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Lawyers Behaving Badly: Attorney Involvement in Recent Securities Fraud and Obstruction of Justice Cases

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Recent corporate scandals, such as Enron and WorldCom, have contributed to an erosion of public confidence in Corporate America and Wall Street and in the legal profession which represented these corporations.

Corporate lawyers hold a public trust as "Gatekeepers." As such they owe a duty to the public to prevent their clients from engaging in fraudulent conduct and to refrain from participating in any such conduct themselves.

Unfortunately, as the recent scandals and high profile trials have unfolded, many lawyers have actually been participants in fraudulent schemes or have aided and abetted fraudulent activity by engaging and counseling clients to obstruct justice and impede regulatory investigations.

In response to these scandals, Congress passed the sweeping Sarbanes-Oxley Act (SOX) in which, among other things, Congress required the Securities and Exchange Commission (SEC) to promulgate rules requiring attorneys to report corporate wrongdoing relating to securities' transactions. The particular mandate relating to attorney reporting under SOX involved "up-the-ladder" reporting such that attorneys must report concerns of "material violations" of securities laws to the Chief Executive Officer (CEO) or Chief Legal Officer (CLO) of the corporation and then, if the official does not respond sufficiently, to the corporation's Board of Directors.

The SEC proposed a Rule which expanded the reporting responsibilities to include a "noisy withdrawal" provision which could require outside counsel to end representation of a corporate client and report that departure to the SEC. However, amid protest from the legal and corporate community, the SEC postponed adoption of any "noisy withdrawal" rules.

Immediately following is a brief discussion of the applicable provisions of SOX as they relate to corporate attorneys. Thereafter, there is a discussion of specific high profile securities fraud and obstruction of justice cases in which attorneys were alleged to have been involved.

Sarbanes-Oxley Act: Rules of Professional Responsibility for Attorneys

In July 2002, President Bush signed the Sarbanes-Oxley Act into law. Section 7245 of the Act directs the SEC to promulgate rules establishing "minimum standards of professional conduct for attorneys appearing and practicing before the Commission in any way in the representation of issuers…"

These standards were to include duties to report evidence of corporate wrongdoing relating to "material violation of securities law or breach of fiduciary duty" to the CEO or CLO. Additionally, if the CEO or CLO does not take appropriate action, the attorney must then report such wrongdoing to either an audit committee of the issuer's board of directors or another committee composed of independent directors.

SEC Rules: "Up-the-Ladder" Reporting Requirements

In January 2003, the SEC adopted final rules (the "Rules"), which promulgate the "**up-the-ladder**" reporting requirements explicitly mandated by Congress. Section 205.1 of the Rules clarifies that the standards adopted by the SEC in conjunction with the Act will preempt any conflicting state laws unless those state laws impose more rigorous requirements.

Section 205.3(b) of the Rules articulates the first step in the up-the-ladder reporting requirements. An issuer's attorney must report "evidence of a **material violation** by the issuer or by any officer, director, employee, or agent of the issuer" to the issuer's CLO or to both the CLO and the CEO. The CLO (or CEO) must then conduct appropriate inquiry into the alleged material violation and report the results of this inquiry to the reporting attorney.

If the reporting attorney is not satisfied that the CLO (or CEO) has "provided an appropriate response within a reasonable time," the attorney must then report up-the-ladder to the issuer's audit committee of the board of directors, another committee of the board of directors (as long as that committee comprises members who are independent from the issuer) or the issuer's board of directors (if the directors are independent from the issuer).

Whether the response of the CLO or CEO is appropriate will be measured against a "reasonableness" standard. If an issuer has retained an attorney to investigate the reported evidence of material violation, this may qualify as an appropriate response under the Rules.

In the Rules, the SEC adopted an objective standard to determine when an attorney has evidence of a material violation. "Evidence of a material violation means credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur."

A violation of the Rules will expose the violating attorney to sanctions imposed by the SEC, including civil penalties and remedies in conjunction with federal securities laws violations.

SEC Proposed Rules: "Noisy Withdrawal" Requirements

In the SEC's proposed rule, attorney reporting responsibilities include a directive that, should the board of directors not take appropriate action, the attorney must then **withdraw** from representing the issuer **and report** the departure to the SEC. The withdrawing attorney must also disaffirm any documents the attorney prepared (or assisted in preparing) which have been submitted to the SEC that the attorney believes may be false or misleading.

As an alternative to the form of "**noisy withdrawal**" rules originally proposed, the SEC has offered an option of placing the burden upon the issuer to notify the SEC of the attorney's withdrawal rather than the attorney. This alternative is meant to address concerns relating to a requirement that the attorney incriminate the issuer by instead requiring the issuer to incriminate itself.

