CORPORATE LAWYERS AND THE CHALLENGE OF THE PROFESSIONAL GATEKEEPER PARADIGM

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ABSTRACT

In corporate governance scholarship, a professional gatekeeper acts as an intermediary between a corporate client and the financial markets. Since the 1930s corporate lawyers have provided a gatekeeping service by carrying out due diligence on their clients for the purpose of facilitating transactions in the capital markets. Legal reforms in 2002 imposed obligations on lawyers, practising before the United States Securities and Exchange Commission, to report material corporate violations to senior officers of corporations. But the Global Financial Crisis has raised questions whether these reforms have been effective in preventing the misbehaviour of corporate clients. The widespread expectation that corporate law firms engage in regulatory arbitrage presents a challenge to those who advocate an expanded view of professional gatekeeping responsibility. The question is whether corporate lawyers should file reports on the suspected misbehaviour of their clients to an external government agency. This has already happened in the member states of the European Union and countries such as Malaysia and Singapore (but not in the United States) where international anti-money laundering standards require lawyers to report suspicious transactions to law enforcement. This amounts to a new paradigm for corporate lawyers who have been compelled to abandon client confidentiality (but not legal professional privilege) when confronted with adverse criminal-related information about their clients. The challenge is that lawyers are now required to be independent gatekeepers in money laundering, that is independent of their clients, but not independent of government.

INTRODUCTION

It is in corporate governance scholarship that the importance of gatekeeper responsibility has been most developed. Corporate governance is defined by the OECD as the 'system by which business corporations are directed and controlled...(through) rules and procedures for making decisions on corporate affairs' (Clarke, 2004, 1). A major aim of corporate governance is to protect shareholders and creditors from management and organisational fraud by making it more difficult for illegal and unethical conduct to take place (OECD, 2004).

A professional gatekeeper acts as an intermediary between a corporation and the financial markets whereby the gatekeeper has the capacity to exercise influence over the behaviour of the 'insiders' of the corporation (Kraakman, 1986). The raison d'etre of gatekeepers is then to influence corporate behaviour in a manner that facilitates efficient and fair financial markets by protecting investors against illegal or fraudulent conduct in the corporate securities markets.

The academic literature has identified the following private actors as potential gatekeepers in relation to the corporation and the markets: the board; directors and officers; managers, underwriters; bankers; rating agencies; security analysts; auditors; and lawyers, both in house counsel and external law firms (Coffee 2006, 2).

There are a range of gatekeeping functions which may influence the behaviour of corporations, including counselling and advising the corporation, declining to give an opinion (for example, legal, audit, or credit rating) which is necessary to consummate a transaction or raise finance, refusing to act on corporate instructions, up-the ladder reporting to senior executives and the board, resignation from the mandate, or reporting to an external government agency.

A more recent development is the professional gatekeeper role imposed on the professions, including lawyers, accountants and company and trust service providers, under international anti-money laundering (AML) standards. A core AML requirement is the duty to report suspicious transactions concerning clients. This is a controversial requirement which has not been accepted by countries such as the United States, whereas the European Union and jurisdictions such as Malaysia and Singapore have embraced the international standard.

PROFESSIONAL GATEKEEPERS IN CORPORATE GOVERNANCE

The idea of professional gatekeepers in capital markets was conceived during the New Deal reforms in the United States (Ernst 2009, 16-17). A major goal of these reforms was to prevent massive securities fraud that had contributed to the collapse of Wall Street and the Great Depression. The US Securities Act 1933 imposed strict liability on corporate issuers for disclosure statements, but the liability of underwriters, accountants, officers and directors of corporates was cushioned by a due diligence defence (Coffee 2006, 206-7). Although corporate securities lawyers were not designated by the securities laws as gatekeepers, nevertheless they were tasked by corporations and insiders with the mandate of conducting due diligence investigations of new securities issues, and thereby performed a gatekeeping service to the market.

With the rapid expansion of international securities offerings of multinational enterprises, coupled with the explosive growth of global mergers, acquisitions and corporate transactions, it was large corporate law firms with international expertise that dominated the due diligence market, earning huge fees by carrying out comprehensive due diligence investigations on behalf of their corporate clients. Moreover, corporate lawyers were given new responsibilities to 'ferret out corporate misconduct' by carrying out internal corporate investigations into violations of not only securities laws, but in anti-trust, foreign corruption, and more recently in money laundering, terrorist financing and sanctions violations ((Block, 1980, 25; American Bar Association, 2008).

