

American Bar Association Task Force on Corporate Responsibility

Testimony of Professor Thomas D. Morgan<sup>1</sup>

Chicago Illinois  
September 20, 2002

I appreciate the chance to offer testimony before this important ABA Task Force. Your review of lawyers' obligations when they represent corporate clients could not be more timely, and while I will express disagreement with some of your preliminary recommendations, your Preliminary Report demonstrates a welcome openness to changing standards that govern lawyers' conduct when such changes are warranted.

I have spent the last fifteen years or so trying to articulate lawyer professional standards through both the American Law Institute and the ABA, so I may appreciate even more than most lawyers the challenging task that faces you. I respectfully offer this testimony in an effort to help break the broad issues before you down into what seem to me to be their critical elements and to offer suggestions about your preliminary positions on those issues.

*Basic Propositions on Which I Believe All Will Agree*

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I will take it as given that there is no dispute at all about a number of basic propositions about the representation of corporate clients. I will simply mention four that come up often.

First, a lawyer representing a corporate client represents the corporation, not the officers or employees who retain the lawyer on the corporation's behalf or who present matters to the lawyer for professional assistance to the corporation. ABA Model Rule 1.13(a); Restatement Third, The Law Governing Lawyers [hereafter Restatement] § 96(1)(a).

Second, business decisions of a corporation are to be made by the corporate officials authorized to make those decisions, even if the lawyer acting as a business person would make different decisions. ABA Model Rule 1.13, Comment [3]; Restatement § 96(1)(b).

Third, a lawyer may not counsel or assist any client – whether or not a corporation – in conduct that the lawyer knows is criminal or fraudulent. The lawyer may and should, however, discuss the legal consequences of a proposed course of conduct with the client as part of the client's effort to conform its conduct to the law. ABA Model Rule 1.2(d); Restatement § 94(2).

Fourth, when a lawyer personally knows that a corporate client, or one of its officials, is engaged in a serious crime or fraud as defined in Model Rule 1.13(b), the lawyer is already required by that Rule to “proceed as is reasonably necessary in the best interest of the [corporate client].”

Some in the current debate over corporate lawyer responsibilities seem to want to make the issue whether that last principle is clear today or needs to be said more vigorously. I think the substantive differences over appropriate conduct reflects something quite different. What I believe underlie most of the debate about lawyers' duties in representing corporate clients are differing assumptions about how legal advice interacts with corporate action.

Some in the debate presuppose that in most corporate settings only a few responsible officials make all key decisions, closely advised by one or a very few lawyers who know everything the executives collectively know. That view, I believe, is as primitive as the sense implicit in the old ABA Model Code of Professional Responsibility that most lawyers engage in a solo practice representing individual clients.

I believe that most significant corporate conduct today is based on the decisions of many business people advised by many lawyers, some of whom work within the corporation and some in several outside law firms. Many of the lawyers in turn, know only a small part of what is going on within the corporate client. My testimony today assumes that these realities describe a great deal of modern corporate practice. That view makes the problem before your Task Force, and before officials at the SEC and elsewhere, significantly more complex than the sound-bite view of a few bad executives advised by a few corrupt lawyers.

### *Three Cautionary Principles*

I believe that the significant questions before you will involve recognizing that lawyers' roles and knowledge differ from case to case and client to client. I believe you will come to see that good lawyers will require flexibility in their efforts to avoid counseling or assisting wrongdoing. Before going any further, then, I will offer three more cautionary principles that I believe transcend the specific questions which will inform your own and others' efforts to prescribe rules for lawyer conduct.

First, it will ordinarily be preferable to focus responsibility for achieving an organizational goal in one or a few offices rather than everyone's office. Unfortunately, that which is everyone's job soon becomes no one's. Clearly, it should be everyone's job not to

*commit* an illegal act, but the responsibility for affirmatively *preventing* illegality can best be centered in a compliance office that reports to the CEO, COO, or perhaps the corporate general counsel. Whoever the person is that is ultimately responsible for compliance can then establish the systems and assign the subordinate responsibilities necessary to see that the job is done right. Making everyone theoretically responsible for preventing – as opposed to avoiding – illegality, on the other hand, will likely tend to be a prescription for inaction, duplicated effort, or both.

