange it. When she was blocked by Maxwell himself, she resigned in protest. There is no record of the external lawyers taking any action, nor is there any suggestion that they should have done so. What this illustrates however is that depending on the circumstances, in-house lawyers may be as capable of recognising and responding to corporate misfeasance, if not more, than their external counterparts.<sup>64</sup>

It is also notable that, in contrast to external lawyers, in-house counsel both in the UK and elsewhere, have taken the lead in addressing lawyers' roles in corporate governance, including when whistle-blowing is permissible.<sup>65</sup> McCormick has suggested that this is because in-house lawyers are not only more likely to be faced with corporate governance dilemmas, but are also protected from the competitive pressures which make it more difficult for external lawyers to address these issues.<sup>66</sup>

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<sup>60</sup> M Twitchell, 'The Ethical Dilemmas of Lawyers on Teams' 72 *Minnesota Law Review* 696 at 761 (1988); L Gross, 'Ethical Problems of Law Firm Associates' 26 *William & Mary Law Review* 259 at 298-299 (1985).

<sup>61</sup> R G B McCombe and J K Heywood, *Norton Group plc investigation under Sections 432(2) of the Companies Act 1985* (DTI) (London : Stationery Office, 1993) pp 85-88

<sup>62</sup> R Nelson and L Nelson 'Cops, Counsel and Entrepreneurs: Constructing the Role of Inside Counsel in Large Corporations' (2000) 34 *Law and Society Review* 457; H Gunz and S Gunz, 'The Lawyers Response to Organizational Professional Conflict: An Empirical Study of the Ethical Decision Making of In-House Counsel' (2002) 39 *American Business Law Journal* 241; D A DeMott 'The Discrete Roles of General Counsel' (2005) 74 *Fordham Law Review* 955 at 967-969.

<sup>63</sup> Hon E Norman Veasey and C T Di Guglielmo, 'The Tensions, Stresses and Professional Responsibilities of the Lawyer for the Corporation' 62 *Business Lawyer* 1 (2006) pp 11-13.

<sup>64</sup> It is true that she was criticised by the DTI Inspectors, but their criticism seems to have arisen out of the position she subsequently accepted as a consultant on the flotation of Mirror Group Newspapers Plc, rather than what she did as in-house counsel: Sir Roger Thomas and R Turner, *Mirror Group Newspapers plc: investigations under Sections 432(2) and 442 of the Companies Act 1985* (DTI) (London: Stationery Office, 2001).at 114-115 and 335 fn b.

<sup>65</sup> In the UK see the Commerce and Industry Group, *Reconciling the Irreconcilable* (2005); A *Fine Line* (2006); *Blowing the Whistle* (2007). In Australia and New Zealand, see Australian Corporate Lawyers Association, Corporate Lawyers Association of New Zealand and the St James Ethics Centre, *Ethics for In-House Counsel* (2<sup>nd</sup> edn, 2004);

<sup>66</sup> R McCormick, *Legal Risk in the Financial Markets* (Oxford, 2006) at p 258; S Duggin, 'The Pivotal Role of General Counsel in Promoting Corporate Integrity and Professional Responsibility' 51 *St Louis University Law Journal* 989 at 1035.

Counter-intuitively therefore, in-house lawyers may be able to act more independently than external lawyers. Other reasons why they may be better motivated to perform such roles are that, unlike external lawyers, who can give advice but need never check whether it has been followed, in-house lawyers are likely to know when their advice has not been followed. Since it will be more difficult for them to claim ignorance of wrong-doing,<sup>67</sup> it is possible that they will feel far more exposed to liability and censure than external lawyers, particularly if they have been present when the decision was made to breach the law.

In summary, the problem of cognitive bias cannot be discounted, but it may be addressed through appropriate incentives. Furthermore, it would be premature to dismiss the ability of in-house lawyers' to perform a gate-keeping or whistle-blowing role. While they may have more incentives than external lawyers to overlook such misfeasance and to identify with management, they also have additional counter-incentives to react.

Assuming that lawyers can identify corporate misfeasance, the question then arises of whether they should report up the line, to the Board if necessary, or even whistle-blow externally. There are various arguments against either of these courses of action. The first is that they would be contrary to the client's interests, since they would discourage managers from being frank with lawyers.<sup>68</sup> Consequently lawyers would miss opportunities to advise against, avert, and/or take corrective action in response to, impermissible courses of action. A second, connected, concern is the threat to legal professional privilege posed by whistle-blowing and finally it is argued that such requirements would be too costly. This section will consider the arguments first in the context of up-the-line reporting and then in the context of whistle-blowing.

## **C. Reform Would be Harmful**

### **1. Up-the-Line Reporting**

#### **a) Chilling Communications**

Turning first to the question of whether a mandatory up-the-line reporting requirement would chill corporate communications, there are two types of manager we need to consider: those who are knowingly engaged in illegal conduct or do not care if they are doing so; and those who are aware that they may be engaging, or are about to engage, in risky conduct in the hope it is not illegal. Intentional law-breakers are likely to conceal their behaviour from lawyers, while those who do not care one way or the other have no reason to speak to lawyers and may well view them as an interference with the successful conduct of the business. Both will fail to communicate irrespective of whether an up-the line reporting or whistle-blowing requirement exists.<sup>69</sup> Other managers, however, are likely to seek legal advice *because* they are aware that a course of action is risky and want reassurance that it is nevertheless legal. These individuals will be anxious about their personal exposure if the law is broken. Often they will seek lawyers' advice to use as insurance should

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<sup>67</sup> See W Simon 'Wrongs of Ignorance and Ambiguity: Lawyer Responsibility for Collective Misconduct' 22 *Yale Journal on Regulation* 1 (2005)

<sup>68</sup> R H Kraakman 'Gatekeepers: The Anatomy of a Third Party Liability Strategy' (1986) *J.L.Econ & Org* 53, 60; S Bainbridge, C Johnson, 'Managerialism, Legal Ethics and Sarbanes-Oxley Section 307' (2004) *Michigan State Law Review* 299, 322.