However, from the middle of the 1970s onwards the capacity of outside legal counsel to act as effective gatekeepers in US corporate securities regulation was diminished. A series of court decisions reduced the potential civil liability of gatekeepers under the aiding and abetting provisions of US securities laws (Bloomenthal, 2006). At the same time, the corporate power balance changed with the growth of internal counsel in corporations who took significant responsibility to screen clients and to control information flows to outside corporate counsel. External lawyers became less important than other gatekeepers in relation to the entire investment transaction, in that they did not have the same leverage over corporate clients (Ernst, 2009).

The financial fraud scandals in the United States at the beginning of the Twentieth Century raised new questions as to why gatekeepers had not prevented these frauds. Subsequently, the *Sarbanes-Oxley Act* 2002 expanded the gatekeeper responsibilities of directors and auditors, and expressly imposed on lawyers practicing before the Securities and Exchange Commission (SEC) mandatory up-the ladder reporting requirements in relation to material violations of securities laws and fiduciary duties (SEC, 2003). Although the new statutory obligation clarified how external law firms may discharge their fiduciary duties to the corporation and gave them increased leverage in dealing with corporate insiders, it did not impose any requirement on corporate lawyers to report to any external governmental agency.

But public disquiet about the responsibilities of lawyers for the fraudulent conduct of their clients, and under the influence of the SEC, various bar associations in the United States amended their bar rules to incorporate a new SEC standard (Final Rule 205.3(d)) which allowed lawyers to report confidential information to the SEC so as to prevent or rectify substantial financial injury to corporate issuers or investors, or to prevent issuers from committing perjury (SEC, 2003). Because the decision of an attorney to make a disclosure to the SEC (without the consent of the corporate client) of a material violation was discretionary, involving matters of professional judgment, the practical impact of the bar rules was limited. Indeed, the expanded gatekeeper capacity was unlikely to be utilised except in rare circumstances because of the strong belief of most lawyers that there was a superior 'public interest in maintaining the sanctity of the solicitor-client relationship' than disclosing confidential information about a client so as to prevent 'even catastrophic financial harm' (Devlin, 2008).

The Global Financial Crisis (GFC) has revived the question as to whether professional gatekeepers should take greater legal and ethical responsibility for the misbehavior of their clients, including their excessive risk-taking behavior (Bainbridge, 2012). Although criminologists have claimed that financial crimes are a major cause of the GFC (Will, 2012) and the United States Government Financial Crisis Inquiry Commission was mandated to investigate financial crime, there is at present little empirical evidence to support this claim. The US Department of Justice has been criticised for failing to launch criminal prosecutions against major financial institutions involved in the GFC but whether this is a result of a lack of political will or the inability of the criminal law to deal with sophisticated and complex white collar crimes, is difficult to determine. There has however, been a number of civil suits for fraud against major financial institutions, although none have included law firms as defendants.

It is worthwhile reflecting on the GFC and the role of gatekeepers. Of the trillions of dollars of losses incurred by financial institutions in the GFC, it is estimated that between 2007 and 2009, $542 billion (or more than half) was attributable to losses in a high risk securitised debt instrument, namely Collateralised Debt Obligations (Barnett-Hart, 2009). It is not surprising that these securitised financial instruments which were mainly sold in the unregulated trillion dollar OTC derivatives markets have been described as 'toxic' (because of their financial composition) and 'financial weapons of mass destruction' (because of their systemic risk) (Berkshire Hathaway, 2002).

It was the fierce competition between investment bankers who sought to expand their share in the burgeoning field of securitisation that drove the marketing of the new financial products. The bankers were assisted by brilliant financial mathematicians who created the financial products, credit rating agencies which issued AAA ratings on 'toxic securities', and auditors who sanctioned off-balance sheet transactions which avoided financial reporting requirements. The failure of the financial models, the conflicts of interest of the rating agencies, and the inadequacies of international accounting standards and external auditing, indicate that 'securitization professionals (who were gatekeepers felt) free to ignore the beneficial intent of Sarbanes' (Tavakoli, 2008, xiv).

