1

Introduction

The role of corporate lawyers and their firms: the issues

In 2010 a leading City law firm, Linklaters, attracted unwelcome media attention[1] when the bankruptcy examiner's report into the collapse of Lehman Brothers found that a legal opinion it had provided to its client had been used to mislead US authorities, although there was no suggestion that Linklaters itself had done anything wrong.[2] The media interest was short-lived and gave rise to no broader debate about the role corporate law firms played for their corporate clients.

In contrast, in the United States, even before Enron collapsed in 2000, there was lively debate on the subject of corporate lawyers and their corporate governance role.[3] After Enron, and with the introduction of the Sarbanes-Oxley Act 2002 which imposed obligations on lawyers to report managerial misconduct up the line within the company, a vast quantity of literature was produced on the subject.[4]

In the United Kingdom there has been little recognition that corporate lawyers have any role to play in corporate governance. There are no references to lawyers in the Cadbury, Greenbury, Hampel, Turnbull, Higgs, Smith or Walker Reports – the main reports in the United Kingdom on corporate governance issues – nor are lawyers mentioned in the UK Corporate Governance Code. Meanwhile the professional codes of

1 G. Hollander, 'Linklaters "could face litigation" over explosive Lehman report', *The Lawyer*, 15 March 2010.

2 A. R. Valukas, *Lehman Brothers Holdings Inc., Chapter 11 Proceedings Examiner's Report* (March 2010), pp. 740, 782–8, 798.

3 See, e.g., D. Luban, *Lawyers and Justice: An Ethical Study* (Princeton University Press, 1988), ch. 10; S. P. Koniak, 'The law between the Bar and the state', (1992) 70 *North Carolina Law Review* 1389; W. Simon, 'The Kaye Scholer affair: the lawyer's duty of candor and the Bar's temptations of evasion and apology', (1998) 23 *Law and Social Inquiry* 243.

4 For examples see R. C. Cramton, 'Enron and the corporate lawyer: a primer on legal and ethical issues', (2002) 58 *Business Lawyer* 143; J. Coffee, *Gatekeepers: The Professions and Corporate Governance* (Oxford University Press, 2006), ch. 6, pp. 347–52.

conduct for solicitors and barristers provide very little guidance on the issues which confront lawyers representing organisational clients. The issue has also received little academic attention.

Yet just because it did not suffer an Enron, it does not follow that the problems presented by US corporate lawyers do not arise in the United Kingdom. There is, for sure, a lack of data indicating that English lawyers have played a part in corporate debacles, but this may be partly because of the rarity, in recent times, of public investigations into corporate failures. This means that their precise causes and the role lawyers and others may have played have not been scrutinised. Legal professional privilege has also shielded interactions between lawyers and their clients from external view. Meanwhile, the failure by the legal profession's regulators to take formal disciplinary action against corporate lawyers may be because the problems presented by such lawyers do not attract regulatory attention, rather than because there are none.[5]

Moreover, the view that the role of English corporate lawyers may require closer scrutiny is supported by evidence from past Department of Trade and Industry (DTI) company investigations. Sargent has identified five types of lawyer failure associated with US corporate scandals: refusal to recognise misfeasance, particularly where this would jeopardise a profitable relationship; providing advice and opinions on, and structuring deals of, questionable legality; inadequate inquiry into questionable transactions; failure to alert boards of risky transactions from which managers would profit; and acting where there was a clear conflict of interest.[6] The DTI reports evidence similar patterns of behaviour. Thus, in the Milbury inquiry, inspectors reported that lawyers had conflated the interests of a shareholder-controller of a group of companies with those of the companies themselves, failed properly to identify their client, overlooked the conflicts of interest between group companies and between a company and its controller, remained silent while a managing director misled his fellow directors, and remained silent while improper transactions were executed.[7] In the Norton Group inquiry, inspectors considered that the

5 D. B. Wilkins, 'Who should regulate lawyers?', (1992) 105 *Harvard Law Review* 799, 822–9; M. Davies, 'The demise of professional self-regulation? Evidence from the "ideal type" professions of medicine and law', (2010) *Professional Negligence* 3, 29.