<sup>69</sup> S Bainbridge, C Johnson, 'Managerialism, Legal Ethics and Sarbanes-Oxley Section 307' (2004) *Michigan State Law Review* 299, 321

things go wrong. For example, the County NatWest scandal saw the eponymous merchant bank, together with the brokers Phillips & Drew, disguise the failure of a rights issue by concealing from the market how many shares remained in the underwriter's hands. It was revealed in the course of the DTI investigation that the parties involved-in particular Phillips & Drew- knew that the arrangement was legally risky. In the words of Allen & Overy, their legal advisors, the arrangement consisted 'of an endeavour to avoid a legal obligation'.<sup>70</sup> Phillips Drew was therefore anxious to receive reassurance from the lawyers that the arrangement was lawful. Had they not received such an assurance they would not have proceeded.<sup>71</sup> Many other parties involved also took comfort from being told the lawyers had confirmed the arrangement was lawful.<sup>72</sup>

Problems are more likely to arise where managers become uncertain about the legality of a transaction after the event. At this point the argument that they could be reluctant to consult company lawyers regarding remedial action becomes more persuasive, since they may fear the consequences of their activities being disclosed. The risk then is that rather than obtaining legal advice which could lead to the problem being ameliorated or eliminated, managers conceal their activities. However lawyers' reporting obligations could be carefully structured so as to reduce the threat to managers. Cramton argues that, currently, 'the informal norms by which sensitive issues are handled within a corporation are extremely powerful'<sup>73</sup> and there is little reason to think that lawyers will suddenly disregard these by reporting up the ladder prematurely. Rather they will continue to rely on existing processes for resolving problems. Again, the lawyer's duty to report up the ladder could be imposed only where management ignored the lawyer's advice to take mitigating action. It should, after all, be the primary responsibility of managers to report problems, and this is what probably occurs in most cases.

In any event, the experience in the US suggests that this argument may have been overstated. Not long after the introduction of the Sarbanes-Oxley Act 2002, a survey of 137 Chief Legal Officers found that 63.6 % disagreed with the statement that the new SEC rules requiring up the line reporting<sup>74</sup> had adversely affected the relationship of trust between the lawyer and the client. 32.2 % agreed. The participants were also asked to agree or disagree with the statement that, 'The new attorney reporting obligations mean senior managers are less likely to seek legal advice for fear of lawyers "tattling" on them'. 55.6 % disagreed, while only 22.2% agreed.<sup>75</sup> These findings are consistent with later research which found that Sarbanes-Oxley had made management more sensitive to compliance issues, much more

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<sup>70</sup> M Crystal and D Spence, *County NatWest Limited, County NatWest Securities Limited: investigations under Sections 432(2) of the Companies Act 1985* (DTI) (London: Stationery Office, 1989) at p 102.

<sup>71</sup> M Crystal and D Spence, *County NatWest Limited, County NatWest Securities Limited: investigations under Sections 432(2) of the Companies Act 1985* (DTI) (London: Stationery Office, 1989) at pp 99, 102-103.

<sup>72</sup> M Crystal and D Spence, *County NatWest Limited, County NatWest Securities Limited: investigations under Sections 432(2) of the Companies Act 1985* (DTI) (London: Stationery Office, 1989) at 115-116, 119-120. In fact these parties were misled about the extent and content of legal advice provided.

<sup>73</sup> R C Cramton, 'Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues' *58 Business Lawyer* 143 at p 182 (2002).

<sup>74</sup> SEC, Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer. Part 205.

<sup>75</sup> Association of Corporate Counsel, *Chief Legal Officer Survey* (2003)

<http://www.acc.com/resource/getfile.php?id=255> (last visited 18 March 2008) at pp 7- 8

receptive to lawyers' advice, and gave lawyers more influence over recalcitrant management.<sup>76</sup> Given the extensive publicity which surrounded the introduction of Sarbanes-Oxley, it is likely that managers became more concerned about their personal exposure and so more, rather than less, likely to consult lawyers. The studies also confirmed that the requirement to report up may work very much in the corporate client's interests, not only because it gives boards the opportunity to take steps to limit the damage caused by the wrongdoing but also because it could lead to better compliance with the law by corporate managers, given their increased willingness to seek and listen to legal advice..

### **b) Too Costly**

There remain concerns that reporting up would impose excessive costs on clients. For example, the establishing of Qualified Legal Compliance Committees (QLCCs)<sup>77</sup> in response to the Sarbanes Oxley Act 2002, was estimated to cost US \$1.5 million a year.<sup>78</sup> However the question of how much the Sarbanes-Oxley Act 2002 has cost business, and whether those costs are outweighed by its benefits, is a contested one.<sup>79</sup> Most US commentators view reporting up requirement at least as relatively unproblematic since many US lawyers were already obligated to report up under their State ethical rules. Consequently the provision did not alter the lawyer-client relationship nor, therefore, costs.<sup>80</sup> Practitioners themselves appear to support it.<sup>81</sup>

While the common law may require UK lawyers to report up the line where the wrongdoing they discover relates to the matter in respect of which they have been retained, or where they are in-house lawyers.<sup>82</sup> It is possible that many lawyers do so as a matter of best practice. Nevertheless the UK case-law on this point has a low visibility and it is safe to assume that there are lawyers who are unaware that they can do this, particularly as the Code of Conduct is silent on the point. Consequently, if reporting up was made a legislative requirement in the UK some short-term impact on lawyer-manager communications could not be ruled out, particularly if lawyers themselves transmitted alarming messages to managers about the implications of such a requirement.<sup>83</sup> The evidence from the States however, is that any detriment would

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<sup>76</sup> S Fortney. 'Chicken Little Lives: The Anticipated and Actual Effect of Sarbanes-Oxley on Corporate Lawyer's Conduct' 33 *Capital University Law Review* 61 at 75.

<sup>77</sup> QLCCs are committees to whom lawyer could report as an alternative to up the line reporting to a chief Legal officer or CEO, and as an alternative to noisy withdrawal. Once the lawyer has reported to the QLCC he is absolved from taking any further steps. A company with a QLCC is therefore more attractive to a lawyer than one without: J Snyder, 'Regulation of Lawyer Conduct Under Sarbanes-Oxley: Minimising Law-Firm Liability by Encouraging the Adoption of Qualified Legal Compliance Committees' 24 *Review of Litigation* 223, at 242-245 (2005)

<sup>78</sup> C Pippel, 'The Lawyer as Gatekeeper: Is There a Need for a Whistle-blowing Securities Lawyer? Recent Developments in the US and Australia?' (2004) 16 *Bond Law Review* 96 at 114-115.