The critical role of corporate law firms which advised the investment banks was to maximize regulatory arbitrage opportunities by devising complex structures to support the new financial products so as to circumvent regulatory obstacles, lower regulatory costs, and in some cases reduce transparency so as to limit governmental oversight (Author, 2013). The leading corporate law firms, which typically have a large number of lawyers who specialise in corporate and structured finance, were expected by their clients to add value to corporate deals by aggressively identifying and exploiting regulatory arbitrage opportunities arising from inconsistencies between different financial products, different financial sectors, or contrasting regulatory and taxation approaches between competing legal jurisdictions (Fleischer. 2010). As one prominent global corporate lawyer informed the author, 'I love regulatory arbitrage … (because) this is the bread, butter and jam' of structured finance (Interview, 2009).

Few questioned the propriety or ethics of regulatory arbitrage (or the lawyers' responsibilities in furthering their client's goals in using arbitrage) especially because arbitrage was welcomed by the markets in the boom years, lauded by some regulators, including the then Chairman of the US Federal Reserve, Alan Greenspan, and justified by academic corporate finance specialists and economists, including Nobel Prize winner Professor Merton Miller (Greenspan 1998, Miller 1991). It was only after the emergence of the Global Financial Crisis (GFC) that regulatory arbitrage was identified as a major factor facilitating excessive leverage in financial institutions and thereby posed a significant obstacle to improving domestic and international financial regulation (Pitt, 2008).

Although lawyers, both in house counsel and outside law firms, were a vital cog in the decision-making process of major financial institutions that resulted in the financial meltdown (Kellog,2008), it is very difficult to assess the responsibility of lawyers, given that legal advice is usually protected by attorney/client privilege. One global corporate law firm was accused of contributing directly to the GFC by providing legal advice which allowed Lehman Brothers to arbitrage differences in the accounting treatment of repo transactions in the United States and the United Kingdom which had the alleged effect of misleading the firm's financial position (Murphy, 2010). The specific legal advice related to $50 billion in repo transactions, which is relatively small compared to the massive size of the bankruptcy of Lehmans with assets of $639 billion (Vaulkas, 2008). Moreover, in the liquidator's report on Lehman Brothers, and in congressional reports and in litigation, it have never been suggested that the legal advice relied on by Lehmans was inaccurate or that the law firm had acted illegally, improperly or unethically.

Nevertheless, there is a significant policy question as to whether corporate law firms should moderate or eschew their participation in regulatory arbitrage if it has adverse public policy effects. There are 'legal, business, professional, ethical and political factors' which potentially may limit regulatory arbitrage (Fleischer, 2010, 252-74). For example, a legal opinion which facilitates regulatory arbitrage in a financial transaction may give rise to civil liability in the case of negligence, and in exceptional cases, criminal liability, on the basis of accessorial liability where the opinion is fraudulent or a sham (McHugh, 1989). Although Fleischer suggests that ethical principles, apart from the bar rules, have no impact on the practice of regulatory arbitrage (2010), legal ethics scholars have argued that lawyers as gatekeepers should not assist their clients in regulatory arbitrage because the latter amounts to taking advantage of 'loopholes' in legislation which defeats the spirit of the law and undermines legislative objectives (Loughrey, 2007, 63, 155; Parker, 218).

PROFESSIONAL GATEKEEPERS AND MONEY LAUNDERING

The development of international AML standards has also expanded the professional gatekeeper paradigm by requiring not only financial institutions but also certain professions (lawyers, notaries, other independent legal professionals, accountants and company and trust service providers) to carry out risk-based customer due diligence, report suspicious transactions involving their clients to an external governmental agency, maintain records, and file compliance reports (Kennedy, 2013). The justification for applying the international AML standards to lawyers is that national and international typologies suggest that certain services provided by the legal profession are vulnerable to criminal misuse (ibid). It is further suggested that there would be a significant AML regulator gap if lawyers were not required to act as gatekeepers to the international financial system. At a theoretical level, it may be surmised that organised crime places strategic value on the knowledge, skills, professional secrecy and reputation of the legal profession (Author, 2013).

