January 2004

The Tournament at the Intersection of Business and Legal Ethics

Stephen M. Bainbridge

Follow this and additional works at: <https://ir.stthomas.edu/ustlj>

Part of the [Legal Ethics and Professional Responsibility Commons](#)

Recommended Citation

Stephen M. Bainbridge, *The Tournament at the Intersection of Business and Legal Ethics*, 1 U. ST. THOMAS L.J. 909 (2004).

Available at: <https://ir.stthomas.edu/ustlj/vol1/iss2/5>

This Article is brought to you for free and open access by UST Research Online and the University of St. Thomas Law Journal. For more information, please contact lawjournal@stthomas.edu.

ARTICLE

THE TOURNAMENT AT THE INTERSECTION OF BUSINESS AND LEGAL ETHICS

STEPHEN M. BAINBRIDGE*

There is little doubt that lawyers played a role in Enron and the other recent corporate governance scandals. Sometimes their negligence allowed management misconduct to go undetected. Sometimes lawyers even acted as facilitators and enablers of management impropriety.¹

According to Enron's internal investigation, for example, "[t]here . . . was an absence of forceful and effective oversight [of the company's disclosures] by . . . in-house counsel, and objective and critical professional advice by outside counsel at Vinson & Elkins."² The report expressly criticized Vinson & Elkins, which the investigators argued "should have brought a stronger, more objective and more critical voice to the disclosure process."³ On the Senate floor, Senator John Edwards (D-N.C.) summed up the problem by concluding that when "executives and/or accountants are breaking the law, you can be sure that part of the problem is that the lawyers who are there and involved are not doing their jobs."⁴

Would new rules of legal ethics lead to more ethical lawyers? If so, would more ethical lawyers contribute to a renewal of business ethics? The theme of this conference—the intersection of business and legal ethics—implicitly assumes an affirmative answer to those questions. Congress evidently thought so too, as a key component of the Sarbanes-Oxley Act was

* Professor, UCLA School of Law. I thank Christina Johnson (UCLA School of Law Class of 2003) for able research. I also thank Mitu Gulati and Larry Ribstein for their constructive criticism.

1. For a discussion of the role played by lawyers in the misconduct of Enron managers, see generally Deborah L. Rhode & Paul D. Paton, *Lawyers, Ethics, and Enron*, 8 Stan. J.L. Bus. & Fin. 9 (2002); Mark A. Sargent, *Lawyers in the Perfect Storm*, 43 Washburn L.J. 1, 19-36 (2003).

2. William C. Powers, Jr., et al., *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.* 17 (Feb. 1, 2002) (available at <http://news.findlaw.com/wp/docs/enron/specinv020102rpt1.pdf>).

3. *Id.* at 26; Rebecca Blumenstein & Susan Pulliam, *WorldCom Fraud Was Widespread*, Wall St. J. A3 (June 10, 2003) (An internal investigation at WorldCom likewise faulted, *inter alia*, the firm's lawyers as part of a pervasive "breakdown in . . . the company's corporate-governance structure.").

4. 148 Cong. Rec. S6551 (daily ed. July 10, 2002).

§ 307's command that the Securities and Exchange Commission ("SEC" or "Commission") develop new legal ethics rules for lawyers appearing before it.⁵

I do not doubt that part of the blame for Enron and its ilk can be laid at the feet of corporate lawyers; nor do I doubt that responsive changes in the rules of legal ethics were appropriate.⁶ In this article, however, I wish to interject a note of pessimism into the debate. As Charles Colson observed, following Michael Novak, "Western liberal democracy is like a three-legged stool. Political freedom is the first leg, economic freedom the second, and moral responsibility the third. Weaken any leg, and the stool topples."⁷ Enron revealed the rot in the third leg.⁸ In this article, however, I argue that we cannot expect legal ethics to do much in the way of carpentry.⁹ At best, it may patch over some rough spots, but it likely will prove a mere Band-Aid.

The critical issue here is the structure of modern big-firm legal practice and the resulting economic incentives for lawyers. Tournament theory is the standard economic and sociological model for analyzing the institutional structures and cultures of large law firms.¹⁰ Indeed, more generally,

5. Public Company Accounting Reform and Investor Protection Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 748 (2002); see generally Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, 58 Bus. Law. 143 (2002); Larry Catá Backer, *The Sarbanes-Oxley Act: Federalizing Norms for Officer, Lawyer, and Accountant Behavior*, 76 St. John's L. Rev. 897 (2002); see generally James Hamilton & Ted Trautmann, *Sarbanes-Oxley Act of 2002: Law and Explanation* (CCH 2002) (on the Act as a whole).

6. See Stephen M. Bainbridge & Christina J. Johnson, *Managerialism, Legal Ethics, and Sarbanes-Oxley Section 307*, 2004 Mich. St. L. Rev. 299, 307-10 (2004) (analyzing the relevant rules of professional responsibility).

7. Charles Colson, *The Wages of Secularism: New Laws Won't Prevent Another Enron*, Christianity Today 64 (June 10, 2002).

8. *Id.*

9. It is perhaps worth noting, as well, that regulatory attempts to promote virtue may undermine the second leg—i.e., economic liberty. As I explained elsewhere:

[M]inimizing state regulation of corporate governance is essential to the preservation of a free, yet virtuous society. Viewed from a sphere sovereignty perspective, subordination of economic institutions to the state poses a grave threat to personal liberty. Society includes a host of communities with the potential to inculcate virtue and other communal values: churches, schools, fraternal organizations, and the like. Although it may be unrealistic to think of a large multinational corporation as constituting such a community, it is perfectly plausible to think of the corporation as an intermediary institution standing between the individual and Leviathan. In other words, although the development of virtuous citizens is arguably best performed by smaller institutions with roots in the local community, the corporation can still act as a vital countervailing force against the state. Resistance to expanding the realm of mandatory corporate law rules thus responds to the "notion that the prevailing moral threat in our era may not be the power of the corporations but the growing power and irresponsibility of the state."

Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 Cornell L. Rev. 856, 897 (1997) (quoting Michael Novak, *Toward a Theology of the Corporation* 34 (Rev. ed. 1990)).

10. David B. Wilkins & G. Mitu Gulati, *Reconceiving the Tournament of Lawyers: Tracking, Seeding, and Information Control in the Internal Labor Markets of Elite Law Firms*, 84 Va. L. Rev. 1581, 1581 (1998); but see George Rutherglen & Kevin A. Kordana, *A Farewell to Tourna-*

tournament theory is a standard tool in the study of the internal labor markets within a wide variety of firms.¹¹

As the story goes, tournaments are a mechanism for reducing agency costs by providing incentives through "comparative performance evaluation."¹² In a promotion tournament, the principal ranks its agents by their performance relative to one another.¹³ The best performing agents are promoted to positions with higher pay and/or status.¹⁴ As applied to lawyers, law firms supposedly rank associates and then promote the best performing associates to partner at the end of an evaluation period.¹⁵

Part I of this article reviews the effort made in Sarbanes-Oxley § 307 to enlist legal ethics in the effort to prevent future Enrons. Part II briefly explains tournament theory as applied to law firms. My thesis herein is that the tournament of lawyers creates a set of carrots that inevitably tempts lawyers to align themselves with corporate managers rather than directors or stockholders. Neither Sarbanes-Oxley § 307, nor any contemplated change in the American Bar Association's rules of professional responsibility, strikes at those carrots.¹⁶ Instead, legal ethics reformers have sought to create a new set of sticks with which to force corporate counsel into aligning themselves with the board of directors rather than management.¹⁷ As I argue herein, however, it may be doubted whether those sticks will suffice.

I. SARBANES-OXLEY § 307: ENLISTING LEGAL ETHICS IN THE PURSUIT OF MORE ETHICAL BUSINESS CONDUCT

Corporate scandals are always a bullish signal for regulatory activity. Hence, it was entirely predictable that the shenanigans at Enron, WorldCom, and their ilk, especially coming after several years of steady decline in the stock market, would lead to regulation. In June 2002, Congress passed the "Public Company Accounting Reform and Investor Protection Act," popularly known as the Sarbanes-Oxley Act.¹⁸ In signing the Act, President George W. Bush praised it for making "the most far-reaching

ments? The Need for an Alternative Explanation of Law Firm Structure and Growth, 84 Va. L. Rev. 1695, 1705 (1998) (arguing that "we now must go beyond tournament theory").

11. Wilkins & Gulati, *supra* n. 10, at 1593.

12. Paul Milgrom & John Roberts, *Economics, Organization & Management* 367 (Prentice Hall 1992).

13. *Id.*

14. *Id.*

15. The standard application to law firms is Marc Galanter & Thomas Palay, *Tournament of Lawyers: The Transformation of the Big Law Firm* (U. Chi. Press 1991).

16. Cf. Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons?*, 48 Vill. L. Rev. 1097, 1122-23 (2003) (opining that the "incentives that drive lawyers and corporate actors raise doubts as to whether Section 307 will force the behavioral changes sought by its drafters").

17. Bainbridge & Johnson, *supra* n. 6, at 315.

18. 116 Stat. 745.

reforms of American business practices since the time of Franklin Delano Roosevelt.”¹⁹

Until quite late in the legislative process, the Act did nothing to address the role of lawyers. During the floor debate, however, Senator Edwards successfully offered an amendment that became § 307 of the Act.²⁰ Section 307 requires the SEC to

issue rules . . . setting forth minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers, including a rule—(1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and (2) if the counsel or officer does not appropriately respond to the evidence . . . requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed . . . by the issuer, or to the board of directors.²¹

In obedience to Congress’ command, in January 2003 the SEC promulgated attorney conduct regulations. The principal substantive mandate imposed on lawyers by the “Part 205 Regulations” is an up-the-ladder reporting requirement.²² This approach is intended to create an “early warning system” about management wrongdoing through mandatory attorney disclosures to independent directors “who might otherwise, due to their limited involvement in day-to-day corporate operations, fail to identify potential problems.”²³

19. Mike Allen, *Bush Signs Corporate Reforms into Law; President Says Era of “False Profits” is Over*, Wash. Post A04 (July 31, 2002).

20. 148 Cong. Rec. at S6552.

21. 116 Stat. at 784.

22. In adopting the Part 205 regulations, the SEC postponed implementing a final rule with regard to “noisy withdrawals.” Press Release, U.S. Securities and Exchange Commission, *SEC Adopts Attorney Conduct Rule Under Sarbanes-Oxley Act* (Jan. 23, 2003) (available at <http://www.sec.gov/news/press/2003-13.htm>).