<sup>79</sup> S Bainbridge, 'Legislate in haste, Repent At Leisure'

<sup>80</sup> See, for example, R Cramton, G Cohen and S Koniak, 'Legal and Ethical Duties of Lawyers After Sarbanes-Oxley' 49 *Villanova Law Review* 725 at 733; M Steinberg, 'Lawyer Liability After Sarbanes-Oxley-Has the Landscape Changed?' 3 *Wyoming Law Review* 371 (2003).

<sup>81</sup> P Kostant, 'From Lapdog to watchdog: Sarbanes-Oxley Section 307 and a New Role for Corporate Lawyers' 535 at 550.

<sup>82</sup> *Swain v. West (Butchers) Ltd.* [1936] 1 All E.R. 224; [1936] 3 All E.R. 261, C.A.; *Sybron Corp v Rochem Ltd* [1984] Ch 112; *Item Software v Fassihi* [2004] EWCA Civ 1244; [2004] B.C.C. 994; See also *Hanco ATM Systems Ltd v Cashbox ATM Systems Ltd* [2007] EWHC 1599 (Ch) unrep 10 July 2007

<sup>83</sup> On the impact on corporate clients of lawyers' messages about the law see L Edelman, S Abraham and H Erlanger, 'Professional Construction of the Law: The Inflated Threat of Wrongful Discharge' 26

be short-lived, and outweighed by the benefits to the corporate client in the longer term. In addition, an up the line reporting requirement, could improve the culture of corporate lawyers by reminding them that their real client is the company and not the manager who instructs them on a daily basis. It could therefore have a broader impact on their corporate governance role, by counteracting the danger of lawyers over-identifying the interests of the company with those of management and so inadequately representing the company.<sup>84</sup>

## 2. Whistle-Blowing

### a) Legal Professional Privilege

The primary objection to the introduction of a whistle-blowing obligation, and what sets it apart from reporting up-the-line, is that it undermines legal professional privilege. Legal professional privilege protects two categories of documentation from compulsory production (i) communications between the client or its lawyers on the one hand, and third parties on the other, where the dominant purpose of the communication is use in connection with reasonably contemplated litigation (“litigation privilege”);<sup>85</sup> (ii) communications between a lawyer, acting in his or her professional capacity, and the lawyer’s client, where the purpose of the communication is related to giving advice as to what should sensibly and prudently be done in the relevant legal context (“legal advice privilege”).<sup>86</sup>

Because reporting up-the-line does not require privileged communications to be disclosed outside the company, it does not breach legal professional privilege. In contrast, requiring lawyers to alert regulatory authorities to corporate misconduct could. The SEC’s ‘noisy withdrawal’ rule required that where a lawyer had reported a material violation of securities laws, breach of fiduciary duty or similar violations up the line within a client organisation and the board of directors had not provided an appropriate response, the lawyer had to withdraw from representing the client and notify the Securities and Exchange Commission (SEC) in writing that he had done so for ‘professional considerations’. The lawyer also had to disaffirm any documents or representations made to the SEC which the lawyer reasonably believed were, or could be, materially false or misleading.<sup>87</sup> The lawyer did not have to disclose the content of the individual communications with wrongdoing managers which triggered his approach to the board.<sup>88</sup> Nevertheless withdrawal would have signalled to the SEC the existence and broad nature of legal advice which the lawyer had provided to the board, namely that the lawyer had advised the board of a material violation of securities regulation, breach of fiduciary

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*Law and Society Review* (1992) 47; E B Rock ‘Saints and Sinners: How does Delaware Corporate Law Work?’ 44 *UCLA Law Review* 1009 (1997).

<sup>84</sup> R C Cramton, ‘Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues’ 58 *Business Lawyer* 143 at p 181 (2002).

<sup>85</sup> *Re Highgrade Traders* [1984] B.C.L.C.151 at 172.

<sup>86</sup> *Three Rivers District Council v Governor and Company of the Bank of England (No. 6)* [2004] UKHL 48, [2004] 3 WLR 1274 at 1287-1288 (Lord Scott), 1296 (Baroness Hale).

<sup>87</sup> Proposed Rule 205.3 (d) (1) at <http://www.sec.gov/rules/proposed/33-8150.htm#xi> (last visited 12 September 2008)

<sup>88</sup> Contrary to what some seemed to suggest: see, for example, Comments of E. Leo Milonas, Association of the Bar of the City of New York, December 17, 2002; John E. Baumgardner, Jr., Chair-Committee on Investment Management Regulation of the Association of the Bar of the City of New York, December 16, 2002 <http://www.sec.gov/rules/proposed/s74502.shtml> (last visited 20 January 2009)

duty or similar violations, and that the board has failed to follow the lawyer's advice to address the problem. An investigation would have quickly followed.

The 'noisy withdrawal' provisions were intended to have extra-territorial effect and consequently initiated a storm of protest both from lawyers and professional bodies from around the world.<sup>89</sup> UK lawyers were concerned that the proposed rule conflicted with UK law and professional obligations, particularly in relation to legal professional privilege and client confidentiality.

