

American Bar Association Task Force on Corporate Responsibility

Testimony of Professor Thomas D. Morgan – October 4, 2002

Supplementing Testimony Given at the Task Force’s Chicago Hearing
September 20, 2002

At your hearing in Chicago, a few questions seemed to stand out as troubling members of the Task Force. These supplemental comments address four of those questions:

(1) Does the “actual knowledge” standard adequately prohibit a lawyer’s willful blindness to knowledge, or is a “reasonably should know” standard required?

(2) If a lawyer may give advice about conduct that falls short of criminality, why should the Model Rules not require the lawyer to do so?

(3) Is giving a lawyer discretion to disclose simply giving an excuse not to disclose?

(4) Why did I suggest that the circumstances that led to formation of your Task Force might not require changes in the Model Rules at all, but rather should be seen as raising narrower issues primarily related to the sale of securities?

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(1) Does the “actual knowledge” standard adequately prohibit a lawyer’s willful blindness to knowledge, or is a “reasonably should know” standard required?

The Model Rules define and use four levels of scienter – belief, reasonable belief, knows, and reasonably should know.

“‘Belief’ or ‘believes’ denotes that the person involved actually supposed the fact in question to be true. A person’s belief may be inferred from circumstances.” Rule 1.0(a).

“‘Reasonable belief’ or ‘reasonably believes’ * * * denotes that the lawyer believes the matter in question and that the circumstances are such that the belief is reasonable.” Rule 1.0(i).¹

“‘Knowingly,’ ‘known,’ or ‘knows’ denotes actual knowledge of the fact in question. A

¹The term “reasonable” is defined in Rule 1.0(h) to “denote[] the conduct of a reasonably prudent and competent lawyer.” Thus, “reasonable” subjects the lawyer’s conduct to objective, “reasonable lawyer” review.

person's knowledge may be inferred from circumstances." Rule 1.0(f).

"'Reasonably should know' * * * denotes that a lawyer of reasonable prudence and competence would ascertain the matter in question." Rule 1.0(j).

Rule 1.0 provides several comments that explain other definitions, but no Comment to Rule 1.0 expands upon the "may be inferred from circumstances" phrase that appears in both Rule 1.0(a) and 1.0(f). In my view, this Task Force could helpfully propose a comment that would help supplement that phrase.

In a side conversation with Professor Hamermesh, I described that phrase as "Delphic," i.e., frustratingly vague but probably intentionally so. The reason is that a "knowledge" standard is used in 37 of the 57 Model Rules. Thus, the same "knowledge" standard triggers both the lawyer's duty not to assist criminal or fraudulent conduct under Rule 1.2(d) and the lawyer's duty to come forward to correct false testimony in Rule 3.3(a)(3). It triggers the duty not to use confidential government information in Rule 1.11(c) and the duty not to contact a represented party in Rule 4.2. Any term that is used in so many different settings inevitably needs to be able to adapt to the many factual contexts in which the issue will arise.

Nevertheless, the Model Rules already recognize that, while it often would go too far to require lawyers to conduct the compulsory investigation inherent in a "reasonably should know" standard, one should not be able to use willful ignorance to support a claim of not knowing relevant facts. Comment [8] to Rule 4.2, Comment [8] makes that point well, saying:

"The prohibition on communication with a represented person only applies in circumstances where the lawyer knows that the person is in fact represented in the matter to be discussed. This means that the lawyer has actual knowledge of the fact of the representation; but actual knowledge can be inferred from circumstances. See Rule 1.0(f). Thus, the lawyer cannot evade the requirement of obtaining the consent of counsel by closing eyes to the obvious." (Emphasis added)

Rule 1.11, Comment [8] makes a related point addressed in my earlier testimony, saying:

"Paragraph (c) [knowing that something is confidential government information] operates only when the lawyer in question has knowledge of the information, which means actual knowledge; it does not operate with respect to information that merely could be imputed to the lawyer." (Emphasis added)

In both cases, this is language that has been in the Model Rules since 1983. It is already part of the court rules in a large majority of American jurisdictions. It reflects the general understanding of what the "knowledge" standard already means. On the other hand, I would agree that putting such language in the Comment to Rule 1.0 as well could further draw attention to the point. Such a new Comment to Rule 1.0 might read:

“[new] When used in these Rules, the terms ‘knowingly,’ ‘known,’ or ‘knows’ denote actual knowledge of the fact in question; they do not refer to information that merely could be imputed to the lawyer. But actual knowledge can be inferred from circumstances; a lawyer cannot evade knowledge by closing eyes to the obvious.”