Your Task Force has already recognized this principle well in the corporate governance recommendations with which your Preliminary Report begins. You have proposed centralizing both executive responsibilities and those of the independent directors to whom the responsible executives report. I would simply suggest that you remember that same principle as you try to integrate those proposals with the responsibilities that you impose on a corporation's lawyers.

Second, illegal conduct does not always come with a clear label. With the benefit of hindsight in egregious cases, it is easy to think that no reasonable person could ever have missed the signs of wrongdoing. Unfortunately, however, life is not that simple, particularly when one has access to only some of the relevant facts. My point is not to countenance willful blindness; it is, however, to urge that you recognize that even conscientious lawyers charged with preventing corporate illegality will often find such conduct hard to interdict.

The other side of the same second point is in some ways even more troubling. A lawyer can sometimes mistakenly believe things to be illegal when they are not. The damage to reputations of persons falsely accused, or the damage from delay of important client initiatives while an investigation proceeds, can be significant consequences of excessive caution. Again, that reality is not a call for lawyer indifference. It is a suggestion that we all need to have the

humility to recognize that there can be a downside to lawyer intervention as well as the clearly sometimes-enormous downside to inaction.

My third cautionary principle is simply that the time and involvement of lawyers in reviewing and assessing the legality of corporate action is not inexpensive. The catastrophic losses to investors and employees from a particular corporate bankruptcy make it easy to think that almost any cost should have been incurred to prevent it. One does not have to ignore real losses, however, to recognize that rules about lawyer conduct that this Task Force proposes will potentially also affect thousands of companies whose employees are not engaged in illegality.

There is a risk, in short, that imposing reporting obligations on lawyers will have the effect of becoming a “lawyer relief act.” Giving lawyers a license – albeit stated as an ethical obligation – to act as expensive internal corporate investigators may impose more costs on the nation’s law-abiding clients than it will save at other companies who discover wrongdoing.

Of course, none of these three principles can resolve all the questions that proposed rules governing corporate lawyers must answer. I offer the cautions to suggest that the challenge before you lies not in seeing who can impose the most aggressive requirements on lawyers, but in defining rules that help prevent genuine crime and fraud but avoid creating arbitrary responsibilities and perverse incentives that will inordinately burden the innocent.

#### *Ten Questions for Thinking About New Rules for Lawyers*

The following ten questions are those I believe that you, the SEC, Congress, and other responsible groups and individuals should carefully consider in formulating rules for lawyers who have reason to suspect illegality in a corporate setting. I acknowledge that it can seem pedantic to break down the issues in this way, but I have found that doing so can tend to reveal

the complexity of the questions you face, how they relate to one another, and important issues that would be easy for you to overlook. The ten questions are:

1. What kinds of corporate misconduct should be reached by a rule?
2. How serious must the misconduct be to trigger a lawyer's obligation to act?
3. What lawyers should be subject to the rule?
4. Should the rule "require" lawyer action or "authorize" lawyers to act?
5. What exactly is it that the lawyer may/must initially do?
6. What degree of knowledge should trigger the authority or obligation?
7. Should the lawyer's knowledge have to be personal or may it be imputed?
8. On what factual representations and legal judgments may a lawyer rely?
9. What follow-up should be required of the lawyer and when should it occur?
10. When should disclosure to other than the client be permitted or required?

My approach in this testimony will be to briefly explain each of these questions, then summarize what I understand the current response of the law is to each,<sup>2</sup> and then to evaluate

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<sup>2</sup>The ABA House of Delegates adopted the Model Rules of Professional Conduct in 1983 and I will take its answers as the most authoritative ABA positions on these issues. The questions were then again reviewed by the American Law Institute in preparation of § 96 of the Restatement Third, The Law Governing Lawyers, published in 2000. Finally, the recently-completed, extensive revisions of the Model Rules proposed by the Ethics 2000 Commission and adopted by the ABA House of Delegates left Model Rule 1.13 virtually unchanged. That means that the questions before your Task Force have been reviewed at least twice by thoughtful people within the last decade and fully three times within the last twenty years. Those reviews are obviously not binding on your Task Force, but I think they may suggest that the answers given to date to the questions raised here have been neither casual nor accidental.

your own answer to each question. In some cases, I will necessarily be suggesting that you have not addressed the question at all.

