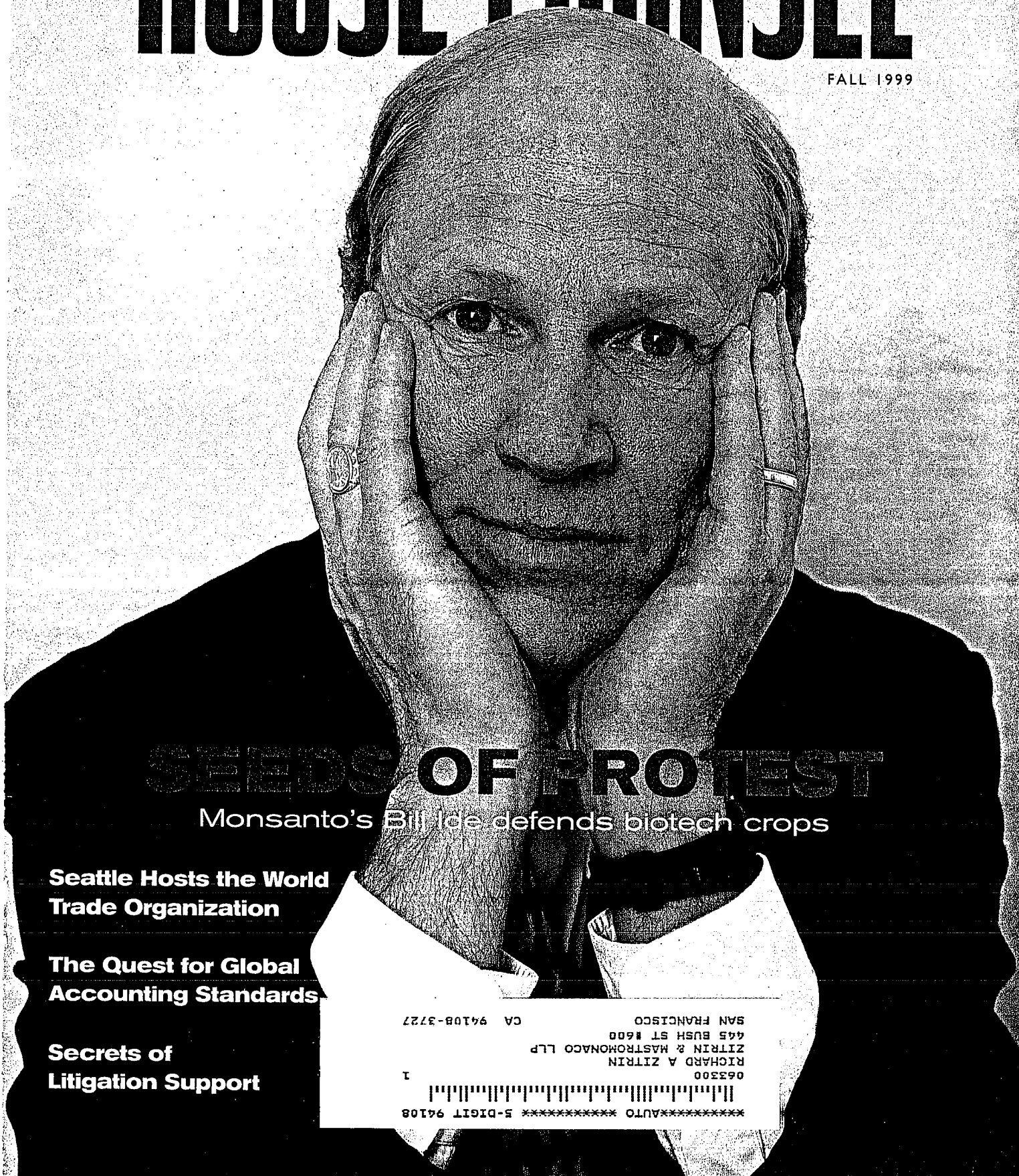


HOUSE COUNSEL

FALL 1999



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False Profits

By Richard A. Zitrin and William M. Balin

In a time when frenzied markets and astonishing gains in per-share value grab the headlines, it is important to remember that a stock price is frequently not an accurate indicator of a company's financial health. Yet a company's earnings picture may have such an impact on its stock price that the pressure to fudge those figures is nearly irresistible. For example, in 1998 the Securities and Exchange Commission accused W.R. Grace & Co. of inappropriately using reserves to report its financial status and, in a separate matter, secured consent judgments from three former officers of California Micro Devices for booking revenue for sales of computer components that had neither been shipped nor, in many cases, even manufactured.