6 M. Sargent, 'Lawyers in the perfect storm', (2003) 43 *Washburn Law Journal* 1, 31–2.

7 Department of Trade and Industry (H. B. H. Carlisle and M. G. Lickiss), *Milbury plc, Westminster Property Group Ltd: Investigations under Section 432(2) and Section 442 of the Companies Act 1985* (London: Stationery Office, 1988) (hereinafter Milbury Inquiry), pp. 299–313 and ch. 14 generally; see also Department of Trade and Industry (R. M. Owen and P. D. Powell), *The Milford Docks Company: Investigation under Section 432(2) of the*

independence of external lawyers could be compromised by their position on the board of client companies and criticised a lawyer who had been a company's director for failing to provide sufficiently objective advice to the company regarding its obligations, which resulted in misleading information being provided to third parties and to shareholders.[8]

Even where no criticism was warranted, the reports frequently raised interesting questions about the role of lawyers. There are instances of lawyers being presented with warning signs of self-dealing transactions or other misfeasance and doing nothing or, in the inspectors' opinion, not doing enough.[9] The House of Fraser report illustrates how representation by a reputable firm gave a client a veneer of respectability, how regulators relied on this and how the firm failed to maintain a sufficient distance from its client.[10] It recounts how a lawyer advised the client that, while it had received legal advice from another firm and by counsel that it would be prudent to disclose certain information to an inquiry, commercial considerations pointed to non-disclosure.[11] There is no suggestion that the lawyer did anything wrong, but this raises questions about the counselling role of lawyers and the consequences of lawyers adopting a commercialised approach to the law. Other reports demonstrate a breakdown in communication between lawyers and the board because their advice had been blocked by the chief executive officer (CEO) or in-house lawyer, and so raise questions about how and when lawyers should report directly to the board.[12]

Companies Act 1985 (London: Stationery Office, 1992) (hereinafter Milford Inquiry), p. 46.

8 Department of Trade and Industry (R. G. B. McCombe and J. K. Heywood), *Norton Group plc Investigation under Section 432(2) of the Companies Act 1985* (DTI) (London: Stationery Office, 1993), pp. 182–183 (hereinafter Norton Group Inquiry).

9 Ibid., pp. 43, 45; Department of Trade and Industry (Sir Roger Thomas and R. Turner), *Mirror Group Newspapers plc: Investigations under Sections 432(2) and 442 of the Companies Act 1985* (London: Stationery Office, 2001) (hereinafter Mirror Group Inquiry), p. 322 and at n. a.

10 See Department of Trade and Industry (H. Brooker, QC, and H. G. C. Aldous, QC), *House of Fraser Holdings plc: Investigation under Section 432(2) of the Companies Act 1985* (London: Stationery Office, 1988), chs. 23, 25.

11 Ibid., pp. 463–4.

12 Department of Trade and Industry (M. H. Arden and G. N. Lane), *Rotaprint plc: Investigations under Sections 432(2) and 442 of the Companies Act 1985* (London: Stationery Office, 1991), pp. 166–9, 172; Department of Trade and Industry (H. Heilbron and M. Boohan), *Blue Arrow plc Investigation under Section 432(2) of the Companies Act 1985* (London: Stationery Office, 1991), pp. 144–6; see also Davis, Polk and Wardell, *Report to Shell Group Audit Committee: Executive Summary* (March 2004, on file with the author), p. 15.

More recently, after Shell misstated the level of its hydrocarbon reserves for the period between 1998 and 2003, which resulted in its being fined £17 million by the Financial Services Authority (FSA),[13] and $120 million by the Securities and Exchange Commission (SEC),[14] the company commissioned an internal investigation. The subsequent report attributed part of the blame for what went wrong to the fact that the in-house legal department lacked key information which could have led the lawyers to advise the company of its obligations and had not been consulted by the directors over disclosure decisions. The lawyers were simply not present at crucial board meetings. Again, the report into the collapse of MG Rover raised a range of issues concerning the role of both external and internal lawyers, including whether lawyers should counsel on the ethical aspects of a client's conduct,[15] how they should respond where the interests of the directors instructing them conflicted with those of the company, particularly where the directors' instructions appeared to be contrary to the company's commercial interests,[16] how legal advice was communicated to the board[17] and the role of in-house lawyers.[18]