23. Fisch & Rosen, *supra* n. 16, at 1112. In assessing the likely impact of Sarbanes-Oxley § 307 on legal ethics and, derivatively, on business ethics, it is critical to differentiate the up-the-ladder reporting requirement contemplated by § 307 from the noisy withdrawal requirement considered by the SEC. The latter would have had a much more direct impact on corporate accountability than will the former. A noisy withdrawal directly calls the corporation to the attention of regulators and the plaintiff’s bar; hence, the threat of withdrawing noisily would give legal counsel a powerful tool by which to affect client decision-making. In contrast, a reporting-up-the-ladder requirement precludes client misconduct only if the higher authority takes action. *See id.* at 1112 (stating that “[t]he expectation of Sarbanes-Oxley is that decisionmakers . . . upon learning of corporate misconduct, will intervene to stop or prevent the wrongdoing Accordingly, much of the value of the reporting up requirement relies on the level of response of other corporate actors.”). In the case of Enron, it seems likely that the board of directors knew most of what

Part 205 applies to any lawyer who is "appearing and practicing before the Commission" in the representation of an issuer.²⁴ In turn, "appearing and practicing" is defined very broadly.²⁵ As I have observed elsewhere, this definition likely will encompass many lawyers who do not regard themselves as securities lawyers.²⁶

When a lawyer who appears and practices before the SEC "becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer," the lawyer's initial duty is to report such evidence to the issuer's chief legal or executive officer.²⁷ Unless the lawyer "reasonably believes that [that officer] has provided an appropriate response within a reasonable time, the attorney shall report the evidence of a material violation to" the audit committee of the board of directors, subject to several exceptions and alternatives.²⁸ The SEC thus implemented Senator Edward's intent that § 307 give lawyers a very "simple" obligation: "You report the violation. If the violation isn't addressed properly, then you go to the board."²⁹

Section 307 was motivated by two basic concerns: (1) lawyers had played a nontrivial role in facilitating corporate misconduct; and (2) the bar associations had blocked legal ethics reforms intended to discourage lawyers from doing so. In introducing the amendment that became § 307, Senator Edwards argued that after "all the . . . corporate misconduct we have seen, it is . . . clear that corporate lawyers should not be left to regulate

the lawyers knew, but nevertheless failed to take action. *See id.* at 1117-1120 (exploring specific examples).

24. 17 C.F.R. § 205.2.

25. In pertinent part, the regulations state:

Providing advice in respect of the United States securities laws or the Commission's rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document.

17 C.F.R. § 205.2(a)(1)(iii). The release in which the SEC adopted the Part 205 Regulations states "an attorney's preparation of a document (such as a contract) which he or she never intended or had notice would be submitted to the Commission, or incorporated into a document submitted to the Commission, but which subsequently is submitted to the Commission as an exhibit to or in connection with a filing, does not constitute 'appearing and practicing' before the Commission." 17 C.F.R. § 205.

26. Bainbridge & Johnson, *supra* n. 6, at 313-14.

27. Specifically, the rule states:

If an attorney, appearing and practicing before the Commission in the representation of an issuer, becomes aware of evidence of a material violation by the issuer or by any officer, director, employee, or agent of the issuer, the attorney shall report such evidence to the issuer's chief legal officer (or the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or the equivalents thereof) forthwith.

17 C.F.R. § 205.3(b)(1).

28. *Id.* at § 205.3(b)(3).

29. 148 Cong. Rec. at S6552.

themselves no more than accountants should be left to regulate themselves.”³⁰

The basic problem is that the rules of legal ethics, as codified by the ABA, are essentially managerialist in their outlook.³¹ As I have explained elsewhere in detail, they encourage lawyers to align themselves with a corporate client’s managers rather than either its directors or shareholders.³² An ABA corporate responsibility task force acknowledged that Sarbanes-Oxley § 307 was a direct response to this “concern that the existing rules of professional conduct did not sufficiently direct the lawyer for the corporation to report illegal conduct to the corporation’s board of directors.”³³ Indeed, as Senator Edwards observed during the floor debate, it was protests from the organized bar that long prevented meaningful reform of the relevant rules of legal ethics.³⁴

Much of the impetus to the process that culminated in § 307 came from University of Illinois law professor Richard Painter. Even before Enron made headlines, Professor Painter had urged the ABA Ethics 2000 Commission to amend Model Rule 1.13 to create a stronger up-the-ladder reporting requirement.³⁵ The Commission adopted that recommendation, but the ABA failed to act.³⁶ After the Enron scandal broke, Professor Painter organized a group of roughly forty legal academics—of which I was a member—to propose that the SEC bypass the ABA and create an up-the-ladder reporting requirement by rule.³⁷ The *pezzonovante* of the organized bar remained hostile. In a shot heard round the academic world, ABA President Carlton said, “I don’t like academics sitting there speculating on what the ABA has or hasn’t done. . . . We’re the lawyers, and we’re the people who have been involved in the issue.”³⁸

When the SEC failed to act, Senator Edwards introduced his amendment.³⁹ The ABA might be “the lawyers,” as President Carlton put it, but Congress no longer trusted “the lawyers” to self-police: “The lawyers . . .

30. *Id.*

31. See Bainbridge & Johnson, *supra* n. 6, at 307 (arguing that the ABA Model Rules of Professional Responsibility have a “managerialist bias”).

32. *Id.*

33. Report of the American Bar Association Task Force on Corporate Responsibility, http://www.abanet.org/buslaw/corporateresponsibility/final_report.pdf (March 31, 2003) [hereinafter ABA Final Report].

34. 148 Cong. Rec. at S6552 (opining that the SEC failed to pursue efforts to impose an up-the-ladder reporting obligation due to “protests coming from the organized bar”).

35. Roger C. Cramton, *supra* n. 5 at 143, 179 n. 147.

36. See ABA Final Report, *supra* n. 33, at 51 (noting that the Model Rules remain inconsistent with, *inter alia*, the Ethics 2000 Commission’s recommendations).

37. Richard W. Painter, et al., *Panel 2: The Evolution of Corporate Governance*, 52 Am. U. L. Rev. 615, 618 (2003).

38. Renee Deger, *Law Professors Led Fight for New SEC Rules*, 126 The Recorder 1 (Dec. 2, 2002).

39. 148 Cong. Rec. at S6552 (noting SEC’s failure to respond).

should not be left to regulate themselves."⁴⁰ To be sure, there are serious and legitimate issues of federalism raised by Congress' intrusion into legal ethics, an area long governed by states.⁴¹ Likewise, legislative intrusion into a regulatory area traditionally within the purview of courts raises legitimate separation of powers concerns.⁴² Yet, at the very least, § 307 broke the logjam blocking reform. The remaining question is whether it will work.