After concerns were raised by the legal and corporate community, the SEC deferred implementing the "noisy withdrawal" Rule.

Document Destruction under Sarbanes-Oxley

Prior to Sarbanes-Oxley, there were three main federal obstruction of justice provisions, all of which could be deployed by prosecutors to combat the destruction of documents: 18 USC 1503, 1502 and 1512. Sections 1503 and 1505 applied to situations in which there was evidence of alteration, destruction, falsification or concealment by someone who was aware of and intended to obstruct or impede a pending **federal proceeding**. In contrast, Section 1512 specifically delineated that "an official proceeding need not be pending or about to be instituted at the time of the offense". However, Section 1512 was limited to those who "corruptly persuade" another to destroy,

alter or falsify documents while Sections 1503 and 1505 were used to prosecute directly the “individual shredder.”

Section 1802 of SOX added two new sections to eliminate the federal criminal code and amended 18 USC 1512 to eliminate supposed loopholes within the existing framework of document destruction proscriptions. Section 1519 is a new general **anti-shredding** provision with a twenty year maximum sentence. It is designed to expand the scope of the current obstruction provisions to reach any person who destroys or alters documents with the intent to “impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency in the United States” or any bankruptcy matter “or in relation to or in contemplation of any such matter or case.”

The amendments to section 1512 bring within the ambit of the section not only to those who “corruptly persuade” others to destroy documents, but also those who themselves “corruptly alter, destroy, mutilate or conceal documents with the intent to impair the documents’ integrity or availability for use in an official proceeding.”

Attorneys Alleged Participation in Securities Fraud Cases

1. Enron - Involvement of Corporate Lawyers In late 2001, Enron, once the seventh largest U.S. Corporation revealed that it would incur losses of at least $1 billion and would restate its financial results for 1997-2000 and the first two quarters of 2001, to correct errors that inflated Enron’s net income by $591 million. The impact of this restatement was enormous as Enron’s stock dropped 91%. Shortly thereafter, Enron’s debt was downgraded to junk bond status and its stock dropped to just $.26 per share after being as high as $80 per share a year earlier.
   On December 2, 2001 Enron filed for Chapter 11 bankruptcy.

   On January 17, 2006, former Enron executives Ken Lay, Jeff Skilling and Richard Causey face criminal charges in Houston, Texas for the Enron fraud. Former Enron CFO Andrew Fastow pled guilty to the fraud and is cooperating with prosecutors.

   The executives’ defense in the case will largely center on “finger pointing”, namely, that Enron’s high priced **lawyers**, investment bankers and accountants “signed off” on hundreds of “off-book partnerships” and “special purpose entities” (SPE) which were used to hide Enron’s massive debt and mislead investors. Lawyers will argue at trial that none of these shenanigans could have occurred without the active participation of Enron’s lawyers, accountants and investment bankers.

   In class action lawsuits brought by defrauded shareholders claiming over $25 billion in stock losses, Enron, its Board of Directors and various “**secondary actors**” such as lawyers, accountants and investment bankers were sued for participating in the fraud.

   The shareholders claimed that Enron’s corporate lawyers Vinson & Elkins (”V&E”) participated in Enron’s fraud by drafting Enron’s shareholder reports, SEC filings, press releases and by structuring certain transactions. The firm of Kirkland & Ellis (”K&E”) was sued for assisting in setting up the off-book partnerships and SPEs.

   In December 2002, Federal Judge Melinda Harmon issued a sweeping ruling denying motions to dismiss brought by Enron’s investment bankers, lawyers and accountants.

With regard to the lawyers' involvement, Judge Harmon denied a motion to dismiss by V&E, but granted the motion to dismiss brought by K&E.

In refusing to dismiss V&E from the case, Judge Harmon concluded that:

"In light of its alleged voluntary, essential, material and deep involvement as a **primary violator** in the ongoing Ponzi scheme, V&E was not merely a drafter but essentially a co-author of the documents it created for public consumption concealing its own and other participants' actions."

V&E, which is appealing the ruling, argued in court papers that it had a "minimal role in the 68 Enron disclosures that the complaint alleges are fraudulent." Minimal or not, the proposed lawyer rules would, if they had been in place at the time, have required V&E to resign from representing Enron and as soon as it got wind of the fraud.

K&E was dismissed from the case for its role in preparing papers for a group of private partnerships. K&E was alleged to have helped Enron structure the fraudulent private partnerships.

In dismissing the securities fraud claims against K&E, Judge Harmon held that K&E might have "breached professional ethical standards" but could not have breached the federal securities laws because K&E stayed in the "back room" and dealt only with the private partnerships and did not "speak to the public" as V&E was alleged to have done in preparing the public filings and other public documents.