Reasons advanced for opposing the provision included that it undermined the independence of the legal profession and the solicitor-client relationship and consequently the rule of law and due administration of justice which required that clients have access to confidential independent legal advice.<sup>90</sup> It was also argued that it would undermine the lawyer's role of zealous advocate.<sup>91</sup> However, as detractors of legal professional privilege in the corporate context point out, such arguments do not differentiate between the role privilege plays when the client is a company as opposed to an individual, nor how it operates in the context of transactional work in contrast to litigation.<sup>92</sup> Claims that privilege is a fundamental human right, an aspect of the rule of law, necessary for the due administration of justice, and required to protect an individual's rights, have most salience in the context of criminal defence work, where an individual faces prosecution by the State, and loss of liberty. Here, the ability to communicate confidentially with a lawyer is of the utmost importance given the high stakes for the individual, the imbalance of power between the individual and the State and the principle that a person is innocent until proven guilty by the prosecution. However, the further one moves from the criminal defence paradigm, the weaker the rationale for privilege. Unlike criminal lawyers, transactional lawyers advising on and structuring deals for companies, or advising on securities legislation, are not concerned with the protection of human rights. Far from being vulnerable, their clients are often extremely powerful and sophisticated repeat players who are well able to tactically exploit substantive and procedural law and who have the capacity to cause extensive harm to shareholders, future investors, creditors and employees.<sup>93</sup> Furthermore, although the UK courts have held that companies can assert rights under the Human Rights Act 1998, and it has also been recognised that legal professional privilege is an aspect of a company's Article 6 rights to a fair trial,<sup>94</sup> it is nevertheless

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<sup>89</sup> See letters from The Law Society of England and Wales; the Canadian Bar Association, March 20, 2003, available at <http://www.sec.gov/rules/proposed/s74502/svspotter1.htm> (last visited 5th August 2008); the New Zealand Law Society, Dec. 18, 2002, available at <http://www.sec.gov/rules/proposed/s74502/mverbiest1.htm> (last visited 5th August 2008); Council of the Bars and Law Societies of the European Union, Statement of Position on Lawyer's Confidentiality, Feb. 22, 2001, available at <http://www.sec.gov/rules/proposed/s74502/ccberesponse.htm> (last visited 5th August 2008); Japan Federation of Bar Associations, March 31, 2003, available at <http://www.sec.gov/rules/proposed/s74502/tmotobayashi1.htm> (last visited 5th August 2008). The full range of comments and letters are available at <http://www.sec.gov/rules/proposed/s74502.shtml> (last visited 5th August 2008).

<sup>90</sup> Comments of Professor Vern Krishna, Q.C., FCGA, Treasurer, Law Society of Upper Canada, December 6, 2002 ([File name: vkrishna1.htm](#))

<sup>91</sup> Comments of E. Leo Milonas, Association of the Bar of the City of New York, December 17, 2002; John E. Baumgardner, Jr., Chair-Committee on Investment Management Regulation of the Association of the Bar of the City of New York, December 16, 2002 ([File name: elmilonas1.htm](#))

<sup>92</sup> P Kostant, 'From Lapdog to Watchdog: Sarbanes-Oxley Section 307 and a New Role for Corporate Lawyers' 52 *New York Law School Law Review* 535 at 542-543 (2007-2008)..

<sup>93</sup> C Stephens, 'Sarbanes-Oxley and the Regulation of Lawyers' Conduct: Pushing the Boundaries of the Duty of Confidentiality' 24 *St. Louis University Public Law Review* 271 at p 298 (2005)

<sup>94</sup> *Dombo Beheer BV v Netherlands* (1993) 18 EHRR 213 (ECtHR).



the case that a company's rights under the Human Rights Act 1998 are of a different nature, weight and function to the fundamental rights of human beings protected by the same Act. Human rights protect fundamental interests such as liberty, freedom from suffering, autonomy and human dignity, and the corporate entity lacks such interests. Consequently legal professional privilege does not perform the same function, nor carry the same weight, in the corporate context as it does when claimed by individuals.

To be fair, in their vociferous fight against the noisy withdrawal provisions, lawyers more frequently relied upon a consequentialist defence of legal professional privilege, namely that legal advice privilege is necessary to encourage full disclosure of relevant facts by clients to lawyers. This allows lawyer to give accurate legal advice which, in turn, enables clients to order their affairs in accordance with the law. It was asserted that if companies could not confide freely in lawyers, with an absolute assurance of confidentiality, communications between client and lawyer would be chilled, the lawyer would be unable to provide full and accurate legal advice, and as a result infringements of the law would increase.<sup>95</sup> Lawyers are often not popular with business people, being perceived as cost centres, as not 'adding value', and as obstacles to achieving, rather than facilitators of, business objectives, and thus to be avoided.<sup>96</sup> Noisy withdrawal, or other whistle-blowing obligations could strengthen this view and could therefore have the perverse consequence of undermining corporate governance and investor protection.

These are not new arguments. They are utilised by the profession every time there is a perceived threat to legal professional privilege, and they raise a range of points which need to be addressed.

First of all, there is a degree of tension between, on the one hand, the assumption that legal professional privilege is justified in the corporate context because it allows lawyers to detect and avert wrong-doing, and the argument examined earlier that lawyers' corporate governance roles should not be extended because they are not well-placed to detect corporate misfeasance due to structural constraints and so forth. If the latter argument is correct, then this rationale for defending privilege against a noisy withdrawal exception is weak.<sup>97</sup> It may be true, though, that insofar as lawyers can play such a socially desirable role, a whistle-blowing obligation could make it more difficult to perform.

Secondly, this defence of privilege assumes that it is an important part of corporate lawyers' role to counsel clients to obey the law and to avert wrongdoing.<sup>98</sup> However in the UK there is no express obligation on lawyers to carry out a counselling role. Rather lawyers are more likely to act as advocates and morally neutral risk engineers, assisting managers to achieve their ends even where this may violate the spirit of the law. Rather than counselling against such conduct, the lawyer-advocate is likely to provide managers with a technical legal argument with which to defend it. The morally neutral risk manager will warn executives of the consequences if the line between technically lawful and unlawful conduct is crossed, but will adopt

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<sup>95</sup> *Three Rivers (No. 6)* [2004] UKHL 48, [2004] 3 WLR 1274 at 1284-1286 per Lord Scott.

<sup>96</sup> S Duggin, 'The Pivotal Role of General Counsel in Promoting Corporate Integrity and Professional Responsibility' 51 *St Louis University Law Journal* 989 at 1017.

<sup>97</sup> R Gordon, 'A New Role For Lawyers?: The Corporate Counselor After Enron' 35 *Connecticut Law Review* 1185 at pp 1202-1203 (2003).