II. THE TOURNAMENT OF LAWYERS

The issue before us is not whether lawyers should be allowed to actively assist—or, for that matter, participate in—fraud by a client. The law has long prohibited such conduct.⁴³ Instead, there are two issues before us. First, to what extent are lawyers positioned to detect the sorts of misconduct that occurred at Enron and its ilk? Here the problem plays out along two axes: (a) the distinct roles of in-house and outside legal counsel, and (b) the types of client misconduct at issue. Enron (accounting fraud) presents legal counsel with a very different set of problems than does Adelphia (looting).⁴⁴ Second, even if the client misconduct is of a type legal counsel is likely to detect and be able to act upon, does counsel have adequate incentives to take affirmative action to prevent client misconduct? As we shall see, Sarbanes-Oxley and its progeny did little about the market incentives that discourage lawyers from actively policing client misconduct. Instead

40. *Id.* In August 2003, the ABA finally amended—over strong opposition and by a very narrow margin—the Model Rules to permit disclosure of client confidences to prevent fraud and to strengthen the up-the-ladder reporting system. Jonathan D. Glater, *Bar Association in a Shift on Disclosure*, N.Y. Times C4 (Aug. 13, 2003).

41. See R. William Ide, *Post-Enron Corporate Governance Opportunities: Creating a Culture of Greater Board Collaboration and Oversight*, 54 Mercer L. Rev. 829, 855 (2003) (complaining that “Section 307 of Sarbanes-Oxley and the SEC proposed rules thereunder exemplify how quickly historic understandings under federalism principles can be cast aside”).

42. Cf. Blewett Lee, *The Constitutional Power of the Courts over Admission to the Bar*, 13 Harv. L. Rev. 233, 255 (1899) (arguing that “it ought to be clearly understood that the responsibility of [bar] admission is in all cases upon the courts, not the Legislature, and a legislative disregard of constitutional limitations ought not to be encouraged by an excess of judicial courtesy”).

43. ABA Model Rule 1.2(d) provides:

A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

Model R. of Prof. Conduct 1.2(d) (ABA 2002).

44. Because so many of the recent corporate scandals were accounting frauds, it is noteworthy that generally accepted accounting principles (GAAP) provide substantial flexibility, which permits the phenomenon of “earnings management” by which corporate managers manipulate financial data so that operating results conform with forecast. Matthew J. Barrett, *Enron, Accounting and Lawyers*, Notre Dame Law. 14, 15 (Summer 2002). It may often be the case that lawyers will lack the mathematical skills and accounting knowledge necessary to tell the difference between earnings management allowed by GAAP and illegal financial chicanery. Indeed, some commentators argue that accounting standards reform is the only really appropriate regulatory response to recent corporate scandals. See e.g. G. Bennett Stewart III, *Why Smart Managers do Dumb Things*, Wall St. J. A16 (June 2, 2003) (advancing proposals for such reforms).

of tempting lawyers with carrots, Sarbanes-Oxley and its progeny created a new set of sticks with which to deter lawyer passivity. Query whether those sticks will suffice to counteract the strong incentives aligning the interests of lawyers with those of the managers who run their corporate clients.⁴⁵

In evaluating that question, it is important to recognize that we face three distinct sets of cases: (1) counsel knows of aggressive or risky conduct by management, but is unaware of fraud or other illegality—in these cases, the lawyer is unlikely to report up the ladder;⁴⁶ (2) counsel actively participated in, or at least facilitated, actual fraud⁴⁷—in these cases, the lawyer also is unlikely to report up the ladder, albeit for the different reason that he now has something to hide; (3) counsel has grounds for suspicion of fraud or other illegality, but no direct evidence.⁴⁸ Only in the latter scenario will the up-the-ladder reporting requirement come into play. My intuition is that this scenario is rare. In many of the recent corporate scandals, the misconduct was committed by a small group of senior managers who took considerable pains to conceal their actions from outside advisors, such as auditors or legal counsel.⁴⁹ In the post Sarbanes-Oxley § 307 environment, managers are even more likely to conceal any hint of impropriety from counsel.⁵⁰ Of greater relevance to this conference, I argue below that lawyers will rarely perceive their own situation to fall within the third scenario. The tournament of lawyers will not be won by whistleblowers.⁵¹

45. A third set of issues beyond the scope of this essay are the social costs and unintended consequences that may follow from Sarbanes-Oxley's attempt to enlist the rules of legal ethics in the service of better business ethics. See Bainbridge, *supra* n. 9 (discussing effect of regulation on role of the corporation as a mediating institution between the individual and the state).

46. Fisch and Rosen speculate that Vinson & Elkins most likely "knew of aggressive and risky transactions and reporting decisions [by Enron's management] but did not have actual knowledge of illegal conduct." Fisch & Rosen, *supra* n. 16, at 1115. Even though Sarbanes-Oxley § 307 and its progeny have many ambiguities and uncertainties, it seems unlikely that most legal counsel would regard those provisions as mandating up-the-ladder reporting of aggressive management. Nor does it seem likely that most boards of directors would welcome such reporting. At the very least, legal counsel who frequently report to the board that management is pushing the edge of the envelope risk developing a "boy who cried wolf" reputation.

47. See Sargent, *supra* n. 1, at 20-22 (discussing cases in which lawyers actively facilitated client misconduct).

48. See generally Fisch & Rosen, *supra* n. 16, at 1117 (discussing these three scenarios).

49. See e.g. Mark Maremont, *Rite Aid Case Gives First View of Wave of Fraud on Trial*, Wall St. J. A1 (June 10, 2003) (describing the "great lengths" to which defendants went in order to cover their tracks); see also Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. Corp. L. 1, 32 (2002) (opining that "[t]hose involved in a fraudulent scheme are unlikely to discuss it with nonparticipants").

