

**American Bar Association  
Task Force on Corporate Responsibility**

**Chicago, Illinois  
September 20, 2002**

**Preliminary Statement of  
Attorneys' Liability Assurance Society, Inc.,  
A Risk Retention Group**

**Introduction**

The Attorneys' Liability Assurance Society, Inc., A Risk Retention Group (ALAS) is an association of more than 260 large United States law firms that provides professional liability insurance coverage to approximately 54,000 lawyers practicing in the United States and abroad. Most ALAS Member Firms are medium-sized to large law firms that regularly represent organizational clients, including public companies, in a wide range of legal matters, including securities offerings. Among other activities, ALAS provides to its insured lawyers legal ethics and liability avoidance counseling. We respond to an average of almost 2,000 requests for such advice each year. In addition, of course, ALAS participates in the defense of professional liability claims against its insured lawyers and law firms. Over its 23 year existence, ALAS had dealt with over 13,000 professional liability claims and potential claims against lawyers.

Despite the commendable efforts of the Task Force to address important issues relating to corporate representation, ALAS believes that some of its recommendations do not and will not serve well either the profession or the public. In fact, some of the Task Force's preliminary

recommendations, if implemented, would destroy the relationship of trust and confidence between lawyer and client that is essential to effective legal representation.

We take this opportunity to bring two of these issues to your attention, and to urge you to reconsider those recommendations before submission of the Task Force's final report to the House of Delegates. The two important issues that we urge for reconsideration are: (1) the proposed revision of Model Rule 1.6 to require mandatory disclosure of confidential client information in certain situations; and (2) the imposition of a "reasonably should know" standard of knowledge to trigger a lawyer's obligations of disclosure or other action under Model Rules 1.2(d), 1.13 and 4.1 in place of the present standard of actual knowledge of client misconduct.

### **I. Core Values of the Profession and the Real World of Business Lawyering**

Our legal system by tradition, in its rules of professional conduct, and in its standards of professional liability, require that lawyers maintain the confidentiality of client matters. It does so in recognition that such confidentiality is essential to a relationship of trust and confidence between client and lawyer, which in turn is necessary for the lawyer to properly advise and vigorously represent the client. Any proposal to broaden the traditionally narrow exceptions to this confidentiality obligation risks fundamentally changing the nature of the client-lawyer relationship. In the worst case, it would turn lawyers into auditors or police, constantly doubting the reliability of their clients' statements, and preoccupied with how to protect themselves rather than how to advance the client's interest.

We have two other concerns about the Task Force's preliminary proposals. First, they seem to suppose that in the give and take of corporate lawyering, where the lawyer may be dealing with dozens of corporate officials, accountants, investment bankers, opposing counsel, regulators and others, and where the lawyer is often under enormous time pressures to prepare, circulate, revise and file documents on behalf of the client, it will always be clear to the lawyer that the some proposed client conduct constitutes a crime or a fraud. This is simply not true. Any given lawyer who is working on a transaction may not even have all of the facts necessary to make such a judgment. In such situations, it is simply not realistic to mandate lawyer disclosure, as opposed to permitting it.

An example makes the point. In preparing a disclosure statement, the lawyer must determine whether the client's disclosure about a particular subject is accurate in all material respects and does not omit any material fact. These are quintessentially issues of judgment on which expert and thoroughly honest lawyers may disagree. If a lawyer is on the opposite side from the client on such a judgment issue, and the consequences of the client's being wrong may be a charge of securities fraud, it is one thing to tell the lawyer that information necessary to correct the situation *may* be disclosed if the client does not do so. It is very different, and very unrealistic, to tell that lawyer that such information *must* be disclosed.

This leads to our second concern about the Task Force's preliminary recommendations: what conscientious, well-informed, risk-averse lawyer — the very kind of lawyer society should want advising senior corporate managements — will be willing to practice in areas where the rules of professional conduct have been tailored to maximize the lawyer's exposure for wrongful

or mistaken client disclosure decisions? This is not an imaginary concern. From our work with ALAS Member Firms, we know that there are already many thoughtful lawyers who are seriously questioning the wisdom of staying involved in securities work. Thus, this Task Force must ask itself whether society, the profession and millions of potential securities purchasers and sellers will really be better off if the rules of professional conduct pose such an exposure risk for securities practitioners that the most conscientious of those practitioners may simply opt out of that practice.

