

Lawyers as gatekeepers

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Abstract

Good corporate governance is an enabling factor for the growth, development and success of corporations in this era of globalization and international competition. The corporate scandals of the early 2000s have reinforced the importance of corporate governance; they have stimulated research and experimentation with new modes of corporate governance.

Following the reforms introduced in North America in the last decade, lawyers have been formally integrated into the corporate governance regulatory framework. Canadian and U.S. regulation now clearly assigns a gatekeeping role to corporate lawyers. The legal qualification of corporate lawyers as gatekeepers has significant theoretical support in the literature. Yet criticism of this position raises doubts, or at least sensitive issues, regarding this qualification. We conclude that further empirical studies would be apposite to gain a finer grained understanding of the practice and contributions of corporate lawyers as gatekeepers and a better appreciation of the appropriateness of such role.

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Contents

I. THE ROLE OF LAWYERS IN CORPORATE GOVERNANCE: A THUMBNAIL SKETCH	2
A. Gatekeepers and Corporate Governance	2
B. Corporate Lawyers as Gatekeepers	3
II. THE IMPACT OF FINANCIAL FRAUDS: THE REGULATION OF CORPORATE LAWYERS' GATEKEEPING FUNCTION.....	5
A. An Overview of the Reform Initiatives Regulating Corporate Lawyers' Gatekeeping Function.....	5
B. In conclusion: A Critical Look at the Regulatory Initiatives	6

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III. Conclusion.....	8
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Corporate governance refers to the process and structures used to direct and manage the business of corporations. Good corporate governance is an enabling factor for the growth, development and success of corporations in this era of globalization and international competition.⁴ Over the past two decades, it has attracted increasing attention from governments and regulators interested in securing a legal and institutional environment in which corporations can thrive. The corporate scandals of the early 2000s have reinforced the importance of corporate governance.

Much attention has been given to the role of the Board in securing good corporate governance. But the Board alone, however well structured, cannot guarantee good corporate governance. In this paper, we look at a further component, to wit gatekeepers. We ask in particular whether corporate counsel can play this role by acting to stop or to whistle-blow where potential or real wrongdoing comes to their attention. In Part I, we look at the role of gatekeepers in corporate governance and the suitability of different kinds of lawyers to play that role. In Part II, we study corporate governance reform regarding gatekeepers in North America following corporate scandals, such as Enron, at the beginning of the millennium and then further reform following the financial disarray from 2008 on. We end with a critical look at whether these reforms are likely to succeed in investing lawyers with the responsibility of corporate gatekeepers.

I. THE ROLE OF LAWYERS IN CORPORATE GOVERNANCE: A THUMBNAILED SKETCH

A. Gatekeepers and Corporate Governance

Our understanding of corporate governance issues has been shaped by law and economics scholarship, which has effectively revived the field of corporate law.⁵ Within law and economics, the operative parts to consider are agency theory and the nexus-of-contracts theory. These theories see three main agency conflicts threatening value maximisation by corporations: 1) conflicts between managers and shareholders; 2) conflicts between dominant and minority shareholders; 3) conflicts between shareholders and stakeholders.⁶ The role of corporate governance norms is to mitigate these conflicts in order to promote value maximisation by the corporation.

From this perspective, there are two broad types of corporate governance instruments: internal and external instruments. The internal instruments refer to the board of directors, shareholder voting, and horizontal monitoring by managers. The external instruments encompass the market for corporate control, the labour market, the products market, and corporate and financial markets regulation.

Traditionally, in North America, corporate governance has been considered to be primarily a private matter best left to the discretion of corporate actors, in accordance with the enabling role of corporation law that flows from the nexus-of-contracts theory. Private initiative is expected to generate value-maximizing governance norms. They are

⁴ R. J. Daniels & R. Morck, "Canadian Corporate Governance: The Challenge", in R.J. Daniels & R.K. Morck, eds, *Corporate Decision-Making in Canada*, Calgary, University of Calgary Press, 1996, at 3.

⁵ See for instance R. Romano, "After the Revolution in Corporate Law", (2005) 55 *J. of Leg. Ed.* 342.

⁶ See R.H. Kraakman, J. Armour et al. (eds), *The Anatomy of Corporate Law: A Comparative and Functional Approach*, 2nd ed., Oxford, Oxford U.P., 2009.

to emerge from the interaction between members of the corporation and are to be enforced by the same mechanism.