Judge Harmon relied on the U.S. Supreme Court's ruling in Central Bank of Denver v. First Interstate Bank of Denver, 511 U.S. 164 (1994), which held that aiding and abetting - in the sense of providing substantial assistance to - someone whom one knows will engage in fraud through misrepresentation is not covered by the securities laws.

In September 2005, K&E paid $5.2 million to settle shareholder claims arising from its legal work for some of Enron's off-balance sheet partnerships.

2. Hollinger International / Conrad Black - Mark Kipnis, Esq. In November 2005, federal prosecutors in Chicago charged media baron Conrad Black with eight counts of fraud in connection with more than $80 million in payments that he and other executives received while he was CEO of Hollinger International. Black and his co-defendants were accused of skimming some $80 million through "non-compete agreements" which newspaper companies often get for payments for agreeing not to compete in the same circulation area after they sell their papers. In normal sales, such payments ordinarily go to the shareholders not to the individual executives of the company.
   Also charged in the scheme was former corporate counsel Mark Kipnis. Kipnis was charged with nine counts of mail and wire fraud for his role in alleged fraudulent diversion of more than $32 million from Hollinger through a complex series of self-dealing transactions. The main scheme alleges that the defendants fraudulently diverted $52 million from Hollinger by funneling payments disguised as non-competition fees, and payment of a "management agreement break-up fee" to themselves individually, at the expense of Hollinger's public shareholders[1].

   Kipnis was also allegedly involved in seeking ratification of these payments, after they were discovered,

allegedly misleading the Board of Directors by misdescribing the transactions in a number of respects. After the directors ratified these payments, Black allegedly lied to Hollinger's shareholders about the payments at Hollinger's annual meeting according to the indictment.

Prosecutors alleged that Kipnis was intimately involved in counseling Black and actually participating in the fraudulent transactions.

3. The Lawyer to the "Boiler Rooms": Hartley Bernstein On May 27, 1999, Hartley Bernstein, an attorney specializing in securities law, pled guilty to a three count Information charging him with fraudulently participating as an insider in five fraudulent public offerings. Four of the offerings were underwritten by Sterling Foster, a now defunct "boiler room" and the fifth was underwritten by two other broker-dealers VTR Capital and Investors Associates[2].
Bernstein was also charged with committing perjury in testimony before the SEC in connection with its investigation into the scheme. As part of his guilty plea, Bernstein agreed to forfeit $850,000 in illegal profits to the Government.

   Through his law firm, Bernstein & Wasserman, he worked for some of the most notorious penny-stock manipulators of the past two decades: Stratton Oakmont, Biltmore Securities and Sterling Foster. He also worked for a host of small companies whose stocks these firms manipulated.

   In reality, he worked for Randolph Pace, a wily Wall Street veteran who, with Meyer Blinder and Robert Brennan, made up what one lawyer had called "the three tenors" of the penny-stock world. Id.

   Blinder was jailed for securities fraud in 1992 after the collapse of his firm Blinder, Robinson & Company. Brennan, the man behind the infamous First Jersey Securities, is serving a nine year prison term after being convicted of fraud in 2001. Id.

   After his plea deal, Bernstein cooperated with investigators and helped decipher Pace's complex deals. He also provided background information about Stratton Oakmont deals with shoe designer Steve Madden, who pleaded guilty to fraud and money laundering in 2001 and served a three and a half year prison sentence.

   Bernstein has since tried to use his knowledge of penny-stock fraud in a business called "stock patrol" in which he assists regulators in detecting and stopping internet and penny-stock fraud.

   His efforts in helping to prevent fraud led to him receive only two years probation instead of a jail sentence.

4. Tyco - Mark Belnick - Corporate General Counsel Tyco's former CEO Dennis Kozlowski and CFO Mark Scwartz were convicted of looting their company of hundreds of millions of dollars and are now serving time in a New York state prison.
Tyco's former General Counsel Mark Belnick was charged by New York District Attorney Robert Morgenthau of "grand larceny" in connection with $15 million of "interest free relocation loans" which he used to purchase a Central Park West apartment and a ski home in Park City, Utah. The loans were later forgiven and Belnick also received a $17 million bonus by Kozlowski which the District Attorney claimed

constituted theft because the CEO failed to get it approved by the Board of Directors.

Belnick, a former partner at Paul Weiss who earned $1 million per year, took the stand in his own defense. Belnick gave an impassioned defense of his actions, even crying on the witness stand. The thrust of his defense was that he believed he was due these loans and bonuses and that he did not need Board approval. He therefore claimed that he did not "intend" to commit fraud or grand larceny, an essential element of the crime.