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*Question 1. What kinds of corporate misconduct should be reached by a rule?*

The simple answer to this question is that the rule should reach all “illegal” conduct, but that answer is too simple. Lots of things are illegal that one might not want lawyers required to correct. Breaches of contract are a violation of contract law, for example. In some cases, the damages for breach might be large, but losses from a failure to breach might be larger. Thus, the decision to breach might seem more a business judgment than a matter for lawyer intervention.

Even criminal conduct varies in seriousness. If paying speeding tickets is cheaper than driving slowly, for example, is it a business decision not to put governors on trucks? Should the lawyers be permitted or required to report the decision to highway safety officials? The answers to such questions may, of course, turn on whether the speeding creates a serious risk of death to the truck drivers and third parties. Some decisions clearly should be reached by a lawyer reporting rule, but broad categorical requirements rarely capture the reality of concrete situations.

And where do securities violations fit into the reporting picture? They are obviously on everyone’s mind because of the recent harm suffered by investors and the interest of Congress and the SEC in such fraud. However, it is often difficult to anticipate securities law violations in otherwise innocent acts. Forming a subsidiary corporation does not violate the securities laws, for example, but a subsidiary might theoretically later be used as a vehicle for conduct that would constitute a violation. The company will clearly be liable for such fraud, as will

executives who participated in it. However, surely little would be gained by making every lawyer who formed the subsidiary also liable for any uses to which it is later put. That point was recognized by the Supreme Court in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*, 511 U.S. 164, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994), when it rejected lawyer “aiding and abetting” liability under § 10(b) of the Securities Exchange Act, a decision that I believe was clearly correct.

The law’s current response to this first question is found in ABA Model Rule 1.13 and Restatement § 96. Both define the kinds of events that trigger appropriate lawyer response as conduct by the corporate client or one of its agents that either:

- 1) Violates “a legal obligation” to the corporation, or
- 2) Violates a law in a way that “reasonably might be imputed” to the corporation.

Notice that those are both broad categories. Current law does not more clearly delineate the kinds of illegal conduct to which lawyer response is appropriate, but the law correctly limits its focus to violations of law and excludes lawyer responsibility for issues better characterized as issues of business risk or business judgment.

Your Preliminary Report on this first question uses language more poetic than precise. On page 25, you say that the rule should address “circumstances in which corporate officers engage in or countenance criminal, fraudulent or deceptive conduct likely to cause harm to the organization or its shareholders.” On page 29 you say that any rule should reach “misconduct by a corporate officer, employee or agent [that] involves crime or fraud, including violations of federal securities laws and regulations.” A better statement of events triggering a duty to act can be inferred from your stated objective on page 25 of creating a direct line of communication

among lawyers “in circumstances in which the lawyer reasonably believes that the corporate client is involved in a violation or potential violation of law or in breach of duty that will adversely affect in a material manner the interests of the corporation.”

This last statement comes closest to the standard in Model Rule 1.13, and it does not seem that you believe the standard in Rule 1.13(b) is inappropriate. Thus, I would urge you to make clear that your report proposes no change in that part of the first sentence of Rule 1.13(b).

*Question 2. How serious must the misconduct be to trigger a lawyer’s obligation to act?*

After the above discussion, it should be obvious that any rule should have a de minimis exception. There is surely a difference between the breach of fiduciary duty implicit in using an company telephone to return a call from a child care provider, for example, and the breach inherent in diverting large amounts of company funds to a private bank account.

Current law acknowledges this obvious reality and calls for lawyer action only if the conduct is “likely to result in substantial injury to the organization.” The approach is not accidental. It represents a conscious judgment that finding internal wrongdoing is not a corporate lawyers’ principal role; having a lawyer shift from a representational role to become an investigator and prosecutor role is a significant step. Thus, responsibility for action under current law is not triggered by conduct that “might” cause injury; the injury must be “likely.” Further, the likely injury must be more than “minor,” even more than “material;” it must be “substantial” before lawyer’s action is required.