These examples are simply the tip of a very large iceberg; approximately 400 securities class actions involving accounting fraud are now pending in federal courts. The SEC has more than 900 employees in its enforcement branch prosecuting alleged securities violations.

Consider the dilemma of house counsel at High Tech, a hypothetical Internet company. High Tech's board of directors consults with counsel because it is considering writing off millions of dollars in research and development in Acme, a start-up company High Tech recently purchased. These write-offs exaggerate the value of the actual R&D being conducted at Acme, but they would allow High Tech to lower its tax liability and avoid having to charge these expenses as good will over a number of years. What advice should house counsel give to High Tech's board?

Knowing that the proposed accounting practices would give shareholders and potential stock purchasers an inaccurate financial picture of High Tech, and knowing that discovery of these practices could well land the company in hot water, High Tech's house counsel has but one ethical option: to advise the corporation not to proceed with the exaggerated write-offs.

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Under both the ABA Model Rules and the California Rules of Professional Conduct, a lawyer may not participate with a client in perpetrating a fraud. ABA Model Rules, 1.2(d), 4.1; Cal Rules of Prof Cond 3-210; Cal Bus & P C §6068(c), (d). Thus, High Tech's house counsel should advise the company that the proposed write-offs twist reality, may be untruthful, and are at best misleading, and that the better practice is to accurately portray the company's financial status. Finally, counsel should advise High Tech that the proposed practices will likely attract the unwanted attention of the SEC.

However, if High Tech still decides to go forward with the proposed large write-offs, house counsel has only limited options under the current ABA and California rules. Under the rules that specifically deal with representing an organization, house counsel may consider only what is best for the organization. Counsel can try to influence the corporate decision makers to take a different and more truthful approach to the financial disclosures by asking that the decision be reconsidered, recommending that the company get a second legal opinion, or taking the matter to the highest authority in the organization, whoever or whatever that may be. ABA Model Rules 1.13(a), (b); Cal Rules of Prof Cond 3-600(A), (B). Beyond that, there's little or nothing that counsel can do.

Despite the limited powers house counsel has under these rules, the best course

is to argue vigorously for a truthful and accurate financial disclosure. There are many reasons for taking this course in addition to the rule that an attorney cannot assist a client in perpetrating a fraud: In representing a client an attorney must use only those means that are consistent with the truth (ABA Model Rules 8.4(c); Bus & PC

§6068(d)), and a lawyer may not give false or misleading information to third parties who may rely on it (ABA Model Rules 4.1). Arguments that the company's stock will rise, thus benefiting shareholders (including, possibly, house counsel themselves), are unpersuasive in view of the misrepresentations on which such benefits rest. Moreover, pressure by the SEC to revise the company's financial disclosures may result in significant long-term damage to the price of High Tech's stock.

When the company is cooking the books, should house counsel feel the heat?

Should the board of directors refuse to follow house counsel's advice, ABA Model Rules 1.13 and California Rules of Professional Conduct 3-600 effectively tie counsel's hands. Those who are sufficiently disturbed by the company's decision and practices may resign. However, under those rules they may not disclose the information they have received to anyone outside the organization.