One might also add to the above language the proposition that a lawyer may accept as “known” the apparently reasonable statements of fact or law provided by apparently reliably third parties. Whatever specific drafting the Task Force might propose, however, the point is that one need not go all the way to a “reasonably should know” standard to get to where questions and comments at the Hearing suggest you may want to go. The present “knowing” standard works, and with a new Comment such as the one that I have proposed, you could make clear to lawyers what the requirements now imposed on them already are.

(2) If a lawyer may give advice to a client about conduct that falls short of criminality, why should the Model Rules not require the lawyer to do so?

Someone at the Chicago hearing observed that lawyers frequently – and appropriately – offer advice about conduct that falls short of actual illegality. Indeed, lawyers’ advice may be most valuable when it heads off problems rather than responds to them. I agree.

What that largely ignores, however, is the distinction between requiring conduct and permitting it. A brief hypothetical may suggest the importance of the difference.

MamaSouth is a restaurant concept that has become popular in southern states. It serves a traditional southern breakfast – with grits – and lunches and dinners served family-style. MamaSouth is a corporation and has about 100 shareholders.

MamaSouth has been considering expansion into Northeastern states. The move will more than triple the size of the company. Private e-mails exchanged among top officers predict that the value of the stock may double and that their salaries will increase proportionally if the expansion occurs.

A restaurant consultant has told the board of directors that 12% of northeastern residents have lived in the south for three years or more and will be hungry for authentic southern cooking. In a focus group of New Jersey residents served a MamaSouth meal, however, 68% said they did not like the food and would not patronize such a restaurant. Other studies were similarly divergent, but the MamaSouth board had confidence in its products and management and, after extended discussion, it approved the expansion.

New stock was sold to public investors; cautionary language in the disclosure materials made clear that no one could guarantee success. MamaSouth officers worked hard to make the expansion succeed, but grits-for-breakfast and family-style service were not concepts that traveled well. The expansion failed badly and investors lost money.

I recognize that one can argue with any hypothetical. For example, this one lacks the dramatic frauds some see in other situations, but the story does let me illustrate important points.

First, under Model Rule 2.1, a lawyer for MamaSouth *could* have counseled against the expansion. Presumably, the advice could have been based solely on the lawyer's "belief" – the lowest scienter standard – that the expansion was unwise. The advice could have been "don't mess with success," or "I don't think the executive team is up to the job," or even "grits will never sell in New York." Board members could then have given this advice whatever weight they thought it deserved, but the point is that in my hypothetical, there was no apparent legal barrier the lawyer could cite to oppose the expansion.

Second, after the expansion failed, one could count on unhappy investors and employees wanting to try to hold everyone in sight responsible for their losses. In hindsight, the officers' e-mails – presumably never shared with the lawyers – will be used to show they were blinded by prospective personal profit, i.e., "greed," when they proposed the expansion. Comments of the New Jersey focus group will become evidence no reasonable board member could have ignored. Whether or not such a suit would ultimately succeed, it would represent a risk that no defendant could ignore, and thus it would have some – possibly even significant – settlement value.

The question your Task Force faces is whether the fact that the lawyer *could* have spoken in opposition to the expansion should make that lawyer subject to professional discipline or liability for professional malpractice for failing to do so. On the facts I have given you, I believe the answer clearly must be no. The lawyer had nothing significant of a professional character to contribute to a question that the board – not the lawyer – had the legal authority to decide.