The corporate scandals of the early 2000s have called into question this conception of corporate governance. Starting with the *Sarbanes-Oxley Act* (“SOX”), in 2002, mandatory rules have been enacted in the U.S. and Canada to address agency problems in publicly-traded corporations. The financial crisis that followed from 2008 on led to calls for further mandatory rules, which in the U.S. took the form of the *Dodd-Frank Act* of 2010.

The reform initiatives targeted primarily the board of directors, given its central role in corporate governance. But they also focused on another group of key actors in corporate governance: gatekeepers.

The concept of gatekeeper is due to Professor Reinier Kraakman. He defines gatekeepers as “private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers.”⁷ Gatekeepers act as “reputational intermediaries who provide verification and certification services to investors.”⁸ By reducing information asymmetries, they contribute to lowering the cost of capital for issuers. In addition, gatekeepers perform monitoring functions, acting as “chaperones” that can detect and disrupt misconduct in an unfolding relationship.

To qualify as gatekeepers, intermediaries must firstly have the power to prevent wrongdoing. Secondly, they must have reputational capital, *i.e.* they must be repeat players so that they have incentives to establish and maintain a trustworthy reputation for themselves. Thirdly, the value of their reputation must exceed the benefit they could draw from false certification. Classic gatekeepers include auditors, corporate lawyers, investment bankers and credit rating agencies.

Gatekeepers are an essential component of an effective corporate governance regime. As Coffee writes, “[n]o board can outperform its gatekeepers.”⁹ Without these independent intermediaries, “boards will predictably receive a stream of selectively edited information from corporate managers that presents the incumbent management in the most favorable light possible.”¹⁰ However, one reason for the scandals and crisis of the first decade of the 21st century stems from the failure of the gatekeepers. Whence the reforms introduced in the past ten years in the hope of improving the gatekeeping function.

B. Corporate Lawyers as Gatekeepers

The idea that corporate lawyers can play the role of gatekeepers has been around for some time. Lawyers were identified as gatekeepers in Kraakman’s 1984 seminal article.¹¹ However, it is the financial scandals of the early 2000s that gave traction to this idea. Starting with the *Sarbanes-Oxley Act*, lawyers have been identified as corporate

⁷ R.H. Kraakman, “The Anatomy of a Third-Party Enforcement Strategy”, (1986) 2 *J. Law Econ. & Org.* 53.

⁸ J.C. Coffee, *Gatekeepers – The Professions and Corporate Governance*, Oxford, Oxford U.P., 2006, at 2.

⁹ *Ibid.*, at 7.

¹⁰ *Ibid.*

¹¹ R.H. Kraakman, “Corporate Liability Strategies and the Costs of Legal Controls”, (1984) 93 *Yale L.J.* 857, 891. See also H.E. Jackson, “Reflections on Kaye, Scholer: Enlisting Lawyers To Improve The Regulation of Financial Institutions”, (1993) 66 *S. Cal. L. Rev.* 1019; S.M. Beck, “Gatekeepers and the Commission: The Role of Professionals in the Regulatory System”, in *Securities Regulation: Issues and Perspectives*, Scarborough, Carswell, 1993, at 239.

gatekeepers, in particular with the "noisy-withdrawal" and "up-the-ladder reporting" regime. Before discussing the reforms introduced by SOX, it is useful to examine to what extent corporate lawyers can indeed act as gatekeepers.

As a starting point, it should be noted that not all lawyers are equally qualified to act as gatekeepers. In North America, the term lawyer refers to the legal professionals who are registered to practice law in any capacity.¹² Amongst lawyers dealing with corporations, it is helpful to distinguish between those acting as litigators and those acting as counsel, and amongst the latter, in-house counsel as against external counsel.

Litigators act as advocate for the corporation and will consider it their role to represent "zealously" the interests of their client, even to make the best case for conduct that looks reprehensible to other eyes.¹³ This does not bode well for the potential of litigators to act as gatekeepers in their dealings with the corporate client.¹⁴

The role of corporate lawyers ("counsel") differs from that of the litigators. Corporate lawyers act as "transaction engineers" in planning, structuring, negotiating, drafting and implementing transactions for their clients.¹⁵ They are continuously involved in due diligence exercises in order to ensure the preparation of transactional and disclosure documents. Given the liability risk associated with these documents, corporate lawyers must have a critical perspective that forces them to eschew the role of "zealous advocates". Corporate lawyers are repeat players involved *ex ante* in transactions "overseeing the ultimate passage of their clients' transactions from planning to fruition".¹⁶ All of this gives corporate lawyers access to information allowing them to detect and disrupt wrongful conduct and might qualify them as potential gatekeepers.¹⁷