50. See *infra* nn. 71, 72 and accompanying text (exploring effect of § 307 on managerial incentives).

51. But cf. Richard W. Painter, *Toward a Market for Lawyer Disclosure Services: In Search of Optimal Whistleblowing Rules*, 63 Geo. Wash. L. Rev. 221 (1995) (setting out a somewhat more optimistic account of lawyer incentives, albeit one in which tournament theory does not figure).

A. *A Brief Overview of Tournament Theory as Applied to Law Firms*

Law firms use the promotion-to-partner tournament to minimize the agency costs inherent in employing associates.⁵² On the one hand, the firm makes investments in its associates' human capital—i.e., skills and client relationships—during their apprenticeship. The firm will want to discourage associates from leaving the firm before it has fully amortized those investments.⁵³ On the other hand, the firm must also deter shirking by associates.⁵⁴ The firm induces associates both to remain for the optimal period, and to maximize their productivity during that period by holding “a tournament in which all the associates in a particular entering class compete and the firm awards the prize of partnership to the top alpha (α) percent of the contestants.”⁵⁵ The prize of promotion to a more secure and higher status position, plus the accompanying increase in compensation, gives lawyers an incentive to remain at the firm. Conversely, the threat of losing the tournament deters shirking. A lawyer who fails to win the tournament loses more than just the opportunity for future wealth and status gains. Lawyers make substantial investments in client-specific human capital by developing relationships with the client and familiarizing themselves with the client's business.⁵⁶ Because the investment is specific to the particular client, it will be lost if the relationship ends. Hence, the lawyer has a strong incentive to maintain that relationship.⁵⁷

In an important contribution to the literature, based on a highly nuanced account of the actual inner workings of large modern law firms, Professors Wilkins and Gulati argued that the standard tournament model is an inadequate model for such firms.⁵⁸ But while they reject the tournament

52. Agency costs are defined as the sum of the monitoring and bonding costs, plus any residual loss, incurred to prevent shirking by agents. Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & Econ. 301, 304 (1983). A sole proprietorship with no agents will internalize all costs of shirking, because the proprietor's optimal trade-off between labor and leisure is, by definition, the same as the firm's optimal trade-off. Agents of a firm, however, will not internalize all of the costs of shirking: the principal reaps part of the value of hard work by the agent, but the agent receives all of the value of shirking. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. Fin. Econ. 305 (1976).

53. Marc Galanter & Thomas M. Palay, *Why the Big Get Bigger: The Promotion-to-Partner Tournament and the Growth of Large Law Firms*, 76 Va. L. Rev. 747, 780 (1990).

54. *Id.*

55. *Id.* at 781. In agency cost terminology, the tournament is both a bonding and a monitoring mechanism. In order for the tournament to provide an effective mechanism for monitoring associate performance, the firm must be able to make a credible commitment—i.e., bond—its promise of promotion to partnership. See Wilkins & Gulati, *supra* n. 10, at 1582-83 (discussing how tournaments provide mutual monitoring for both firms and associates).

56. Galanter & Palay, *supra* n. 53, at 768.

57. See generally Stephen M. Bainbridge, *Privately Ordered Participatory Management: An Organizational Failures Analysis*, 23 Del. J. Corp. L. 979, 1043-44 (1998) (discussing the incentive effects of making firm-specific investments).

58. See Wilkins & Gulati, *supra* n. 10, at 1586-87 (noting ways in which the promotion-to-partnership tournament differs from standard economic tournaments).

model, they continue to use the tournament concept as a metaphor for understanding large law firms.⁵⁹ In particular, they suggest that the tournament metaphor is most relevant to "senior associates in their last few years before partnership."⁶⁰ This point is critical for purposes of my analysis, because my own practice experience suggests it is precisely senior associates who often have the sort of client contact in which potential misconduct may come to light.⁶¹

What skills and attitudes contribute to success in the promotion-to-partner tournament? Survey data demonstrates that the ability to develop "good working relationships with clients and peers" is a highly ranked consideration in the promotion to partnership decision.⁶² Also highly ranked were a willingness to pursue the interests of clients aggressively and the potential for bringing new business to the firm.⁶³

In other words, winning the tournament requires developing a set of skills and attitudes aimed squarely at keeping clients happy. The tournament thus develops lawyers with strong incentives to overlook management wrongdoing. Because it is management—not the board of directors—that hires outside legal counsel,⁶⁴ it is management whom attorneys must please in order to retain or attract business.⁶⁵ This pressure is especially true given the large number of capable firms and attorneys available for hire; law firms are something akin to fungible goods.⁶⁶ In addition, legal counsel normally works far more closely with senior management than with the board of directors.⁶⁷ Senator Edwards aptly explained these factors during the floor debate over Sarbanes-Oxley:

59. *Id.* at 1587.

60. *Id.* at 1632-33.

61. Cf. Royce de R. Barondes, *The Business Lawyer as Terrorist Transaction Cost Engineer*, 69 *Fordham L. Rev.* 31, 54 (2000) (observing that "[w]hile a client may have an ongoing relationship with a partner at a prestigious law firm, substantial drafting roles are played by senior associates").

62. Renee M. Landers & James B. Rebitzer, *Rat Race Redux: Adverse Selection in the Determination of Work Hours in Law Firms*, 86 *Am. Econ. Rev.* 329, 341-42 (1996).

63. *Id.*

64. See Fisch & Rosen, *supra* n. 16, at 1123 (explaining that because most large corporations now utilize the services of several outside law firms, the amount of such work that is allocated to a particular lawyer on an ongoing basis is determined by management—not the board of directors).