I believe the current law has the standard right, and your Preliminary Report should say directly that misconduct must be serious before lawyer action is required. In your proposal on page 45, for example, you appear to say that any “misconduct,” of whatever kind or level of

seriousness, should require the lawyer to pursue remedial measures. We all agree that there may be times when it is necessary and in the best interests of the corporate client to pursue such measures, but it should not happen every time a lawyer observes a corporate employee's breach of fiduciary duty inherent in minor misuse of the copy machine.

Further, as lawyers have learned from experience under rules requiring reporting of lawyer misconduct, a duty to report everything frequently results in a practice of reporting nothing. That, for example, is why DR 1-103 of the Model Code of Professional Responsibility that required reporting of all lawyer misconduct was changed in Model Rule 8.3 to only require reporting of misconduct that "raises a substantial question as to [a] lawyer's honesty, trustworthiness or fitness as a lawyer in other respects."

You come closest to proposing a standard of seriousness when you speak of a "material" adverse effect on the corporation's interests in the passage from page 25 quoted above. The term "material" in legal ethics is normally understood to be triggered by a fairly low level of harm. The standard in current Model Rule 1.13(b) is a "substantial injury," and I respectfully suggest that you propose retaining that standard. It will reach the cases you should want to reach and not burden and eventually damage the lawyer-client relationship by automatically requiring lawyers to police matters better left to other corporate officials.

*Question 3. What lawyers should be subject to the rule?*

Talk about a corporation's lawyers often seems to assume that all have similar duties, comparable access to information, and direct access to high-level company officials. Clearly, that is not true. No lawyers should be able to knowingly counsel or assist a client's crime or fraud, but when we get to matters like the duty to report or investigate, the distinctions among

the roles and responsibilities of lawyers should be significant.

Some lawyers have narrow responsibilities, while others' responsibilities extend to the entire range of corporate activities. The corporate general counsel differs in almost every way, for example, from the in-house patent lawyer or the outside lawyer acting as local counsel in a fender-bender law suit. An in-house tax lawyer stationed in Hong Kong might hear from a salesperson transferred from Denver that the company is rumored to be releasing toxic waste in New Mexico. That lawyer's required action and authorized disclosures are surely not self-evident where his or her responsibilities, access to information, and access to top executives are so obviously limited.

Under current law, of course, at least in theory, any licensed lawyer may represent corporate clients and even assist in their compliance with securities laws. The consequence for anyone thinking about rules to govern such lawyers may initially seem to be to say that, as a result, all lawyers must be subject to all rules. Current law has not drawn lines that distinguish categories of lawyer in terms of corporate general counsel, outside local counsel in a single law suit, and specialized counsel dealing with particular corporate concerns, in part because those categories are themselves sufficiently imprecise that a rule built upon them would leave many questions unanswered.

To the extent lines have been drawn in current law, they have been drawn in terms of the lawyer's relationship to the client conduct in question. Under Model Rule 1.13, conduct must be "related to the [lawyer's] representation" to trigger required action. Restatement § 96, on the other hand, speaks of a duty arising in terms of any "circumstances" about which the lawyer knows. The company's Hong Kong tax lawyer, then, need not address alleged violations of

environmental regulations under the Model Rule standard but might have to do so under the Restatement rule.

Your Preliminary Report selects the Restatement standard that the rule should apply to lawyers whether they learn of a problem that “related to the representation” or “that has come to the lawyer’s attention through the representation.” In terms of the issues that led to formation of your Task Force, a better approach might be to limit the rule to lawyers in their appearances before the S.E.C. and state securities agencies, much as local court rules establish particular rules for appearances before those tribunals.

In any event, however, your decision to make the rule applicable to all lawyers will only work if the first two questions discussed above are answered correctly. If your rule requires reporting of information not directly related to the subject of the lawyer’s representation, it becomes even more important to describe clearly the nature of the information that must be reported and to establish a triggering standard of serious harm to the corporation.