Belnick was acquitted by the New York jury.

5. Refco Fraud Case - Mayer, Brown, Rowe & Maw Involvement On October 13, 2005, Phillip Bennett, the CEO of Refco, Inc., a leading commodities brokerage firm, was indicted by Federal prosecutors for allegedly falsifying Refco's books to mislead investors who bought nearly $600 million of stock when Refco became a publicly traded company in August 2005. Prosecutors claim that Bennett used a firm he controlled to hide a $430 million bad debt owed to the company, which debt was not disclosed in the IPO filings[3].
   The prominent Chicago based law firm Mayer, Brown, Rowe & Maw is under scrutiny from securities regulators who are trying to sort out the players in the brokerage firm's stunning fall from grace. Investigators are looking into the role Mayer Brown played in drafting the loan documents that allegedly enabled Bennett to carry out a scheme to hide hundreds of million of dollars in old customer trading losses for years. Id.

   The federal indictment references various unnamed co-conspirators who assisted Bennett in his alleged fraud.

6. KMPG's Alleged Fraudulent Tax Shelters - Sidley Austin Brown & Wood In August 2005, Federal prosecutors indicted Raymond Ruble, a former partner with Sidley Austin, for his part in helping KPMG sell alleged fraudulent tax shelters to wealthy individuals.
   Ruble is accused of assisting with the development of the shelters and of writing opinion letter for KPMG assuring clients that the tax shelters "more likely than not" would withstand IRS scrutiny.

   Sidley Austin and KPMG recently agreed to a $225 million settlement with former customers of the big audit firm in a civil law suit arising out of the tax-shelter scheme.

Attorney Involvement in Obstruction of Justice Cases

1. Enron - Arthur Andersen attorney Nancy Temple In 2000, accounting firm Arthur Andersen provided accounting, auditing and consulting services to Enron, Andersen's single largest account.
   In August, 2000, the SEC opened an informal investigation of Enron in response to newspaper reports of financial improprieties at the company. On October 7, 2000, the SEC notified Enron that it had opened an investigation and requested various documents. On October 19, 2000, Enron forwarded that notification to Andersen. On October 30, the SEC opened a formal investigation of Enron and sent Enron a letter requesting accounting documents.

   On October 10, 2000, Michael Odom, an Andersen partner, encouraged members of Andersen's Enron

"engagement team" to comply with the firm's "document retention policy." This policy instructed employees to retain "only that information which is relevant to supporting our work"; it also stated that "in case of threatened litigation no related information will be destroyed."[4]

On October 12, Nancy Temple, one of Andersen's in-house counsel, sent an e-mail to Odom recommending that he remind the Enron engagement team of Andersen's document retention policy. On October 16, Temple sent David Duncan, the head of Enron's engagement team, an e-mail responding to his draft memorandum concerning an Enron press release which characterized certain charges as "non-recurring." In the e-mail, Temple recommended that Duncan delete "language that might suggest that we have concluded the release is misleading." Id.

On October 19, Temple sent an e-mail to a member of the Enron engagement team with the document retention policy attached, and on October 20, she instructed the members of Andersen's crisis response team during a conference call. Following this call, Duncan instructed all members of the engagement team to comply with the policy. From then until November 9, the engagement team destroyed large numbers of both paper and electronic documents. Id.

Because at the time (pre-SOX), altering and destroying documents under such circumstances did not constitute obstruction of justice, Andersen was not and could not be indicted for its employees' acts of document destruction or alteration. Id.

Instead, Andersen was indicted for and convicted of witness tampering in violation of 18 U.S. 1512 which prohibits "knowingly.. corruptly persuading another person with the intent to cause or induce a person to withhold testimony, or a record, document, or other object from an official proceeding or to alter, destroy, mutilate or conceal an object with intent to impair the object's integrity or availability for use in an official proceeding."

Duncan pleaded guilty to obstruction of justice.

Andersen was convicted by the jury of its efforts to persuade employees to alter or destroy documents. The conviction appeared to have been based solely upon Nancy Temple's recommendation to David Duncan to alter his draft memorandum.

The United States Supreme Court subsequently reversed the conviction based upon improper instructions by the trial judge to the jury.

As a result of the conviction, the largest accounting firm in the world went out of business.

2. Martha Stewart - John Savarese Martha Stewart was being investigated by the SEC for allegedly selling her Imclone stock after receiving a tip from her broker that Imclone's CEO Sam Waksal was selling his Imclone stock (after learning that the FDA would be rejecting approval of a key drug of Imclone). Stewart sold her stock on December 27 - the day before the FDA's announcement, and avoided a $50,000 loss. Stewart was convicted by a New York jury of lying to FBI and SEC investigators and obstructing justice into the investigation by falsely telling investigators that she had a "prearranged sale" to sell her stock when it hit $60 per share.