## **II. Any Lawyer Disclosure of Confidential Client Information Under Model Rule 1.6 Should be Permissive, Not Mandatory**

### **A. The Preliminary Report's Model Rule 1.6 Recommendations**

The Task Force's Preliminary Report recommends that the ABA adopt two recommendations of the Ethics 2000 Commission to amend Model Rule 1.6 that were rejected by the House of Delegates in August of 2001. Those amendments would permit, but *not* require, lawyer disclosure of client confidences to prevent or rectify consequences of a client crime or fraud in which the client has used or is using the lawyer's services and which is reasonably certain to result or has resulted in substantial harm to another's property or financial interests. (Prel. Rept. 31) The Preliminary Report quotes approvingly the Ethics 2000 Commission's explanation of the need for *permissive* lawyer disclosure, and specifically endorses that rationale. (Prel. Rept. 31-32)<sup>1</sup>

Curiously, the Preliminary Report then recommends that the ABA amend Model Rule 1.6 in a manner that is *inconsistent* with the Ethics 2000 Commission recommendations it has just endorsed. This inconsistent recommendation is that Model Rule 1.6 be amended:

to make disclosure mandatory, rather than permissive, in order to prevent client conduct known to the lawyer to involve a crime, including violations of federal securities laws and regulations, in furtherance of which the client has used or is using the lawyer's services, and which is reasonably certain to result in substantial injury to the financial interests or property of another. (Prel. Rept. 32)

**B. Mandatory Disclosure Is Inconsistent With The  
Ethics 2000 Commission's Model Rule 1.6  
Recommendations and With Other Authorities**

This recommendation differs from the Ethics 2000 Commission's recommended Model Rule 1.6(b)(2) and (3) in several respects. Most important, the Task Force's recommendation would make lawyer disclosure of intended client criminal conduct mandatory, rather than permissive. In this last respect, mandating rather than merely permitting disclosure, the Task Force's recommendation is fundamentally at odds with the recommendations of the ABA Ethics 2000 Commission, with the law in most American jurisdictions as reflected in Section 67 of the *Restatement of the Law Governing Lawyers*, and with the legal ethics rules of 47 of the 51 United States jurisdictions. This is all the more surprising because the Preliminary Report

contains not one word of explanation or justification for this momentous proposed change in the Model Rules.<sup>2</sup>

For the reasons discussed below, ALAS opposes the Task Force's preliminary recommendation to make disclosure of client confidences mandatory under any circumstances.

**C. Mandatory Disclosure Will Deprive Lawyers of Their Most Effective Means of Assuring That Clients Obey the Law**

The most effective means available to a lawyer to cause a client to abandon an intended course of criminal conduct is to persuade the client that the intended conduct is not only risky, but that it will not succeed in achieving the client's objectives. By engaging in this process of persuasion, the lawyer becomes the single most effective force for assuring lawful client conduct. And the most effective way for a lawyer to convince a client bent on criminal conduct that the crime will not achieve the client's intended goal is to make the client aware that if all else fails, the lawyer has discretion to reveal whatever information is necessary to prevent the crime. Mandatory disclosure, however, will deprive the lawyer of this argument because the lawyer will no longer have discretion in the matter. The result will be that instead of seeking their lawyer's advice about proposed conduct, clients will hide their intended conduct from their lawyers. Lawyers, and society, will lose the opportunity to persuade clients that their intended criminal conduct will not succeed in achieving their goals.

