LESSONS FOR LAWYERS FROM THE ENRON DEBACLE

BY EDWARD J. CLEARY

The accounting industry has long fought changes that would put teeth into the oversight efforts of the self-regulatory bodies. The industry has been notorious for failing to discipline its members, fearing that the process would increase private liability in private class-action lawsuits.[1]

It seems likely that reverberations from the Enron implosion will be felt economically and politically for years to come. There is plenty of blame to go around; business executives, government officials and at least one prominent law firm appear to have been compromised and many have a great deal of explaining to do. Undoubtedly, some of that explaining will be before a grand jury. Yet it is in the court of public opinion that at least one group is under severe attack — and this time it is not primarily the legal profession that is targeted, but rather the accounting industry. A look at the failed attempts to self-regulate and the mistakes made by the accountants is instructive in evaluating the strengths and shortcomings of our profession.

A TOOTHLESS OVERSIGHT BOARD

In 1977, the accounting industry created a Public Oversight Board, a five-member group of prominent business people without direct ties to the accounting firms. The board was charged with overseeing and approving the peer reviews conducted by accounting firms of each other. The staff at the board was also charged with looking into "failed audits" when accounting rules had been violated but not detected by auditors. In truth, the board was a paper tiger and "the system has been heavily criticized because no large accounting firm has ever been given an unfavorable review."[2] In the meantime, in the past three years alone, accounting fraud has led to scandals at Waste Management, Sunbeam, and Cendant, among others. So in the wake of these failures, capped off by the demise of Enron, what should the accounting industry do?

The Securities and Exchange Commission held a series of private meetings with officials of the Big Five accounting firms leading to a proposal for a new private sector panel body to be funded by corporate audit clients. Unfortunately, the SEC chairman was formerly the representative of a number of the Big Five accounting firms before assuming his position. To some observers, the proposal was more of the same, raising as many questions as it answered. Another put it more bluntly: "It's not the high water mark of public accountability when the industry to be regulated designs its own regulatory structure in negotiations with its former lawyer."[3] While the SEC pondered new regulations, the members of the accounting industry's Public Oversight Board, acting either petulantly or in recognition of the heavy criticism headed their way, "unexpectedly voted itself out of existence."[4] Finally, demonstrating once again that survival skills are often incompatible with integrity, a number of politicians quickly criticized the accounting practices at Enron, even though "Congress, including some of Enron's most vocal critics there, routinely opposed significant new accounting rules over the past decade."[5]

So, in the final analysis, what is the likely fallout of the Enron mess, at least in the near term? It seems likely that federal indictments for obstruction of justice will be forthcoming as the shredding of documents will almost certainly lead to this result. In the past, "U.S. attorneys . . . rarely pursued large white-collar crime cases like accounting fraud because of their daunting complexity and the difficulty of proving criminal intent."[6] The odds are these hurdles will be overcome. Successful prosecutions will likely result in severe consequences as Enron is "the first major white-collar crime investigation since the new [sentencing] guidelines became effective" November 1 and these guidelines "have nearly doubled for insider trading and fraud in excess of $1 million."[7] There will undoubtedly be a wringing of the hands by the accounting industry, acknowledging the failure to properly regulate accountants, while some fight to prevent true oversight reform through the enacting of new rules and enforcement mechanisms (the peer review concept failed miserably in this context). This will likely be followed by more posturing by politicians, with, hopefully, real reform to follow. Pressure for this reform will be tremendous. Given that Enron employee pensions were decimated with, as one commentator noted, the employees "locked in steerage like the lower orders on the Titanic,"[8] and given that many state pension funds[9] were among the casualties, both state and national public officials will be forced to act.

Perhaps most important, one can hope that the accounting industry will finally recognize and accept the inherent conflict of interest in doing both consulting and auditing work for the same company. In the case of Enron, Arthur Anderson was both the accountant and the consultant. "The resulting coziness reeked of conflict of interest and surely helped produce Enron account books that should be filed under 'fiction.' Enron never reported even a bad quarter before collapsing."[10] Enron paid Anderson $25 million dollars for its audit last year and $27 million for consulting work and other services.[11] The same conflict exists closer to home. With more and more accounting firms treating auditing, or "the attest" function, as a type of loss leader that is offered in an attempt to land non-audit business, Minnesota based publicly traded companies from U.S. Bancorp to Xcel Energy to 3M to Best Buy, along with many others, have allowed their auditor to be compromised by the delivering of conflicting services.[12] "Auditors have a hard-to-resist incentive to go easy on companies to avoid jeopardizing lucrative consulting contracts."[13]

AN "ELABORATE ACCOUNTING HOAX"

Our profession may not have sustained the black eye suffered by the accounting

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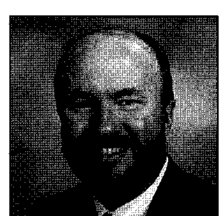