65. See ABA Final Report, *supra* n. 33, at 39-40 (noting the economic incentives law firms have to stay on the good side of the corporate managers who hire them). Individual attorneys feel a personal stake in client relationships because of the interrelation of their law career to the partnership structure at law firms which requires an attorney to bring business to the firm, and to keep it there. Fisch & Rosen, *supra* n. 16, at 1123.

66. As the ABA corporate responsibility task force's report observed, because it is increasingly common for corporations to retain a number of law firms, many outside counsel in fact will not have regular contact either with senior executives or the board of directors. ABA Final Report, *supra* n. 33, at 39. This makes it less likely outside counsel will detect client misconduct, as well as making it more difficult for outside counsel both to investigate potential misconduct and/or to communicate evidence of such misconduct to appropriate corporate officials.

67. Fisch & Rosen, *supra* n. 16, at 1123.

We have seen corporate lawyers sometimes forget who their client is. What happens is their day-to-day conduct is with the CEO or the chief financial officer because those are the individuals responsible for hiring them. So as a result, that is with whom they have a relationship. When they go to lunch with their client, the corporation, they are usually going to lunch with the CEO or the chief financial officer. When they get phone calls, they are usually returning calls to the CEO or the chief financial officer.⁶⁸

Consequently, despite the attorney's overarching legal obligations to report misconduct, the attitudes engrained by the promotion-to-partner tournament will incline him to intentionally or subconsciously overlook evidence of management misconduct.

Sarbanes-Oxley does not address these incentives. Indeed, while it is intended to create counter-incentives in the form of potential disciplinary proceedings, § 307 may have the unintended consequence of actually encouraging lawyers to turn a blind eye to corporate problems. Under the Part 205 Regulations, an attorney is only responsible for material violations of which he "becomes aware."⁶⁹ As such, the rational lawyer has yet another rationale for closing his eyes to potential misconduct. Avoiding detailed information about their clients' conduct is one way of avoiding even the risk of incurring a duty to report or any subsequent liability exposure.⁷⁰

In the wake of Sarbanes-Oxley, it will become even easier for lawyers who wish to turn a blind eye to client misconduct to do so. As Professor Larry Ribstein observed, "The new rules may inhibit even innocuous conversations that might have helped indirectly in uncovering frauds by making them fodder for federal litigation and investigations."⁷¹ Corporate managers will not welcome the kind of investigation that an attorney's "reporting up" would engender. Even a mistaken accusation of wrongdoing by an attorney could have adverse consequences for the implicated managers, who in turn will minimize the overall amount of information to which an attorney has access—just to be on the safe side.⁷² Indeed, managers likely will try to shield their lawyers from information not only about potential wrongdoing but also of aggressive—edge-of-the-envelope-pushing—accounting and disclosure practices.

68. 148 Cong. Rec. at S6551-52; see also ABA Final Report, *supra* n. 33, at 14-15 (noting that "[t]he competition to acquire and keep client business, or the desire to advance within the corporate executive structure, may induce lawyers to seek to please the corporate officials with whom they deal rather than to focus on the long-term interest of their client, the corporation").

69. See 17 C.F.R. § 205.

70. Fisch & Rosen, *supra* n. 16, at 1127.

71. Ribstein, *supra* n. 49, at 32.

72. Cf. Fisch & Rosen, *supra* n. 16, at 1128 ("[l]awyers who are seen by their clients as being motivated by fears for their personal liability will not be consulted on difficult issues'") (citation omitted); Sargent, *supra* n. 1, at 42-43 (discussing how management may seek to limit the role of their lawyers in corporate transactions).

B. A Note on In-House Counsel

The analysis thus far has focused on the incentives of outside legal counsel. What about in-house lawyers? Much the same analysis would seem to apply, as in-house counsel face very similar incentives. Even if the legal department's human resources policies do not create a promotion tournament, although I suspect that many do, in-house lawyers have strong incentives to stay on the good side of senior management. Although the general counsel often is formally appointed by the board of directors, his tenure normally depends mainly on his relationship with the CEO.⁷³ As the ABA's corporate governance task force explained, "the general counsel may be reluctant to communicate with the board of directors" for fear that doing so will "destabilize the relationships among senior executive officers and directors."⁷⁴

C. What About the Winners?

Winning the promotion-to-partner tournament does not eliminate the incentives that discourage lawyers from reporting misconduct by the managers who hire them. In the first place, all partners have an incentive to keep key clients happy. Enron was Vinson & Elkins' largest client, generating about seven percent of the law firm's revenues.⁷⁵ About twenty former Vinson & Elkins lawyers took jobs at Enron.⁷⁶ Vinson & Elkins therefore had strong incentives to remain on good terms with Enron's managers. Can the Enron example be generalized? Professor Coffee argues that attorneys are likely to have a more varied client base than do auditors, which reduces the conflicts of interest that apparently contributed to the auditing failures at the base of the most recent corporate scandals.⁷⁷ Professor Coffee cites no empirical data for this proposition, although I suspect he may well be correct with respect to large national law firms. At the smaller regional firms—like Vinson & Elkins—that were involved in many of the recent scandals, however, I suspect it is far more common that a firm will be dependent on billings to a single client.⁷⁸

73. See Stanley Sporkin, *The Evolving Legal and Ethical Role of the Corporate Attorney After the Sarbanes-Oxley Act of 2002: Keynote Address*, 52 Am. U. L. Rev. 639, 651 (2003) (observing that "[t]here are a lot of overbearing CEOs that think that because they hire the general counsel the general counsel better be beholden to that person").