Although more than 180 countries have agreed to apply the international AML standards, national implementation of the standards to the legal profession has been patchy, with countries, such as the United States, refusing to countenance any mandatory reporting requirement. From the US perspective, the standards entail an unacceptable redefinition of the role of lawyers in the criminal justice system by compelling lawyers to function as 'whistleblowers' in violation of their traditional fiduciary duties of loyalty and attorney/client confidentiality (Shepherd, 2009). A different view has been taken in the European Union where the Third AML Directive has required member states to enact comprehensive AML regulation of both the legal and accounting professions. Although the legal profession in certain member states resisted the Directive, the European Court of Justice ruled that the obligation on the legal profession to report suspicious transaction was consistent with the European human rights treaties (Komárek, 2008). Not only has the Directive's requirements been implemented in 27 member states, but they have been copied by Switzerland and Liechtenstein, as well as the Bahamas, Cayman Islands, British Virgin Islands, Cook Islands, Vanuatu, Cook Islands. In the Asia/Pacific region Malaysia and Singapore have led the way by applying AML regulation to the legal profession; Philippines has followed the US position of rejecting government AML regulation of lawyers, while Australia has promised to apply the *Anti-Money Laundering and Counter-Terrorist Financing Act* 2006 (Cth) to lawyers and accountants, but has not yet carried out this promise.

Whether AML regulation of lawyers produces valuable criminal intelligence and whether it is of significant assistance in countering financial crimes, and whether the criminal justice benefits justify the violation of privacy and attorney-client confidentiality are matters which require further examination. An empirical study of US money laundering prosecutions suggests that requiring mandatory reporting would have little efficacy in that any suspicious reporting regime could only possibly be of value in cases where lawyers unwittingly facilitate money laundering (Cummings, 2010). In the sample study only 6 of 123 cases were lawyers' unwitting dupes of money laundering, and more than 80 per cent of these cases concerned real estate money laundering (Ibid, 42). Moreover, in those countries that have applied AML to lawyers, the results are inconclusive, There is a variation of reporting practices by lawyers in Europe which are subject to AML, for example, in the year 2009, 6,486 suspicious transaction reports were filed by British lawyers, while only 16 reports were filed by German lawyers (Author, 2013). No rational explanation has been given for such a discrepancy, but this is part of a larger problem that there has not been a comprehensive assessment of the effectiveness of the AML suspicious reporting regimes.

CONCLUSIONS

The professional gatekeeper paradigm in corporate governance stands in stark contrast to the view that the legal profession as a matter of practice use its knowledge and skills to identify opportunities for regulatory arbitrage. This raises the question whether gatekeeping responsibility and arbitrage facilitation are competing, if not, irreconcilable ideas (Author, 2013). It also raises the important policy issue as to whether corporate lawyers should moderate their participation in regulatory arbitrage if it has adverse public policy effects. The problem is how does one determine what is in the public interest in a globalised and complex network of markets. This may well depend on the particular market. For example, lawyers should not allow themselves to be used to facilitate money laundering regulatory arbitrage, but can the same be said for tax planning arbitrage or asset protection arbitrage? The temptation is that some corporate lawyers will not apply an appropriate legal or ethical perspective when answering these questions because arbitrage has been a very profitable activity for such lawyers (Davidson, 2009, Gilson 1984).

Any assessment of the role of corporate lawyers as professional gatekeepers should take into account that lawyers are not 'public watchdogs' (in contrast to auditors) in that they are the 'client's confidential advisor and advocate...whose duty is to present the client's case in the most favourable possible right' (*United States v Arthur Young,* 817). In the corporate governance context, lawyers are 'dependent gatekeepers' who are required to carry out their fiduciary duty of loyalty even when they are performing a gatekeeping role (Laby, 2006, 124). This means that lawyers 'perform their responsibilities under the yoke of unconscious bias that affects the rigour they bring to the gatekeeping task' (Id, 121). In contrast, lawyers are expected to be 'independent gatekeepers' under the AML laws, in that they abandon client confidentiality (albeit not legal professional privilege) for the public interest. Whether AML regulation of lawyers will result in a shift in the balance of power so that lawyers become too dependent on the government is a matter that may be addressed on another day.

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