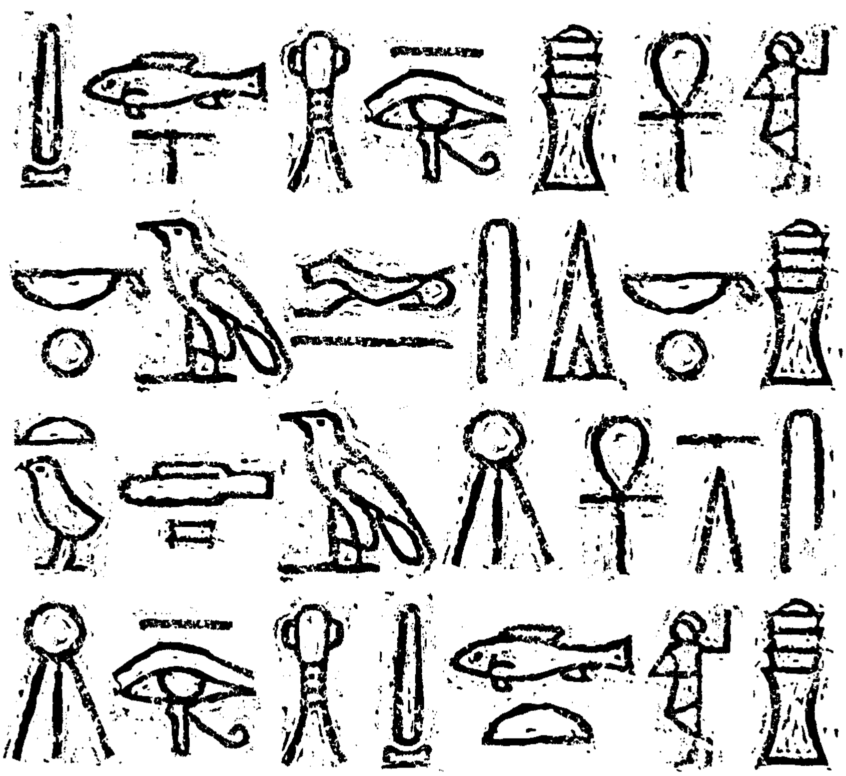
industry (so far), but there were clearly lawyers involved in the Enron debacle and it appears a number of them did not acquit themselves admirably. To the lawyers inside of Arthur Anderson who were involved directly or indirectly with the shredding of pertinent documents, to the lawyers outside of the firm who dismissed the early warnings from an Enron employee about improper accounting for the partnerships, some members of our profession failed miserably. The shredded documents included "accounting records, expense reimbursement requests, wire fund transfer requests and what appear to be insurance records."[14] Since under federal law it is a felony to "persuade another person to destroy records with an intent to impair their availability for use in an official proceeding" and since the law says the proceeding "need not be pending or about to be instituted at the time of the offense" the document destruction is "close to indefensible" and "it is likely the firm will face heavy liability."[15]

As noted in an earlier *Bench & Bar* article,[16] the American Bar Association "failed last year to approve new ethics rules that would have given lawyers more latitude to report wrongdoing by their clients, including fraudulent business deals and financial crimes."[17] While it is "not clear whether the changes dropped last year would have made any difference in preventing the catastrophic Enron bankruptcy," there were reports that a "senior lawyer warned about the appearance of sweetheart deals and dubious transactions" and that his warnings "were largely unheeded."[18] Would that attorney have revealed the financial wrongdoing going on if the rule had been different? Would those revelations have prevented Enron from becoming the disaster it became? We don't know and we can't know but it is reasonable to conclude that the ABA should take another look at loosening the ability of a lawyer to report the ongoing fraud and criminal activity of his clients.

REPERCUSSIONS FOR MULTIDISCIPLINARY PRACTICE

Lawyers outside of Enron appear to have developed too cozy a relationship to their client, perhaps losing their objectivity and independent judgment. Given those failures and the accounting lapses, what are the implications for multidisciplinary practice?

As most readers are aware, Minnesota has decided, along with a number of other states, to petition the highest court



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in each state for a rule change that would allow multidisciplinary practice under certain delineated circumstances. It is fair to say that the idea of allowing multidisciplinary practice has always had its detractors in our state and elsewhere. Sharing of fees with non-lawyers has always struck some as likely to result in the "erosion of the core values of the profession, resulting in the loss of ownership and control of law firms and, finally, in the loss of professional independence of the lawyers involved."[19] Such concerns cannot be ignored, particularly in light of the Enron experience. Without being too self-congratulatory, our profession can reasonably conclude that we require our members to adhere to a consistently more refined and demanding ethical framework and that we do a better job of self-regulation than the accounting industry (which isn't saying much). So would "permitting non-lawyers — those who have not been grounded in the professional responsibility of the legal profession — to participate in . . . difficult decisions . . . place the clients at risk of having these critical decisions dictated solely by the marketplace?" Would it be "virtually impossible for a lawyer to exercise independent judgment in the face of a non-lawyer boss who is ordering the lawyer's conduct on the basis of cold numbers printed on a balance sheet?"[20]