74. ABA Final Report, *supra* n. 33, at 37.

75. Fisch & Rosen, *supra* n. 16, at 1111.

76. *Id.*

77. John C. Coffee, Jr., *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 Colum. L. Rev. 1293 (2003).

78. Larry Ribstein argues that law firms are useful monitors of client misconduct because the firm provides a reputational bond that the firm will monitor its members to ensure that those members are not co-opted by corporate managers. See e.g. Larry E. Ribstein, *Ethical Rules, Agency Costs, and Law Firm Structure*, 84 Va. L. Rev. 1707, 1739 (1998) (opining that "clients can use large law firms as reputational intermediaries or signals of good behavior by choosing firms that have a reputation for honesty and fair dealing"). Query whether the firm will do so,

In the second place, winning the tournament does not put an end to survival of the fittest competition. In recent years, law firms have shifted away from the old rules of partnership in which promotion to partner carried with it job tenure and seniority-based compensation to new models in which compensation is variable and partners lack job security.⁷⁹

Compensation based on business generation means that partners are more vulnerable to shifting market conditions. Factors over which a lawyer may have no control, such as the merger of her client into another company, a corporation's decision to assign more work to its legal department, or a downturn in a particular economic sector (witness Internet start-ups) may significantly reduce her compensation. If business does not pick up or she cannot retool her skills, she may be asked to leave the firm, since her partners may not be willing to sacrifice profits to cushion her fall. Some of this unwillingness may be due to simple resistance to earning less money. Some of it, however, may also reflect concern that if profits per partner drop, key rainmakers may go elsewhere, or the firm may be perceived by clients and competitors as in trouble. A partner subject to an "eat-what-you-kill" system may be anxious about where her next meal is coming from.⁸⁰

Because an individual partner is even more likely than a firm to be dependent on billings to a single major client, the eat-what-you-kill phenomenon makes it highly unlikely that such a partner will risk antagonizing key clients absent the proverbial smoking gun—and maybe not even then.

In the third place, behavioral economic analysis suggests certain basic cognitive biases likely to discourage lawyers from detecting or acting upon management misconduct.⁸¹ Behavioral economists have identified a num-

however, where the firm as a whole is dependent on billings to a single major client. In addition, as Ribstein has argued elsewhere, the current ethical rules governing law firms arguably interfere with the reputational bond and, accordingly, with law firm monitoring. See Larry E. Ribstein, *Ethical Rules, Law Firm Structure and Choice of Law*, 69 U. Cin. L. Rev. 1161, 1169 (2001) (arguing for ethical rules that "deregulate firms in order to free them to adopt more efficient structures for creating and preserving their reputational capital, thereby more effectively serving clients"). As a result, there remains an agency problem within law firms. Individual lawyers respond to their personal interest of pleasing the managers who most directly hire them, rather than to the firm's long-term interest in its reputation. See *infra* n. 80 (discussing incentives of individual partners).

79. See Wilkins & Gulati, *supra* n. 10, at 1615-16 (discussing modern law firm partnership compensation).

80. Milton C. Regan, Jr., *Corporate Norms and Contemporary Law Firm Practice*, 70 Geo. Wash. L. Rev. 931, 937 (2002).

81. The seminal behavioral analysis of lawyer incentives to act on client misconduct is Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry Into Lawyers' Responsibility for Clients' Fraud*, 46 Vand. L. Rev. 75 (1993). As I argued elsewhere, behavioral economic analysis is a useful tool, but also one that must be applied sparingly and cautiously. Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. Cin. L. Rev. 1023 (2000). In particular, there is a strong temptation to glibly rely on behavioral economics to identify a purported market failure justifying regulatory intervention. *Id.* at 1059.

ber of the well-documented cognitive errors relevant to the problem at hand. One is the overconfidence bias, which has been defined as “the belief that good things are more likely than average to happen to us and bad things are less likely than average to happen to us.”⁸² If a lawyer is subject to this bias, his judgment will be skewed against believing that his clients are bad people committing fraud.

A closely related bias is the confirmatory bias, which is defined as the tendency for actors to “interpret information in ways that serve their interests or preconceived notions.”⁸³ As former Delaware chancellor Allen aptly noted, albeit in a rather different context, “human nature may incline even one acting in subjective good faith to rationalize as right that which is merely personally beneficial.”⁸⁴ Lawyers who made the decision to associate with a particular client therefore are less likely to recognize client misconduct, because evidence thereof would be inconsistent both with the lawyer’s self-interest in maintaining a relationship with the client and the lawyer’s self-image as someone who identifies and associates with honest people.⁸⁵ In view of the uncertainties created by some of the Part 205 Regulations, it is particularly significant that self-serving biases typically “arise when there is a reasonably high level of ambiguity surrounding a situation.”⁸⁶

Taken together, these systematic decision-making biases generate a type of “cognitive conservatism” that makes a lawyer “likely to dismiss as unimportant or aberrational the first few negative bits of information that she receives regarding a client or situation.”⁸⁷ Given the incentives created by the promotion-to-partner tournament, winners of that tournament are likely to be particularly vulnerable to these biases.⁸⁸

82. Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 Cal. L. Rev. 1051, 1091 (2000).

83. *Id.* at 1093.

84. *City Capital Assn. Ltd. Partn. v. Interco Inc.*, 551 A.2d 787, 796 (Del. Ch. 1988) (emphasis omitted).

85. Cf. Donald C. Langevoort, *The Organizational Psychology of Hyper-Competition: Corporate Irresponsibility and the Lessons of Enron*, 70 Geo. Wash. L. Rev. 968, 970 (2002) (arguing that winners of promotion tournaments tend to be characterized by “ethical plasticity” that allows them “to construe what is self-serving to be reasonable, so that moral anxiety is buffered”).

86. Donald C. Langevoort, *When Lawyers and Law Firms Invest in Their Corporate Clients’ Stock*, 80 Wash. U. L.Q. 569, 574 (2002).