Moreover, although the principal blame for the financial crisis which began in 2007 has been placed elsewhere,[19] it has been argued that lawyers were at fault by engaging in 'creative compliance', by advising financial institutions on how to design credit swap securitisations and derivatives so as to avoid regulation.[20] The term 'creative compliance' was coined

13 FSA, 'FSA fines Shell £17,000,000 for market abuse', press release, 24 August 2004.

14 J. Blum, 'Shell to pay $151 million in regulatory fines', *Washington Post*, 30 July 2004.

15 Department for Business, Innovation and Skills (G. MacGregor, FCA, and G. Newey, QC), *Report on the Affairs of Phoenix Venture Holdings Ltd, MG Rover Group Ltd, and 33 Other Companies (Inspectors appointed by the Secretary of State for Trade and Industry under section 432(2) of the Companies Act 1985) Vol. 1* (London: Stationery Office, 2009) (hereinafter Rover Group Inquiry), pp. 174–5.

16 There are many illustrations, but see, e.g., ibid., pp. 97–8, 336.

17 There are a number of critical moments where the external lawyer's advice regarding the propriety of a transaction was misunderstood by the board; see, e.g., ibid., p. 352.

18 The head of legal affairs for the MG Rover Group sought advice on whether notice of directors' meetings had to be given to all directors. Such notice was not given: ibid., pp. 656–8. She felt sufficient disquiet about a number of the transactions she witnessed that she sought independent legal advice: ibid., pp. 62, 226, 315.

19 See FSA, *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009) (hereinafter Turner Review), blaming regulatory failure, non-executive directors, poor control of risk and shareholders' failure to monitor.

20 D. Wilkins, 'Team of rivals? Toward a new model of the corporate attorney–client relationship', (2010) 78 *Fordham Law Review* 2067, 2068; E. Wald, 'Foreword: the Great Recession and the legal profession', (2010) 78 *Fordham Law Review* 2051, 2056 at n. 28; D. McBarnet, 'Financial engineering or legal engineering? Legal work, legal integrity and the banking

by McBarnet and Whelan to describe the practice of using legal rules in an artificial way so as to defeat the purpose of regulation – that is, 'to escape legal controls without actually violating legal rules'.[21] It involves keeping to the letter of the law while violating its spirit and avoiding its norms. These schemes are often extremely complicated and opaque, because complex manipulation of the rules is needed in order successfully to circumvent regulation and because the more impenetrable a scheme is, the less vulnerable it is to a successful challenge.[22] The concept of creative compliance, its legitimacy and how it should be regulated will be returned to later in the book.

Finally case law evidences that lawyers frequently face conflicts of interest problems in the context of entity representation, fail to identify correctly who their client is, and confuse the interests of management instructing them with the interests of the company.[23] It also reveals just how blind to corporate misconduct lawyers can be. This remarkable blindness may not be deliberate, but rather a result of cognitive bias.[24] To explain: in order for people to interpret their social world and to cope with the noisy amounts of information surrounding them, they construct models or mental maps. These incorporate heuristic devices to filter, weigh and give meaning to that information. However, these devices may be based on erroneous assumptions and, where this is so, people will not interpret correctly the information they receive. Thus lawyers who are approached by a new client are likely to make positive assumptions about that client unless there are obvious danger signs, not least because a new client is generally good news for the lawyer.[25] Once a person constructs a mental map about a client or situation, he or she will be slow, and subconsciously reluctant, to alter it. As a result, where danger signs emerge later, after the lawyer has formed a positive view of the client, there is a real risk that the lawyer will discount them. This is particularly likely

crisis', in I. MacNeil and J. O'Brien (eds.), *The Future of Financial Regulation* (Oxford: Hart, 2010), pp. 68–72, 76.

21 D. McBarnet and C. Whelan, 'The elusive spirit of the law: formalism and the struggle for legal control', (1991) 54 MLR 848, 848.

