

Book It

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BOOK IT

Scene 1

The General Counsel (GC) of Dataco is having a conversation with Dataco's sales VP, who tells him that the quarter will finish well, and that some personnel will receive bonuses because of three sales that closed just before the end of the quarter. One of those is a sale of certain data processing services to Nucleus for \$12 million.

The GC asks if the legal department has provided necessary support for these deals. The sales VP says yes, but that the Nucleus deal was given to outside counsel because of some tricky IP issues.

Scene 2

A Dataco contract lawyer is discussing with the General Counsel the work she is doing. She tells him that she is working on a contract Dataco is entering into with Nucleus to purchase \$12 million of its telecom equipment. The GC looks puzzled by the coincidence of these reciprocal \$12 million transactions.

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1. *Why is the General Counsel concerned?*

The GC is justifiably concerned about these back-to-back transactions, which permit Dataco to book \$12 million in revenue, but at the same time requires it to book a \$12 million expense payable to Nucleus. Nucleus sees the same accounting treatment, in reverse.

Nucleus' financial position is essentially unchanged after the two transactions. Dataco, however, is able to book \$12 million in revenue this quarter, but depreciate only a portion of the \$12 million equipment. If the useful life of the equipment is, say, six years, it will record only \$2 million in costs for the year in which it recognizes the full \$12 million in revenue from Nucleus. That leaves Dataco better off in financial statement terms by \$10 million. It also helped it hit its earnings target, which can be of major importance, including for executive bonuses.

The GC's suspicion of the transaction may be increased by the fact that the company's Sales VP asked for an outside law firm to do the work on the Nucleus purchase from Dataco, perhaps to prevent the Dataco legal department from linking the two transactions.

There have been several celebrated examples of accounting fraud using these reciprocal transactions, sometimes referred to as “roundtripping” (e.g., Securities Exchange Commission - SEC- Release 2005-38, March 21, 2005)

Dataco’s transactions could be a fraud on the company perpetrated by the Sales VP in order to earn a bonus. And by possibly creating a misleading Dataco financial statement, they could comprise the elements of a fraud on third-parties, such as lenders, who rely on the company’s financial statements. These two transactions could also be evidence of lack of honesty and business integrity of the Sales VP and of Nucleus, the counter-party.

If Dataco is a public company, these transactions, if fraudulent, could also subject the company to securities laws violations for publishing to investors a false and misleading financial statement.

On the other hand, the two transactions could be completely proper and only coincidental. Should the GC assume that the innocent explanation is the correct one and move on to worry about other things?

2. What are in-house counsel’s ethical obligations in this situation?

As one of Dataco’s in-house lawyers, you have an obligation to assure that the company complies with its legal obligations. Since non-compliance is often disguised as lawful behavior and is sometimes indicated only by actions or events that are only suspicious or maybe only ambiguous, overlooking these suspicious or ambiguous circumstances could mean that illegal conduct is being overlooked.

Here, ABA Model Rule 1.13 of Professional Conduct provides the applicable standard of professional conduct.

Rule 1.13(b) and (c) provide as follows:

(b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances to the highest authority that can act on behalf of the organization as determined by applicable law.

(c) Except as provided in paragraph (d), if

(1) despite the lawyer's efforts in accordance with paragraph (b) the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action, or a refusal to act, that is clearly a violation of law, and

(2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization,

then the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.

Under this ethical rule, corporate counsel must take action to protect the company from the illegal conduct of one of its employees. Note, however, that the threshold for taking action is a high one – the lawyer must “know” that corporate personnel have engaged in illegal conduct and that substantial injury to the organization is likely. For an in-house counsel, however, these specific elements should be viewed as technicalities to be litigated in a bar disciplinary matter. For everyday performance of a lawyer’s professional obligations to a corporate client, they should be viewed as informing a lawyer when prudence (even if not also an ethical obligation) requires action to expose and rectify corporate misconduct. In addition, Comment 3 to Rule 1.13 states that “knows” includes “know or reasonably should know.”

When constituents of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful. Decisions concerning policy and operations, including ones entailing serious risk, are not as such in the lawyer's province. Paragraph (b) makes clear, however, that when the lawyer knows that the organization is likely to be substantially injured by action of an officer or other constituent that violates a legal obligation to the organization or is in violation of law that might be imputed to the organization, the lawyer must proceed as is reasonably necessary in the best interest of the organization. As defined in Rule 1.0(f), knowledge can be inferred from circumstances, and a lawyer cannot ignore the obvious.

So these circumstances would appear to justify at least a preliminary investigation by the legal department. The usual first step in a lawyer's investigation of suspicious behavior is to become better acquainted with the facts. Here, consultations with the sales VP and with the company's IT or telecommunications department, to determine the bona fides of the equipment purchase, seems to be a good first step. That investigation may show that each of the two transactions is legitimate and independently justified on business grounds. If so, counsel can move on to other business.

But let us assume that this is an instance of fraudulent round-tripping, and that it was conceived by the Sales VP. What should the in-house counsel do next?