<sup>98</sup> R Gordon, 'A New Role For Lawyers?: The Corporate Counselor After Enron' 35 *Connecticut Law Review* 1185 at p 1195-1196 (2003).

a non-directive approach as to whether that risk should be taken.<sup>99</sup> The problem with this approach is that the more managers engage in legally risky conduct, the greater the risk that some of that conduct will be unlawful. Furthermore, if managers and corporate lawyers consider it acceptable to engage in conduct which stretches the boundaries of legality, and violates the spirit of the law, it is a short step to thinking it acceptable to breach laws which are viewed as mere technicalities, or unjustifiable obstructions. Such an approach breeds contempt for the law and undermines the rationale for privilege.<sup>100</sup> As Coffee points out, the ultimate goal of the law of privilege is not to promote maximum communications between lawyers and corporate employees, but to achieve law compliance. Legal professional privilege in the corporate context is a means to an end, not an end in itself and if that end cannot be achieved, the rationale for upholding privilege falls away.<sup>101</sup>

Consequently, if lawyers seek to resist whistle-blowing obligations on the basis that legal professional privilege assists lawyers in counselling their corporate clients to be law-abiding corporate citizens, it is suggested that lawyers need to take seriously a counselling role aimed at keeping corporate clients safely within the bounds of the law.

If the client does break the law, privilege cannot be claimed in respect of communications between a lawyer and the client which are required by the client to structure a fraudulent or criminal transaction, or otherwise commit a crime or fraud ('the crime-fraud exception').<sup>102</sup> This, by itself, is unlikely to address the problem of corporate privilege encouraging, and being used to shield, arguably legal conduct, since managers consult lawyers in order to devise schemes which avoid, rather than break, the law. However the Court of Appeal decision in *Barclays Bank v Eustice* addresses this issue. Here the clients wished to set up a scheme which placed assets out of the reach of their creditors.<sup>103</sup> The reason they consulted lawyers was because they wished to achieve their ends within the law. In particular they wished to avoid breaching section 423 Insolvency Act 1986.<sup>104</sup> Nevertheless, in the course of an interim application for disclosure brought by their creditor against the clients, the Court of Appeal held that the scheme was prima facie fraudulent, and contrary to public policy. It was not necessary for the creditor to show that the clients had been dishonest in setting up the scheme.<sup>105</sup> As a result, communications between the lawyers and the clients concerning the scheme were not privileged.

The implications of this case are that privilege could be lost where managers consult lawyers to learn how to exploit legal loop-holes and engage in arguably legal conduct but are unsuccessful and commit a criminal offence or a fraud. As Schiemann LJ commented: 'Public policy does not require the communications of those who misapprehend the law to be privileged in circumstances where no privilege attaches to

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<sup>99</sup> A Alfieri, 'The Fall of Legal Ethics and the Rise of Risk Management' 94 *Georgetown Law Journal* 1909 (2006) at p 1911.

<sup>100</sup> R C Cramton, 'Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues' 58 *Business Lawyers* 143 at 173.

<sup>101</sup> J Coffee, 'The Attorney as Gatekeeper: An Agenda for the SEC' 103 *Columbia Law Review* 1293, 1307 (2003).

<sup>102</sup> *R v Cox & Railton* (1884) 14 Q.B.D. 153. For a detailed discussion see C Passmore, *Privilege* (St Albans: XPL publishing, 2<sup>nd</sup> ed) 2006 Ch 8.

<sup>103</sup> [1995] 1 W.L.R. 1238

<sup>104</sup> Section 423 Insolvency Act 1986 permits the courts to set aside transactions which have been made for the purpose of putting assets beyond the reach of creditors, or otherwise prejudicing creditor interests.

<sup>105</sup> [1995] 1 W.L.R. 1238 at 1250

those who correctly understand the situation.’<sup>106</sup> It has even been suggested that privilege could be lost where the court takes the view that the conduct is ‘intrinsically contrary to public policy’.<sup>107</sup> Some may view this as an unwelcome extension of the crime-fraud exception, and as an erosion of privilege.<sup>108</sup> However if fear of losing privilege deters managers from consulting lawyers about, and so pursuing, arguably legal courses of action, this is a better outcome than one in which corporate clients and lawyers devise increasingly ingenious schemes directed at avoiding the law with impunity. To cite Schiemann LJ again:

‘I do not consider that the result ... will be to discourage straightforward citizens from consulting their lawyers. Those lawyers should tell them that what is proposed is liable to be set aside and the straightforward citizen will then not do it and so the advice will never see the light of day. In so far as those wishing to engage in sharp practice are concerned, the effect of the present decision may well be to discourage them from going to their lawyers. This has the arguable public disadvantage that the lawyers might have dissuaded them from the sharp practice. However, it has the undoubted public advantage that the absence of lawyers will make it more difficult for them to carry out their sharp practice.’<sup>109</sup>

And if it turns out that, despite the risk of losing privilege, clients continue to consult lawyers in order to devise such schemes, and continue to put such schemes in place, then this somewhat undermines the arguments in favour of privilege in the first place. This is because it is central to the consequentialist argument against whistle-blowing that the protection of legal professional privilege is necessary if corporate employees are to be candid with lawyers, and they will be less candid if privilege is absent or uncertain.

However in the UK, as a result of *Three Rivers DC v Governor and Company of the Bank of England (Disclosure) (No.5)* (*‘Three Rivers (No. 5)’*)<sup>110</sup> it will often be unclear when a corporate employee’s communication with the company lawyer will be privileged. This case substantially narrowed the number of corporate employees whose communications could be protected by legal advice privilege.<sup>111</sup> While it is not known to what extent, if any, the decision had a chilling effect on communications between company employees and company lawyers, such communications which do take occur cannot do so because the employee is relying on legal professional privilege, since the employee does not know whether privilege applies or not. In any event, an employee could never be guaranteed absolute confidentiality in respect communications with the lawyer, because privilege belongs to the company not the employee, and the company could choose to waive it against the employee’s wishes. Furthermore privilege is not absolute but can be lost through accidental waiver or set aside if the client sues the lawyer.<sup>112</sup>

So the argument that whistle-blowing is offensive because it undermines the absolute guarantee of secrecy required for employees to communicate with lawyers is

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<sup>106</sup> [1995] 1 W.L.R. 1238 at 1252

<sup>107</sup> *The David Agmashenebeli* [2001] C.L.C. 942 at 947 (Colman J), but here the iniquity comprised the creation of false evidence.