"Empowering" a lawyer to do something is different from "requiring" the lawyer to do it. Rule 2.1 empowers lawyers to give advice; Rule 1.6(b) empowers lawyers to disclose some confidential information and should empower disclosure of more than it now does, but "empowerments" do not require disclosure or other action, nor should they.

The question of "required" action is the one addressed in Rule 1.13, and also Rules 1.2 and 4.1. As other witnesses and I have suggested to you, the question before you is what should "trigger" a "required" disclosure or other response. I continue to suggest that the Model Rules have those triggers about right today, and my point here is simply that one should not think change is necessary as a result of confusing what a lawyer has the discretion to do with what a lawyer must do.

(3) *Is giving a lawyer discretion to disclose simply giving an excuse not to disclose?*

That leads naturally to the possible response that "discretion" is simply a code word for "inaction." Indeed, such a belief may underlie the proposal on page 32 of your preliminary report that in certain cases lawyer disclosure should be mandatory. I believe that such concern about lawyer discretion is unwarranted and that acting on it will ultimately be counterproductive.

First, as I suggested in my earlier testimony, corporate lawyers have widely different

roles, responsibilities, and access to decision makers. Discretion is what allows lawyers in countless unpredictable situations to respond to the facts before them in appropriate, sensible ways. The more you narrow the scope of discretion – even with the best of motives – the more you will limit the ability lawyers need to deal appropriately with situations no one can now describe.

Second, lawyers are as suited to exercise discretion as probably any group in our society. The bar admission and disciplinary process in each state seeks to assure that lawyers have the character and judgment to make appropriate decisions in tough situations. Law schools seek to train lawyers to deal with ambiguity and come up with practical action. There will always be lawyers – as well as doctors and others – who use discretion badly and require later sanction, but I respectfully suggest that whatever rule you propose will be violated and require similar action. That is, the fact that some lawyers may exercise discretion incorrectly is no basis for denying all lawyers the discretion they require to act well.

Third, when a rule moves from “reasonably-exercised discretion” to “mandatory action,” a lawyer’s question moves from “how would a reasonable lawyer behave in this situation” to “is there an argument the rule covers me.” One could apply your proposed compulsory disclosure rule, for example, to my earlier hypothetical. It surely is not a crime to expand a restaurant chain, but the company might commit tax fraud if its accountant improperly treats expense items as investments. Likewise, managers might be assuming that they can construct restaurants in locations where city ordinances would forbid construction, thus exposing the company to large fines, delays, or both. What is it that we really want lawyers to do in that world of uncertainty?

As I indicated in my earlier testimony, even now, lawyers are required to exercise discretion as a reasonable lawyer would in the circumstances. Under a mandatory rule such as the one the Task Force has proposed, however, lawyers would necessarily find themselves warning of theoretical problems that might possibly arise to protect themselves against a later charge of non-disclosure. Unfortunately, those warnings would then very likely be available to persons charging that the decision to proceed in the face of the warnings was actionable.²

Finally, discretion gives a lawyer’s warnings and threats to resign a moral authority that compulsory disclosure does not. That is, when a lawyer tells a CEO that something is wrong – and the lawyer is not *required* to do so – the CEO knows the lawyer has made a considered judgment that the warning is significant. If letters from lawyers warning of theoretical crimes become a way of life in corporate representation – as a rule of mandatory disclosure will tend to make them – the significance of those letters will be less, not more. In my opinion, the

²The corporation would certainly assert the attorney-client privilege with respect to the warnings, but in a case alleging fraud, the crime-fraud exception might apply. Or, if the lawyer were also charged with wrongdoing, the lawyer’s use of the warnings in self-defense would similarly render them available for use against the client.

consequent reduction in lawyers' moral suasion in corporate life will be counterproductive in seeking the increase in corporate responsibility that the Task Force was created to help achieve.

(4) Why did I suggest that the circumstances that led to formation of your Task Force might not require changes in the Model Rules at all, but rather should be seen as raising narrower issues primarily related to the sale of securities?