You have already taken some steps to protect the company's interests by completing a factual investigation. You have also presented your concerns to the Sales VP who, not unexpectedly, disagrees with you. What should you do next? Under Model Rule 1.13, it is clear that the lawyer must bring the matter to the attention of more senior management so that steps can be taken to, among other things, rectify the misconduct and prevent its recurrence, which could involve the creation of auditing systems to identify such conduct (recall that you only stumbled upon it) and the imposition of disciplinary measures against the employees responsible for the fraudulent conduct.

We should be able to assume that senior management, when informed of the misconduct, will take appropriate remedial steps. If so, the lawyer's ethical responsibilities will have been discharged. If senior management does not take appropriate action, then the lawyer will have to report the problem to the board of directors.

In the unlikely event that the board takes no action, the lawyer will be faced with the question of whether to disclose the illegal conduct outside the corporation, presumably to some governmental authority. This difficult question exists because Rule 1.13 creates an exception to the confidentiality of the lawyer's information (under Rule 1.6) "if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization." Note that the disclosure is discretionary, not mandatory, and subject to the further limitation of substantial injury to the company.

This is obviously a very difficult situation for the lawyer to be in – should she: stop making waves after the Board declines to act; blow the whistle on the company in a report to a governmental enforcement body; or resign.

The Nucleus transactions may also be deceptive practices that constitute securities fraud, because they mislead investors into thinking that the company is in better financial shape than it actually is. If Dataco is a public company, certain persons associated with its financial statements are subject to Sarbanes-Oxley Act of 2002. Because you may have evidence of a "material violation" of securities law, you may have a reporting obligation under the SEC Rules adopted under the authority of the Sarbanes-Oxley legislation. While at one time the SEC was considering an implementing rule that would require a lawyer to not only report fraudulent conduct "up the ladder" of the corporation, but also "out," meaning to outside authorities, the proposal was abandoned. The current rule requires only reporting "up" (17 CFR Section 205), which obligation would be satisfied by a Model Rule 1.13 report to higher authorities.

ADDITIONAL RESOURCES

Ethics Rules

ABA Model Rule 1.2(d):

ABA Model Rule 1.13: Organization as Client

Restatements

Restatement (Third) of the Law Governing Lawyers §94(2): Advising and Assisting a Client – In General

Restatement (Third) of the Law Governing Lawyers §96: Representing an Organization as Client

Articles

Steven L. Schwarcz, *Financial Information Failure and Lawyer Responsibility*, 31 Iowa J. Corp. L. 1097 (2006)

David Henry, *Fuzzy Numbers: Despite the Reforms, Corporate Profits Can Be as Distorted and Confusing as Ever; Here's How the Game is Played*, Business Week (October 4, 2004)

Steven M. Cutler, *Speech at UCLA Law School: The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program* (September 20, 2004), available at <http://www.sec.gov/news/speech/spch092004smc.htm>

Manning Gilbert Warren III, *Revenue Recognition and Corporate Counsel*, 56 S.M.U. L. Rev. 885 (2003)

Lawrence A. Cunningham, *Sharing Accounting's Burden: Business Lawyers in Enron's Dark Shadows*, 57 Bus. Law. 1421 (2002)

ACC Articles

Deborah M. House, *Lessons Learned the Hard Way: Ten Flags of Possible Financial Mismanagement and Fraud*, ACC Docket (November/December 2006): 28-42 available at <http://www.acc.com/vl/membersonly/ACCDocketArticle/loader.cfm?csModule=security/getfile&pageid=14595>

Leading Practices Profiles: Leading Practices in Providing In-House Legal Support to the CFO & Finance Function (June 2004)

ACC Annual Meeting Materials

CL01: Designing a “Best Practices” Plan to Ensure Financial Compliance, 2007 ACC Annual Meeting, available at

<http://www.acc.com/vl/membersonly/ProgramMaterial/loader.cfm?csModule=security/getfile&pageid=19862>

James J. Eisenhower, Howard Silverstone, & James A. Stavros, 509: *Vampires of the Bottom Line: A Look at Corporate Fraud*, 2002 ACCA Annual Meeting, available at:

<http://www.acc.com/vl/public/ProgramMaterial/loader.cfm?csModule=security/getfile&pageid=20579>

Other ACC Program Materials

Robin B. Schwill, 106: *Financial Analysis for In-House Counsel*, ACC Canadian CCU: New Challenges/New Solutions (November 18-20, 2007), available at

<http://www.acc.com/vl/membersonly/ProgramMaterial/loader.cfm?csModule=security/getfile&pageid=19996>

Stephen Faciszewski, Axel Viane, & David Williams, 104: *Financial Analysis for In-House Practitioners*, ACC Europe (2006), available at

<http://www.acc.com/vl/membersonly/ProgramMaterial/loader.cfm?csModule=security/getfile&pageid=20195>

Miscellaneous

Securities and Exchange Commission, Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer, 17 CFR Part 205