<sup>108</sup> J. Auburn, *Legal Professional Privilege: Law and Theory* (Hart, Oxford, 2000), pp.162-163, 169-170; C Passmore, *Privilege* (St Albans: XPL publishing, 2<sup>nd</sup> ed) 2006, pp 436-437.

<sup>109</sup> [1995] 1 W.L.R. 1238 at 1252

<sup>110</sup> [2003] EWCA Civ 474, [2003] QB 1556.

<sup>111</sup> For discussion see J Loughrey, ‘Legal Advice Privilege and the Corporate Client’ (2005) 9 *International Journal of Evidence and Proof* 183.

<sup>112</sup> C Passmore, *Privilege* (St Albans: XPL publishing, 2<sup>nd</sup> ed) 2006 Ch 7.

vulnerable, since communications with lawyers still occur despite the uncertainty surrounding whether privilege will apply.<sup>113</sup>

Nevertheless it remains possible that whistle-blowing could have a serious chilling effect on corporate communication, irrespective of considerations of legal professional privilege. From an employee's perspective, there is a great deal of difference between not knowing whether privilege will apply to a communication, so that perhaps, at some future point, a court or state authority may require the production of that communication, and the knowledge that the person you are speaking to may himself blow the whistle because of what you have told him. The latter involves the lawyer in a betrayal of confidence, and may be perceived by the employee as presenting a much more immediate and intimidating threat.

However whistle-blowing need not pose this kind of threat. The noisy withdrawal provisions proposed by the SEC, for example, did not require the disclosure of specific lawyer-employee communications. Rather the lawyer would have been blown the whistle on the board's inaction, rather than on individual corporate managers. For sure, once the lawyer's noisy withdrawal had signalled that something was wrong in the company it might only be a matter of time before the relevant lower level employees' actions came to the attention of the regulators. On the other hand noisy withdrawal was only proposed where those in the very highest positions in a company refused to take action in the face of a widespread risk to investors and creditors. In most companies managers would expect the board to respond to the lawyer's report. As a result, the employee's threat of exposure through whistle-blowing would not have been immediate, and would usually not be substantial. In such companies the risk to the employee of confiding in the lawyer would have been no greater than under a reporting up requirement.

Furthermore, Coffee has argued that whistle-blowing may increase the flow of communication to the lawyer. This is because managers' awareness of the possibility of whistle-blowing obligations being triggered by *ex post* revelations of wrongdoing may make them more likely to seek advice regarding the lawfulness of their conduct *ex ante*. Coffee has also argued that noisy withdrawal would only have a chilling effect on corporate communications *ex post* the wrongdoing, and that such communications do not deserve protection.<sup>114</sup> Certainly, as argued earlier, the chilling of certain communications may be welcome. Koniak, for example, has argued that many securities frauds could not occur without lawyer involvement and it would be a social benefit if such consultations were deterred.<sup>115</sup> However Coffee may be wrong to conclude that we should not worry about chilling *ex post* communications. Employees who disclose illegal activities to lawyers are may do so for two reasons. Firstly they may seek advice regarding whether it is possible to limit the damage to the company and/or third parties through corrective action. Secondly, they may seek advice regarding a company's defences to future regulatory action. Both serve desirable aims and should not be discouraged.

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<sup>113</sup> Both here and in the US: see comments of Professor Susan P. Koniak, Boston University School of Law; Professor Roger C. Cramton, Cornell University Law School and Professor George M. Cohen, University of Virginia School of Law, April 7, 2003 (<http://www.sec.gov/rules/proposed/s74502.shtml>) (last visited 20 January 2009)

<sup>114</sup> J Coffee, 'The Attorney as Gatekeeper: An Agenda for the SEC' 103 *Columbia Law Review* 1293, 1307-1309 (2003).

<sup>115</sup> Susan P Koniak, 'When the Hurleyburly's Done: the Bar's Struggle with the SEC' [2003] 103 *Columbia Law Review* 1236, 1253; see also R Tomasic, 'Corporate Collapse, Crime and Governance-Enron, Andersen and Beyond' [2002] *Australian Journal of Corporate Law* 1 at 15.

The question therefore remains whether, as an empirical matter, whistle-blowing obligations would have a detrimental chilling effect. Evidence in support is scant and inconclusive.<sup>116</sup> One survey on the impact of legal professional privilege indicated that privilege did have a positive effect on the candour of communications with lawyers, but 23 of the 52 executive respondents consulted stated that it would make no difference, and of the 39 who said it did matter, some said it would only make a difference to written communications: oral communications would remain frank.<sup>117</sup> The researcher noted that those surveyed had a vested interest in overstating the effect of privilege, and so even these results must be treated with caution.<sup>118</sup> Furthermore the study suggested that executives would continue to consult lawyers because the benefits of doing so outweighed the risks.<sup>119</sup> Companies need legal advice in order to comply with the law, and the risks of breaching the law if they fail to obtain legal advice are likely to be greater than the risks associated with the loss of confidentiality for communications with lawyers. However this survey did not address the issue of lawyers' whistle-blowing or noisy withdrawal.

In the UK, the introduction of the money-laundering legislation, which requires lawyers to blow the whistle on their clients if they suspect them of using the proceeds of crime, was also fiercely resisted on the basis that it would chill communications and deter clients from consulting lawyers. However there is little evidence that this has occurred. In 2005 the European Commission conducted a study on the impact of the EU money laundering rules on the legal profession in the EU generally.<sup>120</sup> It noted claims from practitioners that law firms in the UK were at a competitive disadvantage compared with law firms in jurisdictions with less stringent controls<sup>121</sup> However it found that there was no evidence that the introduction of the money-laundering rules had had any impact on the demand for the services of legal professionals.<sup>122</sup> This is a challenge to the idea that threatening the confidentiality of lawyer-client communications, or imposing whistle-blowing roles on lawyers would deter clients from seeking legal advice and thus result in more infringements of the law.