This gatekeeping function of corporate lawyers may be considered from the angle of in-house counsel as well as that of external counsel. According to Professor Gilson, in-house general counsel is the best candidate for the gatekeeping function.¹⁸ In-house counsel is arguably well placed within the corporate structure to discharge this function, being involved with management in planning, strategy and decision-making process.¹⁹ Their position provides in-house counsel with unique access to formal and informal information channels.

External corporate lawyers can also act as gatekeepers. Coffee remarks that external counsel have traditionally considered themselves as "wise counselors".²⁰ As such, their role is to "gently guide their clients toward law compliance by pointing out the

¹² The distinction between barristers and solicitors does not exist in North America.

¹³ J.C. Coffee, *supra* note 8, at 192.

¹⁴ See however F. Zacharias, "Lawyers as Gatekeepers", (2004) 41 *San Diego L. Rev.* 1387.

¹⁵ J.E. Fisch & K.M. Rosen, "Is There a Role for Lawyers in Preventing Future Enrons?", (2003) 48 *Vill. L. Rev.* 1097, 1130; R. Gilson, "Value Creation by Business Lawyers: Legal Skills and Asset Pricing", (1984) 94 *Yale L. J.* 239, at 290.

¹⁶ R. Campbell & E.R. Gaetke, "The Ethical Obligations of Transactional Lawyers to Act as Gatekeepers", (2003) 56 *Rutgers L. Rev.* 98.

¹⁷ J. Loughrey, *Corporate Lawyers and Corporate Governance*, Cambridge, Cambridge U.P., 2011, at 77.

¹⁸ R.J. Gilson, "The Devolution of the Legal Profession: A Demand Side Perspective", (1990) 49 *Md. L. Rev.* 869, at 915.

¹⁹ S.H. Kim, "The Banality of Fraud: Re-Situating the Inside Counsel as Gatekeeper", (2005) 74 *Fordham L. Rev.* 983.

²⁰ J.C. Coffee, *Gatekeepers – The Professions and Corporate Governance*, Oxford, Oxford U.P., 2006, at 193.

risks of alternative courses of actions”.²¹ The influence of external corporate lawyers rested in particular on the long-term relationship they built up with their clients.

II. THE IMPACT OF FINANCIAL FRAUDS: THE REGULATION OF CORPORATE LAWYERS’ GATEKEEPING FUNCTION

In the wake of the financial scandals that led to the collapse of Enron and of other public corporations, a number of reports identified professional and ethical failings on the part of corporate lawyers and questioned their role as gatekeepers. The *Sarbanes-Oxley Act* sought to address the failings of corporate lawyers and enhance the effectiveness of their gatekeeping function. While Canada was affected differently by corporate frauds, regulators nonetheless followed the U.S. initiatives and implemented reforms pursuing the same goals.

A. An Overview of the Reform Initiatives Regulating Corporate Lawyers’ Gatekeeping Function

Section 307 of the *Sarbanes Oxley Act* instructed the SEC (*Securities and Exchange Commission*) to enact rules setting “minimum standards of professional conduct” for attorneys “appearing or practicing before the Commission.” Such rules were required in particular to institute an up-the-ladder reporting system: lawyers were to be required to report “evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company”. In addition, the rules should specify that in cases where the counsel or officer does not appropriately respond, lawyers must report to the audit committee of the board of directors or another committee comprised solely of external directors. As Fish and Rosen summarize, “Section 307 is designed to provide a type of early warning system for independent directors, who might otherwise, due to their limited involvement in day-to-day corporate operations, fail to identify potential problems”.²²

The SEC moved swiftly to adopt a rule that implemented these instructions. The American Bar Association, whilst opposed the enactment of Section 307, subsequently amended the *Model Code of Professional Conduct* to provide an exception to the ordinarily strict requirement of confidentiality in cases of financial fraud.²³ Rule 1.6(b) was added to permit a lawyer to reveal information relating to the representation of a client to the extent that the lawyer reasonably believes: 1) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services; 2) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services. Further, ABA Model Rule 1.13 empowers a lawyer to disclose information relating to the representation where the highest authority in the

²¹ *Ibid.*

²² J.E. Fisch & K.M. Rosen, “Is There a Role for Lawyers in Preventing Future Enrons?”, (2003) 48 *Vill. L. Rev.* 1097, at 1112.