**D. Mandatory Disclosure Will Erode and Eventually Destroy the Trust and**

## **Confidence Essential to an Effective Client-Lawyer Relationship**

By changing the ground rules of the lawyer-client relationship, mandatory disclosure will fundamentally change the nature of that relationship. By mandating that a lawyer inform on her client in order to prevent conduct the lawyer believes to be criminal, the ABA would assure only one thing: that clients will no longer confide in their lawyers when their intended conduct may be arguably criminal. Lawyers will no longer have their clients' trust, and clients will therefore no longer seek their lawyer's counsel on proposed courses of conduct. Nothing in this Task Force's charge justifies a recommendation that would so fundamentally change the nature of the client-lawyer relationship.

### **E. Mandatory Disclosure Could Expose Innocent Lawyers to Claims for Civil Liability for Non-Disclosure**

Contrary to the clearly expressed intent of the original Model Rules, the standards of lawyer conduct incorporated into the ABA's model disciplinary rules have become standards of civil liability in most states. Until last year the Model Rules contained the following statement:

Violation of a Rule should not give rise to a cause of action nor should it create any presumption that a legal duty has been breached. The Rules are designed to provide guidance to lawyers and to provide a structure for regulating conduct through disciplinary agencies. They are not designed to be a basis for civil liability. . . . Accordingly, nothing in the Rules should be deemed

to augment any substantive legal duty of lawyers or the extra-disciplinary consequences of violating such a duty.

ABA Model Rules of Professional Conduct, Scope, paragraph [18], as in effect until August 2001.

Unfortunately, courts in many jurisdictions, when called upon to adjudicate professional liability claims against lawyers, did not agree. In case after case against lawyers, the Model Rules have been the basis for testimony by legal ethics experts that a particular lawyer's conduct had not met the standard care normally observed by lawyers, and this testimony was considered by triers of fact as evidence of lawyer malpractice. Thus, in order to avoid misleading lawyers about legal significance of the Model Rules and to accurately reflect the case law of legal malpractice, the Ethics 2000 Commission recommended, and the ABA House of Delegates voted, to change the last sentence quoted above to the following:

Nevertheless, since the [Model] Rules do establish standards of conduct by lawyers, a lawyer's violation of a Rule may be evidence of breach of the applicable standard of conduct.

ABA Model Rules of Professional Conduct, Scope, paragraph [20], as approved in August 2001.

As the Model Rules now expressly recognize, a disciplinary rule that mandates disclosure of client confidential information to prevent a client's financial and property crimes could well

become a legal duty of lawyers. (Section 52 of the *Restatement of the Law Governing Lawyers* is consistent with the Model Rules in this regard.) Breach of that duty could subject them to civil damage claims for failure to prevent client conduct that may not have been clearly criminal at the time, but that — with the benefit of hindsight — is found to have been criminal and to have damaged third parties. This risk of civil liability, in turn, will predictably cause some lawyers to err on the side of disclosure, even when there is doubt about the nature of the client's intended conduct or about its likely effect. Lawyers will cease to be advisors to clients on what is and is not lawful conduct, and will become instead regulators of client conduct. A rule making lawyer disclosure permissive will not have this result, because such a rule makes clear that the lawyer retains discretion to deal with a client's intended criminal conduct in a way that will most effectively deter that conduct.

**F. The Task Force Should Defer to the Overwhelming Weight of Existing Authority in Favor of Permissive Disclosure**

The ABA Ethics 2000 Commission spent five years studying revision of the Model Rules, including Model Rule 1.6. It made significant proposals for expansion of a lawyer's *authority*, but not a lawyer's inflexible *duty*, to disclose confidential client information in order to prevent, rectify or mitigate unlawful client conduct. Significantly, however, it did *not* propose that disclosure be made mandatory. We understand that as one of its last official acts, the Ethics 2000 Commission intends to communicate with this Task Force about, among other things, why such mandatory lawyer disclosure would be unwise. This Task Force should defer to the Ethics 2000 Commission's conclusion on this issue.