Again, in the US, privilege has been the subject to a much more sustained and serious attack than would have been posed by noisy withdrawal as a result of the policy of coerced/voluntary waiver. This is a Department of Justice and SEC policy, which has offered leniency to companies being investigated for criminal offences who waive privilege and reveal the results of internal investigations carried out by their lawyers into the alleged wrongdoing. This has resulted in a remarkable number of

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<sup>116</sup> 'Functional Overlap between the Lawyer and Other Professionals: Its Implications for the Privileged Communications Doctrine' (1962) 71 Yale LJ 1226: this study did not differentiate between corporate and non-corporate communications; Note, 'Attorney-Client and Work Product Protection in a Utilitarian World: An Argument For Recomparison' 108 Harv L Rev 1697 at 1700, note 32.

<sup>117</sup> V. Alexander, 'The Corporate Attorney-Client Privilege: A Study of the Participants' (1989) 63 *St. John's Law Review* 191 at 246.

<sup>118</sup> V. Alexander, 'The Corporate Attorney-Client Privilege: A Study of the Participants' (1989) 63 *St. John's Law Review* 191 at 197

<sup>119</sup> Vincent C Alexander, 'The Corporate-Attorney Privilege: A Study of the Participants' 63 *St John's Law Review* 226 at 370 (1989).

<sup>120</sup> European Commission Staff Working Document SEC (2006) 1793. This study had certain shortcomings, including a low response rate, and it did not differentiate between the impact of the rules on corporate lawyers and other categories of lawyer: at p 4.

<sup>121</sup> European Commission Staff Working Document SEC (2006) 1793 para 34. The Commission will be carrying out a further assessment of the effectiveness of the money-laundering legislation across the EU and its impact on lawyers in 2009.

<sup>122</sup> *Ibid* paras 34-36.

convictions of very high level employees, but it has been fiercely attacked by the corporate bar, civil liberties groups and corporate interests.<sup>123</sup> Its relevance to the current discussion is this: such practice goes further than noisy withdrawal in that it exposes communications of individual employees to regulators. It is difficult to imagine anything more likely to chill communications between corporate lawyers and employees, given that employees may well be exposed to regulatory or criminal action as a result. Yet these communications continue to occur and internal investigations continue to produce useful material for prosecutors.<sup>124</sup> On the other hand, employees face dismissal if they do not co-operate with an internal investigation, and this may counteract the chilling effect caused by the prospect of the imminent disclosure of their discussions with the company lawyers. Although US lawyers have strenuously asserted that this practice has impeded lawyer-employee communications, they have not provided empirical evidence of their claims. Those surveys which have been conducted have been directed at lawyers themselves, rather than non-lawyer employees, and have produced largely subjective accounts from those lawyers.<sup>125</sup> This lacuna is surprising since, if the practitioners are correct, such research would surely provide them with powerful arguments against such a dramatic erosion of privilege.

In summary, although it seems intuitively likely that imposing whistle-blowing obligations on company lawyers would counter-productively chill communications between company employees and the company lawyer, there is reason to think that this might be an unfounded fear. Much would depend on the structure of the whistle-blowing requirements. The SEC's noisy withdrawal provision, for example, did not immediately expose employees to the risk of investigation by regulators-provided the board responded to the lawyers report, as would be the case in most companies, no such risk of exposure would ever arise, or at least, no more than exists under up-the-line reporting. Even if reporting out breached privilege this would not, in the corporate context, pose a threat to fundamental rights. Again, provided that the lawyer was not forced to disclose information relevant to the company's defence in any regulatory proceedings, which would impair the lawyer's ability to act as advocate for the client, and the company's ability to prepare its defence, reporting out would not affect the administration of justice. Nor, for the reasons explored above, would it necessarily deter the company from seeking legal advice. Most boards and employees are law-abiding, if only to avoid the risk of personal liability, and the argument that they will avoid seeking legal advice, or instruct lower level employees to avoid doing so, so that they can remain inactive in the face of serious corporate misfeasance, and conceal that fact, has to be treated with some scepticism. The question is one of balancing the cost of whistle-blowing against its benefit. As for privilege, arguments that it must be treated as absolute, as clients rely on a guarantee of absolute secrecy, are unsustainable, not least because that lawyers themselves reserve the right to disclose privileged information if their clients choose to sue them. As for the fear that this would be the thin end of the wedge, and lead to the erosion of privilege or it being 'balanced away', a narrowly drafted legislative provision would not cause this to occur.

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<sup>123</sup> See L Griffin, 'Compelled Co-operation and the New Corporate Criminal Procedure' 82 *New York University Law Review* 311 (2007).

<sup>124</sup> Seigel, 'Corporate America Fights Back: The Battle over the Waiver of Attorney-Client Privilege' 49 *Boston College Law Review* 1 at p 35-36 (2008)

<sup>125</sup> See for example, L Brown, 'Reconsidering the Corporate Attorney Client Privilege: A Response to the Compelled Waiver Paradox' 34 *Hofstra Law Review* 897 at 946 (2006).

## b) Too Costly

The final arguments against imposing a whistle-blowing requirement are that any benefits would be exacted at too great a price and would create an unethical conflict of interest between lawyers and their clients.<sup>126</sup> In order to protect themselves from liability lawyers may whistle-blow unnecessarily, and contrary to the client's interests. Lawyers' tendency to be risk adverse would exacerbate the likelihood of over-reporting, as would the imposition of criminal penalties for failing to comply with the requirement. Again, while some have argued that the level of uncertainty which would be unavoidably inherent in any reporting out provision would give lawyers the wiggle room to avoid reporting out<sup>127</sup> it is more likely to increase the tendency to over-report. For example, under the SEC's Rule 205 noisy withdrawal provision, a lawyer would have had to have made the following judgment calls: whether there had been a *material* violation of securities regulation, or a *material* breach of fiduciary duty likely to result in *substantial* injury to the financial interest or property of the issuer or investors; and whether an *appropriate* response to his report had been made within a *reasonable* time.<sup>128</sup> Assessing whether the board has made an appropriate response to the lawyer's report, as Rule 205 could lie outside a lawyer's expertise and would have been something about which lawyers and boards could reasonably disagree. This would also have required a lawyer to second guess and challenge the board's decisions and, possibly, commercial judgment. There may well have been cases where it was clear that the board's response was inappropriate but equally there would have been cases where it was a close judgment. Despite this, in order to avoid being judged harshly by those having the benefit of hindsight there would be a real risk that lawyers would respond to such uncertainty by resolving any doubts against their client. Such a response would give rise to systemic costs, blunt the whistle-blowing message by creating 'noise' as a result of which it would become difficult to detect cases of real concern, and would unnecessarily damage the relationship between client and lawyer.<sup>129</sup>