²³ *Model Code of Professional Conduct*, online: AMERICAN BAR ASSOCIATION http://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/model_rules_of_professional_conduct_table_of_contents.html

organization fails to address in a timely and appropriate manner an illegal act which the lawyer reasonably believes is reasonably certain to result in substantial injury to the organization.

Following the U.S. initiatives, Canadian authorities undertook similar reforms. In 2004, the Law Society of Upper Canada amended its *Rules of Professional Conduct* to introduce up-the-ladder reporting obligations in Ontario that are similar to the U.S. Rules.²⁴ The *Barreau du Québec* modified its *Code of ethics of advocates*²⁵ in 2004 to bring it into line with the U.S. reforms. The up-the-ladder reporting obligation is now generally recognized across Canada, being enacted in the *Model Code of Professional Conduct* of the Federation of Law Societies of Canada.²⁶

One significant difference with the U.S. regime should be noted. According to the Canadian rules of professional conduct, lawyers are not allowed to reveal privileged information to third parties under the guise of whistle-blowing. For instance, the Québec *Code of ethics of advocates* provides that a lawyer cannot report anything to an organization outside the client-corporation even where the latter fails to address the violation reported adequately. The only exception where a lawyer can communicate information protected by the duty of confidentiality is in order to prevent an act of violence. Otherwise, a lawyer needs to preserve the confidentiality of the client's information, even in a financial fraud case.²⁷ Hence, the only option for a lawyer where the highest authority fails to address financial fraud is to resign in accordance with the rules for withdrawal of representation and to cease representing the client-corporation.²⁸

B. A Critical Look at the Regulatory Initiatives

While it has been recognized in case law from time to time,²⁹ the role of corporate lawyers as gatekeepers remains a moot point in the literature. Critics argue that lawyers cannot be qualified as gatekeepers because this role runs counter to their classic role as advocates.³⁰ As Zacharias argues, this critique blurs two different dimensions of the lawyer's role. Lawyers do have the role to act on behalf of their clients to assist them pursuing lawful goals with lawful means. However, this is "quite different from saying that lawyers should do whatever clients want, assist clients in achieving illegal pursuits, or have no business shaping client ends".³¹ Furthermore, this critique overlooks the status of lawyers as public officers of the justice system, which implies obligations to the public.

It is important to draw a distinction between the functions of gatekeepers and of whistleblowers. Whistle-blowing "involves lawyers reporting confidential information

²⁴ The Canadian Bar Association adopted changes to its *Code of Professional Conduct* in 2004.

²⁵ *Code of ethics of advocates*, c. B-1, r. 3, s. 3.00.01, 3.05.18.

²⁶ *Model Code of Professional Conduct*, 2012, s. 2-8, online: Federation of Law Societies of Canada: http://www.flsc.ca/_documents/ModelcodeWTCrevdec2012FI.pdf

²⁷ *FAQS about Privilege and Confidentiality for In-House Counsel*, November 2012, at 13-15, online: Canadian Bar Association: <http://www.cba.org/cba/activities/pdf/CCCA-FAQs.pdf>

²⁸ *Code of ethics of advocates*, c. B-1, r. 3, s. 3.03.04; *Model Code of Professional Conduct*, 2012, s. 2-8, online: Federation of Law Societies of Canada <http://www.flsc.ca/_documents/ModelcodeWTCrevdec2012FI.pdf>

²⁹ See cases cited by S. Ben-Ishai; J.E. Fisch & K.M. Rosen, "Is There a Role for Lawyers in Preventing Future Enrons?", (2003) 48 *Vill. L. Rev.* 1097

³⁰ See, e.g., B. Fish, "Pointing the Finger at Professionals : The Responsibilities of Lawyers and Other Gatekeepers for Corporate Governance Failures", in P. Puri & J. Larson, Eds., *Corporate Governance Regulation in the 21st Century*, Toronto, LexisNexis, 2004, 97, at 114.