Part of the Ethics 2000 Commission's charge was to study instances in which individual states had departed from the original Model Rules. It did so, and with respect to Model Rule 1.6 it found that many states had expanded the circumstances under which permissive lawyer disclosure is appropriate. It also found, however, that only four of 51 jurisdictions have opted for a mandatory disclosure rule. This overwhelming weight of state authority should tell the Task Force something about what state supreme courts and other lawyer regulators have found to be the appropriate resolution of this question. The Task Force should defer to this overwhelming weight of state authority.<sup>3</sup>

Just before the Ethics 2000 Commission reported its recommendations to the ABA House of Delegates, the American Law Institute had completed its ten-year study, compilation and publication of authorities regulating lawyer conduct, the *Restatement of the Law Governing Lawyers*. Based on the ethics rules, statutes and case law authorities throughout the country, the *Restatement* makes clear that the current rule on lawyer disclosure of confidential information to prevent crimes is permissive, not mandatory. (*Restatement of the Law Governing Lawyers* § 67)

Section 67 reflects not only the consensus of United States jurisdictions on the issue of mandatory versus permissive disclosure, but also the considered judgment of the eminent judges, legal scholars and practitioners who make up the American Law Institute. The *Restatement* has already been cited in hundreds of decisions by state and federal judges. This Task Force should defer to the consensus and the judgment reflected in the *Restatement* on the issue of permissive versus mandatory lawyer disclosure.

### **III. The Standard of Knowledge Under Model Rules**

## **1.2(d), 1.13 and 4.1 Should Not be Changed**

### **A. The Preliminary Report's Recommendations**

The Task Force's Preliminary Report urges the ABA to "expand Rules 1.2(d), 1.13 and 4.1 to reach beyond actual knowledge to circumstances in which the lawyer reasonably should know of the crime or fraud." In particular, the Task Force recommends that the ABA change the standard of knowledge required for a lawyer to act in the case of client crime or fraud from the present standard of "actual knowledge" to a "reasonably should know" standard. Although the Preliminary Report appears to assume that these changes to the Model Rules would be relatively minor, the proposal is actually revolutionary.

The Task Force proposal is also unique. The term "reasonably should know" is used in the blackletter of six of the current Model Rules, but none in the context of a lawyer's relationship with the lawyer's own client.<sup>4</sup> We are not aware of any state ethics rules that have imposed a "reasonably should know" standard in the circumstances proposed in the Preliminary Report. Nor are there any comparable provisions in the *Restatement of the Law Governing Lawyers*.

The reason that the Task Force proposal is unique seems clear. It would fundamentally alter the traditional relationship of trust and confidence between lawyers and their clients. At the same time, these changes could ultimately result in a drastic extension of lawyers' exposure to civil liability.

## **B. The Proposal Would Change the Nature of the Lawyer-Client Relationship**

Although apparently designed to inhibit misconduct in a relatively small number of high-profile corporate failures, the Task Force proposal would have broad consequences throughout the entire profession. Provisions of the Model Rules, if adopted by the states, would apply to *every* lawyer in *every* representation. If the Task Force proposal were adopted widely, it would fundamentally change the traditional relationship between lawyers and their clients.

Every version of the ABA's rules governing professional conduct, as well as decades of tradition, require lawyers to be vigorous advocates for their clients. Starting with the 1969 Model Code of Professional Responsibility, Canon 7 directs that "A Lawyer Should Represent a Client Zealously Within the Bounds of the Law." In the 1983 Model Rules, Comment [1] to Rule 1.3 on lawyer diligence provides that "A lawyer should act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client's behalf." That commitment to the interests of the client was strengthened further in 2002 by the Ethics 2000 amendments to the Model Rules, which changed the "should" in Comment [1] to say that a lawyer "must" act with commitment on the client's behalf. (As explained below, there have always been, and continue to be, exceptions for criminal and fraudulent conduct by the client of which the lawyer has actual knowledge.)

In the practice of law, illegal conduct never comes with a label. Especially in complex transactions, what constitutes illegal or improper conduct is not always clear. It usually depends on evaluations of vague concepts like reasonableness and materiality. Indeed, the relationship

between legal and illegal conduct is often ambiguous, and lawyers render the most highly valued service when exploring the borders of the law, distinguishing between what is clearly forbidden and what may be permitted. The Task Force proposal would alter that inquiry, and prompt lawyers to make decisions based on their own safety rather than their clients' interests.