87. Langevoort, *supra* n. 81, at 101; see also Sargent, *supra* n. 1, at 32-34 (discussing incentives of lawyers to turn a blind eye to client misconduct).

88. Finally, it is noteworthy that most of the recent corporate scandals involved accounting fraud at the bottom. See Lawrence A. Cunningham, *Sharing Accounting’s Burden: Business Lawyers in Enron’s Dark Shadows*, 57 Bus. Law. 1421, 1429 (2002) (observing that Enron is primarily “an accounting scandal”). Typically, the books were cooked so as to raise—or at least support—the firm’s stock price so that the managers could profit from their stock options. See Shane A. Johnson, Harley E. Ryan & Yisong S. Tian, *Executive Compensation and Corporate Fraud* (April 16, 2003) (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=395960) (concluding from empirical analysis that executives of firms where fraud occurred “have significantly larger equity-based compensation and greater financial incentives to commit fraud than do executives at

III. CONCLUSION

My project herein has been positive rather than normative. I signed the law professor letters organized by Richard Painter because, as a normative matter, I believe in director primacy, not managerialism.⁸⁹ I did not sign them because I thought they would work, let alone prove a panacea for the problems of corporate governance.

In evaluating the likelihood that Sarbanes-Oxley § 307 will prove effective, it is worth remembering that Enron and its ilk were hardly the first time corporate lawyers fell down on the job. In connection with the Lincoln Savings & Loan scandal, Judge (and former SEC director of enforcement) Stanley Sporkin famously observed:

Where were these professionals, a number of whom are now asserting their rights under the Fifth Amendment, when these clearly improper transactions were being consummated?

Why didn't any of them speak up or disassociate themselves from the transactions?

Where also were the outside accountants and attorneys when these transactions were effectuated?

What is difficult to understand is that with all the professional talent involved (both accounting and legal), why at least one professional would not have blown the whistle to stop the overreaching that took place in this case.⁹⁰

The answer is that they were doing precisely what the promotion-to-partner tournament taught them to do—keeping their clients happy even if it meant sticking their heads in the sand.

The point is not that lawyers are pervasively co-opted or immoral. The point is only that lawyers have both economic incentives and cognitive biases that systematically incline them to at least shut their eyes to instances of client misconduct. The principal flaw in Sarbanes-Oxley § 307 is that it focuses on the wrong players. What is necessary is to change the incentives

industry- and size-matched control firms"). This phenomenon is relevant to our analysis of lawyer incentives to report client misconduct because it has become fairly common for transactional lawyers to hold stock in their clients. Poonam Puri, *Taking Stock of Taking Stock*, 87 Cornell L. Rev. 99, 101 (2001) (noting that in 40% of IPOs in 1999, issuer counsel owned more than \$1 million worth of the issuer's stock at the time of the IPO). Hence, lawyers will have much the same incentives with respect to the firm's stock price as will the firm's managers. In turn, such counsel is more likely to subconsciously overlook, or even be co-opted into, management misconduct.

89. See Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. Rev. 547 (2003) (making the economic case for director primacy and criticizing managerialism as a normative account).

90. *Lincoln Sav. and Loan Assn. v. Wall*, 743 F. Supp. 901, 920 (D.D.C. 1990).

of clients.⁹¹ Once that happens, we can then enlist legal counsel to provide an additional layer of protection.⁹²

91. See Steven L. Schwarcz, *Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures*, 70 U. Cin. L. Rev. 1309, 1318 (2002) (arguing that "the focus [of post-Enron regulatory reform] should be on preventing the material conflicts of interest that allowed, and indeed encouraged, the Enron abuses to thrive"). The mechanism by which to most efficiently effect a change in the incentive of clients already exists in the growing emphasis in state corporate law on law compliance programs. See Stephen M. Bainbridge, *Corporation Law and Economics* 291-96 (Foundation Press 2002) (discussing the board's role to exercise oversight in this context). In a variety of regulatory contexts, the law increasingly requires law compliance programs. See *In re Caremark Intl. Inc. Derivative Litig.*, 698 A.2d 959, 968-70 (Del. Ch. 1996) (citing examples). In most cases, one-size-fits-all law compliance programs make little sense. Bainbridge, *supra*, n. 91 at 293-94. Securities disclosure may be an exception to that general principle, however. It is an area where the law already imposes due diligence obligations on the board of directors in connection with many disclosure documents. See e.g. *Atherton v. Anderson*, 99 F.2d 883 (6th Cir. 1938) (holding that directors have an obligation to ensure that basic accounting practices are followed in preparing and auditing the firm's financial records). Imposing a due diligence obligation on the board of directors with respect to all major disclosure statements would be a comparatively modest extension of existing law. Indeed, Sarbanes-Oxley already moved in this direction by imposing a new obligation for the chief executive officer and chief financial officer to certify disclosure documents. See Cunningham, *supra* n. 88 at 1444 (noting that corporate "internal controls [are] now functionally required by federal securities laws").

92. If Sarbanes-Oxley § 307 and its progeny prove ineffective, as our analysis suggests seems likely, pressure for additional regulation may well arise. Most likely, Congress and/or the SEC will seek to further increase either the probability of enforcement and/or the nominal sanction imposed on lawyers to facilitate—or, perhaps, fail to prevent—client misconduct. Cf. Coffee, *supra* n. 77, at 1306 ("[t]he more we suspect that attorneys will avert their gaze, the more we need to raise the penalties to deter them from so doing"). This prospect obviously implicates the concern alluded to above with regard to the impact of additional regulation on the corporation as a mediating institution between the state and the individual. See *supra* nn. 9, 45; see generally Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, Regulation 26 (Spring 2003) (discussing mediating role of the corporation).