³¹ F. Zacharias, "Lawyers as Gatekeepers", (2004) 41 *San Diego L. Rev.* 1387.

pertaining to the client to outsiders, usually to protect third-party interests rather than the client's".³² Hence, whistleblowing raises conflicts with two basic principles that govern lawyers' practice: the duty to promote the client's interests and the duty of confidentiality. Nonetheless, as we saw above, the ABA chose to assign such a whistle-blowing role to lawyers when it modified its professional rules of conduct following the Enron debacle. It is debatable whether this reform was sound policy given the extent to which it runs counter to lawyers' traditional obligations.

Another line of criticism questions the incentives facing corporate lawyers. With respect to in-house counsel, Professor Bainbridge aptly notes that even though in-house general counsel are formally appointed by the board, their tenure is generally determined by their relationship with the CEO.³³ Moreover, the relationship with the CEO can also influence the compensation of general counsel, thereby increasing their dependence.³⁴ Finally, in-house counsel are not really reputational intermediaries as they do not have reputational capital distinct from that of the corporation.³⁵

The trust that characterizes the relationship between lawyers and their clients may also affect the effectiveness of the reforms. Lawyers tend to identify with their client, creating a behavioural bias that limits their ability to consider management behaviour to be wrongful.³⁶ Moreover, lawyers have a regular dialogue with management.³⁷ Assigning to the lawyer the role of corporate gatekeeper might undermine the flow of information coming from management and reduce the quality of legal services that can be provided. In permitting the disclosure of confidential information in the case of corporate misconduct, lawyers may compromise their relationship with management, who might fear that information revealed would be used against them and abstain from revealing it. Yet "[t]he quality of the attorney's counsel is a function of the quality of information he receives from the client ... [t]he need for attorneys to act on an informed basis is at the heart of one of the bar's most valued ethical principles – the attorney-client privilege".³⁸

As regards external corporate lawyers, they are subject to pressures that can affect their effectiveness as gatekeepers.³⁹ External counsel must maintain good relationships with the management and with in-house counsel who provide them with their business. The need to attract and retain clients may dampen their incentives to detect and disrupt misconduct. In addition, external counsel's role as transaction engineers may limit their ability to provide a gatekeeping function, at least with respect to the transactions in which they have been involved. In such cases, they will not have the independence required to be reliable gatekeepers. Finally, the increasing reliance on in-house counsel has transformed the relationship of external lawyers with their clients. Increasingly, external lawyers are hired on a transaction-specific basis, thereby eroding their "wise

³² J. Loughrey, *Corporate Lawyers and Corporate Governance*, Cambridge, Cambridge U.P., 2011, at 78.

³³ S.M. Bainbridge, "Corporate Lawyers as Gatekeepers", (2012) 8 *J. of Scholarly Persp.* 1, at 4-5.

³⁴ S.H. Kim, *supra* note 19, at 997 (citing the example of Tyco's general counsel).

³⁵ J.C. Coffee, *Gatekeepers – The Professions and Corporate Governance*, Oxford, Oxford U.P., 2006, at 195.

³⁶ J.E. Fish & K.M. Rosen, *supra* note 15, at 1124.

³⁷ S.M. Kim, "Dual Identities and Dueling Obligations: Preserving Independence in Corporate Representation", (2000-2001) 68 *Tenn. Law Rev.* 179, at 181.

³⁸ J.E. Fish & K.M. Rosen, *supra* note 15, at 1128.

³⁹ *Ibid.*, at 1123-1124.

counsellor” role. A recent empirical study adds fuel to the doubts about external lawyers as gatekeepers.⁴⁰

Although these criticisms do not altogether disqualify corporate lawyers as gatekeepers, they do raise sensitive issues that must be taken into account in legal regimes aiming to give them a role in corporate governance.

III. CONCLUSION

Following the reforms introduced in North America in the last decade, lawyers have been formally integrated into the corporate governance regulatory framework. Canadian and U.S. regulation now clearly assigns a gatekeeping role to corporate lawyers. The legal qualification of corporate lawyers as gatekeepers has significant theoretical support in the literature. Yet criticism of this position raises doubts, or at least sensitive issues, regarding this qualification. We conclude that further empirical studies would be apposite to gain a finer grained understanding of the practice and contributions of corporate lawyers as gatekeepers and a better appreciation of the appropriateness of such role.

⁴⁰ M. Bradley, I.A. De Lira Salvatierra and G. Mitu Gulati, *Lawyers: Gatekeepers of the Sovereign Debt Market?*, Economic Research Initiatives at Duke (ERID) Working Paper No. 2178487 2014, online : http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2178487.