

Testimony of Professor Charles W. Murdock, Loyola University

The purpose of my appearance is to support the recommendations of the ABA's Preliminary Report.

I expect that you will not receive much opposition to your corporate governance recommendations since they are in line with the NYSE position and the Sarbanes-Oxley Act. However, from conversations with corporate lawyers. I do expect that you will hear opposition regarding your proposed changes to the professional responsibility provisions. I support your proposed changes wholeheartedly.

I would like to start my comments with a reference to the NYSE report on corporate governance. In it, the NYSE cautions against modifying the 1995 Private Securities Litigation Reform Act (PSLRA). The NYSE concern is not to discourage director service. But, I believe this Act, coupled with a Supreme Court decision a year earlier, *Central Bank of Denver v. First Interstate Bank of Denver* (511 U.S. 164) set a tone for the corporate mismanagement that followed in the second half of the 1990's, and which led to the formation of your task force.

Central Bank eliminated aiding and abetting liability for accountants and lawyers in corporate disclosure situations. Thus professionals no longer need fear civil liability unless the professional made the misrepresentation. Thus, short of conduct amounting to criminal liability, the professional need not worry. And, in the 1990's the populace was not crying out for criminal prosecution.

PLSRA followed by indicating to the client that the client had little to fear – at least as it was interpreted by Silicon Graphics (183 F.3d 970 (1999)). Plaintiffs needed to plead fraud with particularity – without benefit of discovery – which would only be possible with a whistleblower. And Silicon Graphics required that the identity of the whistleblower be disclosed, which meant there would never be a whistleblower.

Thus the tone of the late 1990's was “why worry”.

Coming back to the legal profession, there has been a tendency for some attorneys to view themselves as “hired guns” rather than “counselors”. In the legal profession, we need to return to the role of counselors and the ABA should set the tone. I think that your proposed changes take us in that direction.

While today there are many vignettes that illustrate the hired gun mentality, this is not a new phenomenon. A few years ago, I gave a presentation for the National Practice Institute on “Ethical Considerations for Lawyers.” I took the case of *Carter and Johnson* (47 SEC 471 (1984)), and analyzed it as a multi-act play, questioning at what point did the attorneys fail in their ethical responsibilities. A copy is attached. The case involved Harvard educated lawyers in a major firm who

viewed the CEO, and not the corporation, as the client and who facilitated a securities fraud. Yet, all the SEC did was merely give them a hand slap.

Again, I believe the failure to confront attorneys down through the years has led to a tone by which some attorneys look at disclosure as if it were a game. Obfuscation – not clarification – is the goal. This mindset needs to be changed.

Let me take one current example: Enron and Chewco (diagram attached). Chewco was designed to take out Calpers for \$372 million. Under the 3% rule for Special Purpose Entities (SPE's), EITF 90-15, Chewco needed over \$11 million in capital, most of which was furnished by the Barclay Bank. But, at the closing, half of the \$11 million was returned to Barclay as a reserve. Vinson & Elkins prepared the letter agreement with respect to the disbursement of Funds.

There is no way the \$11 million to Chewco was at risk and thus the 3% rule was violated. This certainly was known to Vinson & Elkins. In the old days, they might have been deemed to have aided and abetted the fraud. Today, they need to realize who the client is – Enron, not Fastow or Koppers – and bring these patent violations to the attention of responsible parties in the entity. This, I believe, your proposal would require.

With respect to corporate governance, I think your proposal for regularized communication between the general counsel and the audit committee is outstanding. The same holds true for communication between outside counsel and the general counsel.

Today, we hear some rhetoric that you can't legislate morality. But we can set up structures that encourage moral behavior. Your recommendations go a long way in this regard.

Along the same line, I call your attention to the September 2002 Harvard Business Review article on "What Makes Great Boards Great," (p. 106). The author points out that independent directors alone won't do the trick. You need people with an independent mind who understand that conflict can be creative, not just destructive. Just going along with the crowd is not how to be an effective director.

Enron had outside directors and financially astute people on its audit committee. I am enclosing a mock agenda I created for a CBA Securities Law program relating the February 12, 2001 audit committee meeting at which the SPE's and the Fastow involvement were supposedly discussed.

There were over twenty agenda items, many of which you would expect to take out-half hour or more. Yet, the meeting lasted only one hour twenty-five minutes. This reflects the casual and irresponsible mindset that the directors brought to their task. Attorneys and directors both need to take their responsibilities more seriously.