22 D. McBarnet, 'After Enron will "whiter than white collar crime" still wash?', (2006) *British Journal of Criminology* 1091, 1094–1095.

23 See Chapters 4 and 5.

24 S. H. Kim, 'The banality of fraud: re-situating the inside counsel as gatekeeper', (2005) 74 *Fordham Law Review* 983, 1001–35; A. B. Laby, 'Differentiating gatekeepers', (2006) 1 *Brooklyn Journal of Corporate Financial and Commercial Law* 119, 143–4.

25 D. C. Langevoort, 'Where were the lawyers? A behavioural inquiry into lawyers' responsibilities for clients' fraud', (1993) 46 *Vanderbilt Law Review* 75, 98–99.

to be the case if everyone else is behaving as if nothing is wrong, thus reinforcing the lawyer's positive view.[26] There is nothing sinister about this – as Langevoort points out, it would be impossible and undesirable to possess a completely open mind which constantly reworked its view of the world.[27] It does mean, though, that lawyers may not react even to obvious signs of wrongdoing. Again, lawyers tend to be socialised into viewing the interests of the company as the interests of those with whom they deal on a regular basis in the company and with whom they have established personal relationships.[28] Finally, since recognising managerial misfeasance confronts lawyers with difficult choices about how to react and could put their interests at stake – external lawyers could lose the client and internal lawyers their job – lawyers may subconsciously overlook problems unless they are made to see them.[29] Cognitive bias, its implications and how to deal with it will be considered later in the book.

In sum, this material highlights a number of questions regarding the role of corporate lawyers and the way in which they can facilitate, or undermine, corporate governance and good corporate behaviour. These can be broadly summarised as, first, what role lawyers should play in detecting and responding to managerial misfeasance; second, whether they should counsel their corporate clients to behave ethically; third, how they should address conflicts of interest that arise in the corporate context; and, finally, whether creative compliance is legitimate and, if not, what should be done about it.

It is timely to consider these questions, because the relationship between lawyers and the state is presently being renegotiated and transformed, and professional regulation is under review.[30] Although the Solicitors Regulatory Body (SRA) and the Bar Standards Board both regulate, and will continue to regulate, solicitors and barristers respectively in England and Wales,[31] the Legal Services Act 2007 introduced the Legal

26 Laby, 'Differentiating gatekeepers', 141–147.

27 Langevoort, 'Where were the lawyers?', 101.

28 J. Fisch and K. Rosen, 'Is there a role for lawyers in preventing future Enrons?', (2003) 48 *Villanova Law Review* 1097, 1123–4; S. Bainbridge and C. Johnson, 'Managerialism, legal ethics and Sarbanes-Oxley section 307', (2004) *Michigan State Law Review* 299, 306–7.

29 Langevoort, 'Where were the lawyers?', 115.

30 SRA, *The Architecture of Change: The SRA's New Handbook* (28 May 2010); N. Green, 'The future of the Bar', 10 June 2010, available at Barcouncil.org.uk/news/FutureoftheBar/ (accessed 15 August 2010), p. 37.

31 Following the recommendations of the Clementi Report, the SRA and the Bar Standards Board came into existence in order to split the regulatory arm of the Law Society and Bar Council respectively from their representative arm: D. Clementi, *Report of the Review*

Services Board (the LSB), an independent body, which came into existence on 1 January 2009, and is responsible for overseeing both the SRA, the Bar Standards Board and other legal regulators.[32] The Legal Services Act 2007 also introduced alternative business structures (ABSs), including multi-disciplinary partnerships (MDPs) and outside ownership of firms. The first ABSs are expected in 2011.[33] Legal disciplinary partnerships, which comprise a mix of lawyers and up to 25 per cent non-lawyer managers, have been permitted since 31 March 2009. All these changes could have a profound effect on the profession and provide an opportunity for reform of the role of corporate lawyers.