The UK's experience with the money-laundering legislation lends credence to these arguments. The number of reports made by solicitors was at its highest level just after the introduction of the money-laundering legislation and during a period of uncertainty regarding whether and how the money-laundering rules applied in the course of litigation.<sup>130</sup> It seems that at this point solicitors were not giving their clients the benefit of the doubt. At the same time, many of the reports were dismissed as having little investigative merit, and a consequence of defensive reporting.<sup>131</sup>

However matters have improved. While the latest data does not clearly distinguish between reports made by solicitors and those made by other regulated persons, there is evidence that the reports are of better quality and of increasing

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<sup>126</sup> T J Canni, 'Protecting the Perception of the Public Markets: At What Cost? The Effects of "Noisy Withdrawal" on the Long Standing Attorney-Corporate Client Privilege' 17 *St Thomas Law Review* 371 at 398-399 (2004)

<sup>127</sup> M Sargent, 'Lawyers in the Perfect Storm' 43 *Washburn Law Journal* 1 at 42 (2003)

<sup>128</sup> Proposed Rule 307 para 205.2(4) at <http://www.sec.gov/rules/proposed/33-8150.htm#xi> (last visited 12 September 2008)

<sup>129</sup> J Fisch and K Rosen 'Is There a Role for Lawyers in Preventing Future Enrons?' (2003) 48 *Villanova Law Review* 1097 at pp 1126-1127

<sup>130</sup> Sir Stephen Lander, *SARS Review* (2006) para 26

<sup>131</sup> The Law Society Gazette, 'Time for Calm on Reports' (18<sup>th</sup> November 2004) <http://www.lawgazette.co.uk/opinion/leader/time-calm-reports> (last visited 12 January 2009)

usefulness to the regulatory authorities and this is due at least in part to an improvement in the quality of reports made by solicitors and a drop in defensive reporting by them.<sup>132</sup> Furthermore, the Law Society appears to be far more accepting of the money-laundering regime and the need to report out.<sup>133</sup> If this attitude is reflected across the profession then it indicates that professional culture may be changing, and the profession may have become more receptive to a whistle-blowing role, at least where legal professional privilege is not at risk.

Nevertheless there remain other potential costs. There is a real risk that if a lawyer reports out unnecessarily, this would result cause a drop in the share price.<sup>134</sup> This could possibly be avoided if reporting out was dealt with on a confidential basis, but if an investigation followed the company would be harmed. This could place lawyers in an invidious position. If they fail to report out, and the regulatory authorities took the view that they should have, they could be exposed to liability. On the other hand if they reported out and should not have done so, so that loss was unnecessarily caused to the company, they would face the prospect of being sued, unless the relevant legislation granted them immunity. Even then, some exposure is inevitable unless the legislature granted immunity to disclosures made in bad faith or without reasonable cause. If, as seems likely, it did not, one could expect litigation on the question of lawyers' good faith and reasonableness in making the reports.<sup>135</sup>

#### **D. Conclusion**

Imposing a legislative requirement on lawyers to report up-the-line would not be controversial, and in fact would be desirable, since it would clarify corporate lawyers' responsibilities and operate for the benefit of the company client. Furthermore, there is no reason why such a requirement should be confined to securities lawyers and their clients. In contrast mandatory whistle-blowing is far more problematic. It is not possible to predict with any accuracy what the consequences of such a requirement would be. While the level of concern over the threat to legal professional privilege is probably misplaced, some chilling effect on inter-corporate communications cannot be ruled out, and furthermore, insofar as any reporting out initiative did threaten privilege, it would meet enormous resistance from the legal profession. There are also real issues about the costs of such an initiative. Much would depend on the terms of a reporting requirement, the level of uncertainty inherent in it, the penalties imposed for breaching it, the level of immunity granted to lawyers for making these reports and the level of confidentiality associated with the reports and any subsequent investigation. At the very least there are likely to be

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<sup>132</sup> SOCA, *The Suspicious Activity Report Annual Review 2007* (2009) p 22 and p 26. This conclusion is drawn because SOCA has indicated that following *Bowman v Fels* the number of technical breaches reported fell. This decision would have impacted on lawyers' reporting behaviour rather than the behaviour of other professionals

<sup>133</sup> The Law Society 'Soca-Suspicious activity report annual review' (27 November 2008)

<sup>134</sup> As occurred in the US in the case of *TV Azteca*: see S Fortney. 'Chicken Little Lives: The Anticipated and Actual Effect of Sarbanes-Oxley on Corporate Lawyer's Conduct' 33 *Capital University Law Review* 61 at 72.

<sup>135</sup> However section 337 of the Proceeds of Crime Act 2002 provides protection for disclosures where the lawyer knew or suspected *or* had reasonable grounds for knowing or suspecting that money-laundering. This suggests that immunity will be granted even though the suspicion was unreasonable. This approach is supported by *K Ltd v National Westminster Bank Plc* [2006] EWCA Civ 1039; [2007] Bus. L.R. 26 at [21] in which the Court of Appeal rejected the argument that there had to be reasonable grounds for suspicion before a report could be made.



significant costs while the procedure ‘beds down’, as there were with the money laundering legislation. In the circumstances, if mandatory whistle-blowing was introduced it should be done cautiously, and confined to securities lawyers and disclosures to the FSA. On the other hand there is no reason why professional guidance should not be amended to provide that all corporate lawyers have a discretion to disclose wrongdoing in a broader range of circumstances than are permitted at present.<sup>136</sup> There are many reasons why lawyers would not exercise this discretion, but fear of professional sanction by their regulatory body should not be one of them.

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<sup>136</sup> SRA Code of Conduct Comment on Rule 4 provides only that disclosure can be made where it is necessary to prevent a criminal act which would result in serious bodily harm or in cases of child abuse but only where the threat to the child’s life or health is sufficiently serious at paras 13 and 14. Compare American Bar Association Model Rules of Professional Conduct Rule 1.13 (c).