Moreover, there's always the chance that house counsel who vigorously protest a company's accounting irregularities may be fired. Consider the plight of Massachusetts attorney Jefferson Davis Stewart III, who was fired as in-house counsel for GTE's lighting subsidiaries for what he says was an effort to persuade management that the companies needed to issue safety warnings to the public about certain dangerous products. Similarly, General Dynamics Corporation fired California lawyer Andrew Rose for, according to Rose, calling attention to the improper and illegal practices of his employer. Courts in both Massachusetts and California held that the fired house counsel could sue their former employers for wrongful termination, but with this catch: They could not reveal any information they had obtained that was confidential. *GTE Products Corp. v Stewart* (Mass 1995) 653 NE2d 161; *General Dynamics Corp. v Superior Court (Rose)* (1994) 7 C4th 1164. Without the confidential information, the lawyers' cases were badly damaged, although Stewart's proceeded using confidential information under seal.

Thus, house counsel have little power over their employers other than the persuasiveness of their arguments and whatever arm-twisting they can exert without losing their jobs. Avoiding questionable accounting practices may therefore have more to do with finding those persons in the company with whom house counsel have the best rapport. These individuals—whether high-level managers, members of the board of directors, or corporate officers—may be more willing to be convinced that the company should make accurate financial disclosures.

In some cases, house counsel may be able to form a united front with accountants willing to oppose the company's proposed conduct. The bottom line, however, is that house counsel may

be unable to prevent a company from adopting questionable bookkeeping practices. In that case the only comfort may be counsel's own clear conscience.

See No Evil

What if house counsel is kept in the dark about the company's accounting procedures? Suppose that High Tech's counsel learns only through rumor or third-party hearsay that the company is engaging in questionable accounting practices that misrepresent its financial posture. Can house counsel decide to do nothing, comfortable in the knowledge that he or she was never consulted about the "cooked books"?

Although the technically correct answer to this question may be yes, we suggest that the ethically correct answer should be no. ABA Model Rules 1.13(b) and California Rules of Professional Conduct 3-600(B) both state that an attorney for an organization "shall proceed as is reasonably necessary" only when the attorney "knows" that the company or an agent of the company is acting or intends to act in a way that may substantially injure the corporation. House counsel who are not consulted about the accounting procedures can claim they did not "know" about it. Besides, since there is no requirement that an attorney who "knows" that the company is employing questionable accounting procedures actually take action, these rules allow house counsel to adopt an ostrich mentality. Consider this language found in Comment 3 to ABA Model Rules 1.13: "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."

But this language cannot justify a "see no evil" approach to the responsibility of being in-house counsel for a corporation. Comment 3 also states that when the company's proposed action may violate a law and thereby substantially injure the company, the lawyer may act.

In our hypothetical situation it would be entirely appropriate for house counsel first to find out from those familiar with the accounting and

bookkeeping procedures whether the rumors or hearsay are true. If counsel confirms that the company is embarked on a course involving misleading financial disclosures, he or she can employ all the remedies available to those who were not kept in the dark: urging reconsideration, advising that the company get a second legal (or accounting) opinion, and taking the matter to the highest constituent in the organization.

Even when the financial practices are technically legal but nevertheless questionable, or when it is unlikely that the SEC or other governmental agencies will act even if the practices are illegal, house counsel may want to consider whether it is in the corporation's best interest to give false or misleading impressions about the company's financial condition to shareholders and the general public. Counsel's primary—in fact, only—concern, must be the well-being of the company itself and not the personal financial considerations of the officers or directors of the corporation or of counsel themselves.

Moreover, when there is even a chance that the SEC may act against the company, house counsel has a duty, at a minimum, to advise the company of the risk it is taking and to try to get it to change its practices before any possible governmental action occurs. Sometimes a good lawyer must act as an unwanted messenger by telling a client to swallow distasteful medicine in order to avoid more serious illness later on.

House counsel is uniquely positioned to advise against attractive but ultimately misleading or outright fraudulent bookkeeping practices. For those house counsel who are uncomfortable with such misleading practices, advising accuracy and prudence may be a lonely, frustrating, and ultimately costly position to take. When they succeed in changing or preventing the corporation's adoption of suspect accounting practices, counsel can bask in the knowledge that they have saved their companies from potentially severe legal trouble and have seen truth triumph over greed. When counsel are unable to change their companies' practices, at least they may be able to sleep at night. □