Minnesota's proposal would create at least two safeguards not always found in proposed multidisciplinary practice. First, Minnesota lawyers must retain majority control of the entity. Second, conflicts are imputed firm wide in a multidisciplinary practice by treating clients of non-lawyer professionals as clients of the firm's lawyers. As I noted over a year and a half ago, "for accounting firms, the recommendation that conflicts of interest be imputed within an MDP is problematic, since it would mean that an accounting firm could not provide legal services to a client if that client had interests adverse to those of an accounting client."[21] While, as one publication noted "the growing Enron scandal . . . shows the kind of conflict lawyers could face if their law firm were based at a Big Five firm,"[22] that type of arrangement would not be authorized within Minnesota because the lawyers would not own a majority of the multidisciplinary practice. So with these restrictions, and with Minnesota's provisions for revealing of client confidences under 1.6(a) to reveal the intention of a client to commit a crime and to rectify the consequences of a client's criminal or fraudulent act in the furtherance of which the lawyer's services were used, hopefully a lawyer's professional independence will continue. One is nevertheless left speculating as to what culture will win out: the legal profession's tradition of ethical precepts and self-regulation with severe consequences for wrongdoers, or the accounting profession's "buyer beware" culture of anything goes. With reforms hopefully to follow, perhaps the climate will be ripe for multidisciplinary practice in Minnesota and elsewhere. Nevertheless, support for multidisciplinary practice, if not eroding, may well be wavering, here and elsewhere, as the Enron disaster continues to unfold. □

NOTES

1 *Michael Schroeder, "SEC Proposes Accounting Disciplinary Body,"* The Wall Street Journal, *1/17/02, p. C1.*

2 *Scot J. Paltrow and Jonathan Weil, "Accounting Industry Review Board Votes to End its Existence in Protest,"* The Wall Street Journal, *1/23/02, p. A2.*

3 *Paltrow and Weil,* The Wall Street Journal, *quoting Prof. John Coffee of Columbia Law School.*

4 *Paltrow and Weil,* The Wall Street Journal, supra.

5 *Michael Schroeder and Greg Hitt, "Congress Fought Changes to Accounting Rules Over Past Decade,"* The Wall Street Journal, *1/24/02, p. A20.*

6 *"The Hot Topic: Accounting Reform,"* The Wall Street Journal, *2/6/02, p. A8.*

7 *"Obstruction Charges Likely to Be First Step in Enron Criminal Case,"* The Wall Street Journal, *1/28/02, p. A6.*

8 *George F. Will, "Indignation over Enron is just the beginning,"* Washington Post, *1/16/02.*

9 *Minnesota's state pension fund was among the casualties.* See *Conrad deFiebre, "State pension funds lost $20 million in Enron collapse,"* Star Tribune, *1/24/02.*

10 *Will,* Washington Post.

11 *Daniel Kadlec, "Who's Accountable?"* Time, *1/21/02, p. 34.*

12 *"Beyond the audit,"* St. Paul Pioneer Press, *2/2/02, p. 9A.*

13 *"Though Enron Case Isn't Over, Lessons Already Emerge,"* The Wall Street Journal, *1/15/02, p. A4.*

14 *Jonathan D. Glater and Michael Brick, "Ex-Official Says Enron Employees Shredded Paper,"* The New York Times, *1/22/02.*

15 *David S. Hilzenrath and Susan Schmidt, "Anderson Dismisses Lead Enron Auditor,"* Washington Post, *1/16/02, p. A01.*

16 See *Cleary, "Revealing Client Confidences,"* Bench & Bar, *December 2001, p. 13.*

17 *Anne Gearan, "Enron Scandal Spotlights Lawyers,"* AP, *2/3/02.*

18 *Richard A. Oppel Jr., "Lawyer Warned Enron Officials of Dubious Deals a Year Before Collapse,"* The New York Times, *2/7/02.*

19 *Cleary, "Multidisciplinary Practice: Minnesota Moves Forward,"* Bench & Bar, *October 2001, p. 14.*

20 *Steven C. Krane, "Let lawyers practice law,"* The National Law Journal, *1/28/02, p. A16.*

21 *Cleary, "Multidisciplinary Practice: One Year Later,"* Bench & Bar, *September 2000, p. 18.*

22 *Geanne Rosenberg, "Scandal seen as blow to outlook for MDP,"* The National Law Journal, *p. A1.*