Although not a part of my earlier written testimony, I suggested to the Task Force at your Chicago hearing that you should consider whether it might be best to see the problems that led to your creation as uniquely relevant to the sale of securities. I was asked to expand on that in written form.

The problems of illegal corporate conduct are certainly not limited to corporations whose securities are publicly traded, but each of the cases that has attracted significant public attention has had that factor in common. Furthermore, the primary effect of allegedly unreliable financial reporting has been in public securities markets. Those markets, in turn, have characteristics that make them especially subject to concerns about corporate misconduct.

First, buyers and sellers of publicly-traded securities do not deal face to face. Parties to securities transactions do not rely on each other's reputations for integrity; they rely on published information about the corporation whose securities are the subject of their trade. The information is believed to be provided, in turn, by professionals operating under public or private reporting standards. That makes the quality of the information crucial.

Second, in the back of every securities' holder's mind is the question, "What don't I know that I wish I did?" To the extent they believe the answer is "very little," they are willing to trade on the basis of what they do know. As the answer becomes "maybe quite a bit," they are only willing to deal at a discount from what prices would otherwise be. The effect of that caution on the market value of publicly-traded corporations can be enormous. It can effect the willingness of securities holders to make purchases, even their ability to retire. Reduction of the uncertainly underlying that caution is thus an important public goal, and a focus on the limited role of lawyers in that area of their work may be desirable, even if the broader changes in the rules governing lawyers generally might create problems of the type I have argued earlier.

There is precedent for having different rules of lawyer ethics in different areas of lawyers' work. In the bankruptcy field, for example, lawyers are subject to a "disinterestedness" standard that is different from and tougher than the usual rules of conflict of interest. Bankruptcy lawyers sometimes also may represent groups of creditors when they would otherwise be barred from doing so by conflicts rules. I had this brought home to me as a result of two or three years spent trying to work these bankruptcy rules into the Restatement of Law Governing Lawyers. The ALI finally decided we should give up trying; the bankruptcy field was simply too specialized to rules of general application.

Then, too, patent law has a doctrine of "fraud on the patent office" that says that a lawyer must disclose prior art about which the lawyer knows and that relates to the proposed patent. It

is now settled law, however, that the lawyer need not inquire into whether there is any such prior art. In short, the doctrine enshrines the conscious ignorance that we all agree should not protect lawyers generally.

This works in the patent field because the Patent and Trademark Office has a team of patent examiners whose job it is to look for prior art, because the issue of prior art may be tested later in an infringement action, and because public policy is said to favor not requiring small inventors to undergo the expense of having their lawyer look for such art. Again, my point is not to advocate this rule be extended to other fields; it is simply to say that there is good precedent for specialized rules in areas of law with their own special requirements.

Third, the Internal Revenue Service would love to have lawyers required to never advise a client to test the limits of the law's requirements, but the law clearly does not so require. The field of tax shelter sales, however, is another story. As your Preliminary Report recognizes, there, the IRS requires that a lawyer give potential purchasers of a tax shelter a realistic assessment of whether the IRS will recognize or courts will approve the tax avoidance that a particular shelter scheme proposes. In short, lawyers in general do not have to disclose to the IRS that positions taken on their clients' returns may one day be held to be improper or even illegal. When the sale of tax-sheltered securities is involved, however, the duty of inquiry and disclosure significantly increases. My point is simply that one could take such a position with respect to the sale of securities generally.

The point I was trying to make to you, then, was that sometimes it makes sense to solve relatively-narrow problems narrowly rather than to try to come up with a rule that applies at all times and places. That is not because the ethics of lawyers who prepare documents used in connection with securities issues should be "higher" or "lower" than those of lawyers generally. It is because the particular consequences that flow from such lawyers' work may differ from those that follow from the work of the literally hundreds of thousands of other lawyers described in my earlier testimony who work with corporations of all sizes, in widely varying settings and whose ethical responsibilities are defined remarkably well today.

I appreciate the chance to supplement my testimony and hope that the above comments will be helpful to the Task Force in its important work. I would be happy to respond at any time to any questions that the Task Force or its Reporter may have.