The scope of the book

Corporate lawyers

Who, then, are the corporate lawyers? This book adopts a broad definition, counting all those who carry out work for corporate clients. However, the legal profession is increasingly fragmented, and even lawyers engaged in corporate work are not a homogenous unit.[34] The issues they have to deal with vary widely, depending on firm size, the nature of the firm's work, whether the firm is international, whether the lawyer is in-house or external and the nature of the company the lawyer represents. This has led to US sociologists referring to 'the two hemispheres of the legal profession'.[35] Within the corporate sector there are three main groups: first, lawyers who work for the large law firms and who represent large, usually multinational, listed companies, banks and other financial service providers; second, lawyers who act for owner-managed companies; and, third, in-house lawyers working in commerce and industry. These are very rough and ready categories, since between the first and second lie a range of middle-sized firms, including boutique firms, who carry out work for a mix of corporate clients, large and small. Barristers form a

of the Regulatory Framework for Legal Services in England and Wales (December 2004), pp. 27–32.

32 Legal Services Act 2007, s.2.

33 Legal Services Board, *Wider Access, Better Value, Strong Protection*, Discussion Paper (May 2009), para. 1.7.

34 A. Francis, 'Legal ethics, the marketplace and the fragmentation of legal professionalism', (2005) 12 *International Journal of the Legal Profession* 173.

35 J. P. Heinz and E. O. Laumann, *Chicago Lawyers: The Social Structure of the Bar* (Illinois: Northwestern University Law Press, 1982), p. 319 and generally.

small but growing fourth group.[36] The focus of the book, though, is on solicitors, as they still make up the majority of lawyers instructed directly by companies or working in-house. Furthermore, the range of services that barristers can offer directly or indirectly to clients remains restricted. They cannot undertake the administration of clients' affairs, or the conduct of litigation.[37] They are usually engaged in advocacy, the provision of specialist advice and drafting documents such as pleadings, whereas the focus on this book (with the exception of Chapter 5) is on transactional work and the handling of client affairs.

The large corporate firms

The large corporate law firms are extremely important because of their contribution to the economy, their influence on the corporate sector of the legal profession, the types of clients they have, their influence on the legal activities of these clients and on the content of the law, and their power to lobby for, or against, law reform.

In 2006, legal services contributed 1.4 per cent to gross domestic product (GDP), while exports of legal services amounted to £2.97 billion,[38] much of which derived from the activities of these large firms. Most are based in the City of London, where they have flourished by meeting the needs of the booming financial services industry. Since 2008 the picture has changed somewhat as the financial crisis impacted on turnover and profits.[39] Nevertheless, it has been predicted that legal services, and in particular the work of the large corporate law firms, will continue to make a significant contribution to the economy.[40]

The large firms are also major employers. The 2 per cent of firms with twenty-six or more partners employ 41.8 per cent of all practising solicitors.[41] The very largest, those with over eighty partners, which constitute just 0.6 per cent of all firms, employ just over one quarter of all solicitors.[42] Over a quarter of all trainees are employed in the City of London and 34.9 per cent are employed in firms with over eighty partners.[43] The big firms also train over half of those who go on

36 Green, 'Future of the Bar', p. 19, reporting a 48 per cent increase in the use of barristers by in-house lawyers.
37 Bar Code of Conduct, para. 401.
38 International Financial Services London (IFSL), *Legal Services 2009*, p. 3.
39 Ibid., pp. 2–3. 40 Ibid.
41 Law Society Strategic Research Unit, *Trends in the Solicitors' Profession: Annual Statistical Report 2009* (2009), p. 6.
42 Ibid., p. 25. 43 Ibid., pp. 39–40.

to take up positions as in-house lawyers.[44] They are, therefore, in a position to influence the professional outlook and ethics of large numbers of corporate lawyers.

Even within this group there are significant differences between the work carried out by, and the resources of, those in the 'Magic Circle', based in the City of London, and those in the so-called second and third tier of the profession.[45] The former possess highly specialised transactional expertise and know-how, for example in relation to complex finance transactions, and detailed knowledge of highly specialist markets. They provide 'products', not just legal advice.[46] In doing so, they shape the content of corporate law and corporate governance.[47] Furthermore, as a result of their transactional expertise the large law firms dominate the market for these cutting-edge products and also particular industry segments. Firms further down the ranking lack the resources and the opportunity to develop such expertise, and so are permanently excluded from such work.[48] In particular, they dominate deals made in international capital markets, where their main competitors are not other English law firms but the large international US-based law firms and accountancy firms.[49] They are market leaders: the largest three law firms in the Global 100 are based in London.[50] Their clients are legally sophisticated global corporations, whose conduct can have a substantial effect on the financial