The Task Force proposal overlooks another fact of corporate practice. Lawyers are not in the business of analyzing financial information. They have no expertise in such matters, and are not paid to render opinions on such issues. Under current law, lawyers are not subject to liability for reasonable judgments made on the basis of information lawyer had no reason to question. Even the most conscientious lawyers seeking to prevent corporate illegality will often find such conduct hard to discover.

In sum, the Task Force proposal stands the traditional role of lawyers on its head. The "reasonably should know" standard would require a lawyer to be suspicious. The Task Force proposal would change the role of lawyers from advocates and advisors to monitors and investigators. The nature of the relationship will change from one of mutual trust and confidence to an adversarial process where the lawyer may no longer expect candor from clients. Clients will know that the lawyer has the incentive to "blow the whistle" on the client because of the possibility that a plaintiff's lawyer or jury will later conclude that the lawyer "reasonably should have known" the client's conduct was improper. Where the question of what is proper conduct in a given transaction is not absolutely clear, lawyers will be forced to protect themselves and not their clients.

Again, it is important to recall that this change will affect all lawyers in all circumstances, not just those few instances cited by the Task Force.

### **C. The “Reasonably Should Know” Standard Could Expose Innocent Lawyers to Civil Liability**

The most significant and troubling aspect of the Task Force proposal regarding the standard of knowledge is its potential impact on lawyer civil liability. As explained in Section II.E above, the Model Rules may be used as evidence of breach of the applicable standard of conduct in most states. Thus, any change to the Model Rules in this important area could have a significant impact on lawyer civil liability.

In this context, it is important to recognize that what a lawyer “reasonably should know” will always be judged in hindsight, long after the client company has declared bankruptcy, long after the investors have suffered loss, and long after the client’s misconduct has been exposed. At that point, it usually is not difficult to argue that the lawyers *should* have known that something was amiss. Under current law, as recognized in the Preliminary Report, lawyers are not required to audit or independently verify their client’s statements of facts. Rather, lawyers are entitled to rely upon their client’s statements of the relevant facts unless there is good reason to doubt such statements.

The “reasonably should know” standard would replace that permitted reliance with a mandate for suspicion. It could also enable claimants to allege that the lawyer had a duty under the revised Model Rules to investigate any transaction that ultimately resulted in losses to

investors or other participants. Under such circumstances, many innocent lawyers who unwittingly represented dishonest, but clever, clients could be found liable.

#### **D. The Current Rules Are Adequate to Maintain Appropriate Professional Conduct**

Fortunately, there is no need to adopt the Task Force proposal. The existing Model Rules already prohibit knowing participation by a lawyer in a client's criminal or fraudulent conduct. Model Rule 1.2(d) provides that a lawyer "shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent." Model Rule 4.1(a) provides that, in the course of representing a client, a lawyer shall not knowingly "make a false statement of material fact or law to a third person." Model Rule 4.1(b) further provides that a lawyer shall not knowingly "fail to disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client." Both Model Rule 4.1(a) and 4.1(b) are subject to the proviso "unless disclosure is prohibited by Rule 1.6." In a similar fashion, Model Rule 1.13(b) requires that a lawyer take action in the best interest of an organization when the lawyer "knows" that a person associated with an organization is engaging in or intends to engage in misconduct likely to result in substantial injury to the organization.

The Preliminary Report, at pages 33 - 35, expresses concern for lawyers' "turning a blind eye to the natural consequences of what they observe." That is a legitimate concern, but the existing Model Rules do not permit a lawyer to turn a "blind eye" in order to avoid obviously damaging facts. Model Rule 1.0(f) defines "knows" to denote "actual knowledge of the fact in question." It further provides that a person's knowledge "may be inferred from circumstances."

Thus, the standard of “knowledge” under the Model Rules is not wholly subjective. Because what a lawyer “knows” may be “inferred from circumstances,” these facts can be subsequently shown to establish what the lawyer knew at the time in question.