Stewart's initial counsel was John Savarese of Wachtel Lipton. According to news reports, Savrese sent Stewart into the hands of prosecutors as an unprepared witness, who may not have told him the whole story, and she had already tried to "doctor" evidence in the case[5].

With Savarese as her counsel, Stewart told investigators the fabricated story about the pre-existing agreement to sell Imclone at $60. Savarese allowed a second interrogation months later, during which Stewart then again lied about the $60 agreement and stated, falsely, that she could not remember whether she was told on December 27 that Waksal was selling. Id.

Savarese has been criticized for allowing his client to take an immense legal risk and for not adequately preparing his client or reviewing the evidence relating to the fabricated story Stewart told investigators. Significantly, Savarese apparently had not gone over Stewart's phone logs. A key piece of evidence in the Stewart conviction was the alteration of a potentially incriminating phone message from her stockbroker Peter Bacanovic, which Stewart later returned to its original form. Id.

3. Frank Quattrone - David Brodsky Frank Quattrone of CSFB was convicted by a New York jury of telling investment bankers to "clean up their files" and follow the firm's document retention policy after Quattrone was warned about an SEC subpoena for documents in an investigation of the firm's IPO practices. The key prosecution witness in the case (other than Quattrone who testified in his own defense), was CSFB's general counsel David Brodsky. Brodsky testified that he had advised Quattrone days prior to him sending the crucial e-mail that CSFB had received an SEC subpoena for documents regarding IPOs done by Quattrone's investment banking team. Brodsky also testified that he advised Quattrone – before he sent his fateful e-mail - to retain his own counsel as there may be a conflict of interest between the firm and Quattrone individually.

   Notwithstanding these warnings, Quattrone sent out his e-mail. He was convicted by the jury and sentenced by the Judge to a year and a half in prison for obstruction of justice.

4. Ron Perleman v. Morgan Stanley - In House/Outside Counsel Ron Perleman sued Morgan Stanley for $2.7 billion for its alleged fraud in the sale of Sunbeam to Perleman. Morgan Stanley provided investment banking services to Sunbeam and were alleged to have made false representations to Perleman about Sunbeam's financial condition. Morgan Stanley was alleged to have "deliberately" violated trial Judge Elizabeth Maas' discovery orders requiring Morgan Stanley to turn over documents and e-mails, including some embarrassing to the firm's bankers.

   As a result of what she described as Morgan Stanley's "bad faith" actions, Judge Maas made an extraordinary legal decision: she told the jury it should simply assume the firm helped defraud Perleman.

   Based on that instruction, the jury found Morgan Stanley liable and ordered Morgan Stanley to pay Perleman $1.5 billion in damages.

   Morgan Stanley's loss in the case can be attributed to its "mishandling" over production of e-mails in the case. Morgan Stanley blamed "honest mistakes", such as computer glitches and misplaced back-up tapes and claimed they were not attempts to stonewall its adversaries. The firm claimed it had been

working hard to fix the problem.

In Court, Morgan Stanley asserted that it is considering a malpractice suit against Kirkland & Ellis, the law firm that represented it in the Perleman case. Id.

Thus, there is a looming dispute between Morgan Stanley's in house counsel and Kirkland & Ellis over responsibility for the debacle in the Perleman case.

Conclusion

As the recent cases have shown, many prominent attorneys' conduct have been at issue in the leading securities fraud and obstruction of justice cases. Attorney ethical standards pre-SOX should have alerted these attorneys to the implications of their involvement in their clients' misconduct.

Certainly, after the passage of SOX attorney responsibility rules and the criminal obstruction of justice rules, attorneys should be well aware of the implications of their misconduct. Time will only tell whether SOX has had a chilling and deterring effect in attorney involvement in their clients' fraud and obstruction of justice.

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[1] CBS Business News, Tara Perkins, November 17, 2005.
[2] "Penny-Stock Fraud, From Both Sides Now," New York Times, By Diana Henriques, February 16, 2003.
[3] "Going After The Lawyers In Refco's Stunning Fall," The Street.com, Matthew Goldstein, November 21, 2005.
[4] "The Significant Meaninglessness of Arthur Andersen LLP v. United States," Cato Supreme Court Review, By John Hasnas.
[5] "A Bad Thing, Why Did Martha Stewart Lose?" The New Yorker, By Jeffrey Toobin, March 15, 2004.

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