44 The Law Society, *Corporate Counsel – A Profile* (June 2008), p. 8 (hereinafter Law Society, *Corporate Counsel*).

45 The Magic Circle comprises the top five or six UK-based law firms: Slaughter & May, Freshfields Bruckhaus Deringer, Clifford Chance, Allen & Overy, and Linklaters. However, *The Lawyer*, a trade broadsheet, has recently introduced a new league table of international law firms, 'The Transatlantic Sweet Sixteen'. The list includes all the above UK firms (and no others) and major US-based firms, which reflects the growing significance of the multinational law firm.

46 R. Lee, *Firm Views: Work of and Work in the Largest Law Firms*, Law Society Research Study 35 (1999), p. 10.

47 Y. Dezalay, 'Professional competition and the social construction of transnational regulatory expertise', in J. McCahery, S. Picciotto and C. Scott (eds.), *Corporate Control and Accountability* (Oxford: Clarendon Press, 1993), pp. 212–13; M. Suchman and M. Cahill, 'The hired gun as facilitator: lawyers and the suppression of business disputes in Silicon Valley', (1996) 21 *Law and Social Inquiry* 679, 707. For a controversial illustration see M. Powell, 'Professional innovation: corporate lawyers and private lawmaking', (1993) 18 *Law and Social Inquiry* 423.

48 Lee, *Firm Views*, p. 16.

49 IFSL, *Legal Services 2009*, pp. 1, 7. See also D. Sokol, 'Globalisation of law firms: a survey of the literature and a research agenda for further study', (2007) 14 *Indiana Journal of Global Legal Ethics* 5, 10–12.

50 IFSL, *Legal Services 2009*, pp. 1, 6; size was measured by gross revenue. The firms were Clifford Chance, Linklaters and Freshfields Bruckhaus Deringer.

markets, the world economy and, hence, society. Good corporate governance is therefore particularly important in such companies, and so, consequently, is the lawyer's role in promoting it.

Smaller firms

Firms who represent owner-manager companies operate in a very different environment. Such firms can range from high-street practices that carry out some commercial work through to more specialised commercial firms catering to the needs of smaller businesses but occasionally carrying out straightforward, low-value, commoditised work such as debt collection, property or personal-injury work for large companies. Smaller firms make up the vast majority of solicitors' practices but, in contrast to the large firms, their influence is limited.[51] Their clients are more likely to be unsophisticated, their work is largely domestic and they will have little influence over the shape of corporate law, the norms of the profession or the behaviour of their largest clients. Nevertheless, they can have a significant impact on how parties within smaller companies relate to each other and in ensuring that the expectations of owner-managers regarding their role in the business are met. While there is evidence that owner-managers are more likely to consult accountants than lawyers for advice on setting up a company,[52] lawyers will be consulted when relationships break down and intra-corporate litigation materialises, and so have an important role to play in these respects. They also have a role to play as regards the shape of the professional conduct rules adopted by the SRA. Although the largest law firms often lobby for deregulatory rules that suit their commercial objectives, smaller firms can oppose such proposals. Because the profession of solicitor in England and Wales is under a single regulator, the largest law firms can therefore find themselves bound by professional conduct rules that they find unduly constraining.[53]

In-house lawyers

In-house lawyers are particularly significant actors in the corporate world and in corporate governance. Their numbers have been steadily increasing: currently 10 per cent of solicitors holding practising certificates work in-house in commerce and industry,[54] compared with around

51 Law Society, *Trends in the Solicitors' Profession 2009*, p. 24.
52 A. Hicks, 'Corporate form: questioning the unsung hero', (1997) JBL 306, 318.
53 J. Flood, 'The re-landscaping of the legal profession: large law firms and professional re-regulation', (2011, forthcoming) *Current Sociology*.
54 Law Society, *Trends in the Solicitors' Profession 2009*, p. 14.