The Preliminary Report, at page 34, cites ABA Formal Opinion 346 (1982) for the proposition that the ABA has long advised lawyers providing third-party opinions must investigate the factual predicate for their advice, “at least to some extent and in some circumstances.” The portion of Formal Opinion 346 cited in the Preliminary Report for this assertion is incomplete. In context, the holding of Formal Opinion 346 is fully consistent with the current Model Rules standard of knowledge:

The lawyer who accepts as true the facts which the promoter tells him, when the lawyer should know that a further inquiry would disclose that these facts are untrue, also gives a false opinion. It has been said that lawyers cannot “escape criminal liability on a plea of ignorance when they have shut their eyes to what was plainly to be seen.” *United States v. Benjamin*, 328 F.2d 854, 863 (2d Cir. 1964). Recklessly and consciously disregarding information strongly indicating that material facts expressed in the tax shelter opinion are false or misleading involves dishonesty as does assisting the offeror in conduct the lawyer knows to be fraudulent.

Careful reading of the rules and relevant opinions shows that lawyers have never been able to ignore the obvious. There is simply no need to change the Model Rules to make the point again.

The present language of the Model Rules regarding knowledge, including the provision that a lawyer's knowledge may be inferred from the circumstances, does not permit lawyers to turn a "blind eye" to client crime or fraud. The current rules are more than adequate to capture the type of conduct that concerns the Task Force. Ironically, the proposal to impose a "should have known" standard will instead snare innocent lawyers who were fooled by clever clients who are later found to be dishonest. The Task Force should abandon this unnecessary and ill-conceived proposal.

### End Notes

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1. ALAS took no position on the Ethics 2000 Commission's recommendations for permissive lawyer disclosure in paragraphs (b)(2) and (b)(3) of Model Rule 1.6. Similarly, it takes no position on the Task Force's recommendation that the ABA House of Delegates reconsider its rejection of those recommendations.
  2. All of the explanation and justification contained on pages 32-33 of the Preliminary Report at the end of the Task Force's discussion of its recommended Model Rule 1.6 changes, relates to the Ethics 2000 Commission's proposed changes in that rule. There is not one sentence or word of explanation or justification for the recommendation to *require* lawyer disclosure of a client's intended criminal conduct in which the lawyer's services were or are being used and which may cause substantial financial or property harm. As noted in the text of this statement, the Ethics 2000 Commission recommended that in such a situation the lawyer's disclosure be permissive, *not* mandatory.
  3. The Preliminary Report states that "[f]orty-one states either permit or require disclosure to prevent a client from perpetrating a fraud that constitutes a crime, and eighteen states permit or require disclosure to rectify substantial loss resulting from client crime or fraud in which the client used the lawyer's services." (Prel. Rept. At 32) While technically correct, these statements are misleading because they blur the critical difference between permissive and required disclosure. In fact, as footnote 28 of the Preliminary Report makes clear, only four states require disclosure to prevent a client crime, and only two require disclosure to rectify loss resulting from such a crime.

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4. The 1983 Model Rules used the phrase “reasonably should know” in Model Rule 3.6 (Trial Publicity) and Model Rule 4.3 (Dealing with Unrepresented Person). Both were cases where the lawyer had, in effect, created the situation, and a higher standard of knowledge is appropriate. Where the lawyer is not a volunteer, the original Model Rules standard was actual knowledge. In the 2002 Model Rules, the phrase “reasonably should know” appears in four additional rules. As before, the most common use is to require that a lawyer be sure that the person with whom the lawyer is dealing does not misunderstand the lawyer’s role. See Model Rule 1.13(d) (constituent who may believe corporate lawyer represents individual); Model Rule 2.4(b) (party to ADR who does not understand neutral’s role); Model Rule 2.3(b) (evaluation that may be adverse to client); and Model Rule 4.4 (possibility that document inadvertently sent). Each situation is one where what it is reasonable to know can be easily determined. All involve relatively simple fact situations when the lawyer is usually dealing with only one other party. None requires a lawyer to undertake an investigation of complex transactions involving multiple parties.