One of most inexorable laws of all is the Law of Unintended Consequences. Without clear boundaries created by answers to these first three questions, one can predict that lawyers will be forced as a matter of self-protection to inundate the corporation with all manner of warnings of theoretical problems that will create repeated burdens of investigation but little very useful information.

*Question 4. Should the rule “require” lawyers to act or “authorize” them to do so?*

We as lawyers typically like to require conduct. Requirements can be violated and the violations can be proved and sanctioned. Authorization, on the other hand, seems to have no teeth; even the lawyer’s choice of inaction can sometimes be acceptable.

What both the Model Rules and Restatement see, however, is that both a requirement and an authorization are important parts of any effective rule. Under Restatement § 96, a lawyer “must proceed as the lawyer reasonably believes to be in the best interests of the organization;” the words of Model Rule 1.13(b) are almost identical. That requirement is unambiguous and broad. It exists whether or not a failure to act would itself “assist” the wrongdoing. Even today, a lawyer does not have the option to look the other way if he or she knows of serious risk of the kinds defined above.

On the other hand, the lawyer is given extremely broad “authority” to come up with a “reasonable” way to address the problem. There are literally almost an infinite number of ways issues could arise that might require action. Current rules address that reality and conclude, I believe correctly, that rule-based micromanagement of possible lawyer responses is likely to be inflexible and ineffective. It is better, the current rules implicitly say, to tell lawyers to devise a strategies that will be assessed against an objective standard of what a reasonable lawyer would have done in the same or similar circumstances.

Your Preliminary Report opts exclusively for “requirements.” I respectfully urge you to see that the present distinction drawn in rule in Model Rule 1.13(b) and Restatement § 96 is the better one. “Requiring” action in general but giving lawyers “authority” to decide what action is reasonable is the only practical way to deal with the complex reality facing lawyers who will represent corporate clients of all sizes, organizational structures, and in varied circumstances.

In this context, your report is clearly troubled by the third sentence of Model Rule 1.13(b), and by portions of Comment [3] that seem to you to “unduly emphasize[] the avoidance of ‘disruption’ of the organization while playing down the more important goal of minimizing

harm resulting from the misconduct” (page 28, emphasis in original). I would simply suggest that you are overemphasizing the significance of these qualifiers; I know of no concrete cases in which the cited language in the Rule and Comment have constituted a successful defense for not taking appropriate action. Indeed, the language is even factually correct in observing that the act of going over the head of a responsible official and subjecting an employee or department to an investigation of alleged wrongdoing is likely to be disruptive to the organization, whether or not later inquiry finds substance to the charges. I believe, however, that those sentences could be deleted from Model Rule 1.13(b) and its Comments without affecting the overall integrity and substance of the Rule, and I would simply suggest that if you do recommend their deletion, you de-emphasize the likely significance of those changes.

*Question 5. What exactly is it that the lawyer may/must initially do?*

This often seems the easiest question to answer, but I believe it will be the hardest, particularly if you decide to require particular action rather than authorize whatever action is appropriate. It is true that Model Rule 1.13(b) lists just three specific options – asking reconsideration of the matter, urging that the corporate official get a second legal opinion, and reporting to higher authority in the corporation, including possibly the Board of Directors. It may be tempting, therefore, for readers to think that those three options are necessarily preferable to all others, that the steps should be taken in order, and that reference to the board of directors is necessarily the gold standard course of conduct.

Your Preliminary Report makes that error of interpretation. You propose on page 29 that every lawyer be required to take the “measures outlined in Rule 1.13(c)(1) through (3).” Model Rule 1.13 and Restatement § 96(3) could not be clearer, however, that the steps are only three of

many options and may not even be the preferred steps in many cases. Advising a corporate official to get a separate legal opinion, for example, will likely be an only infrequently-useful option. I urge you to alter the portion of your Preliminary Report on pages 29 - 30 that would give a mandatory character to those steps and to retain the present “best interest” standard of Model Rule 1.13.

It seems possible that the portion of pages 29 - 30 to which I refer may simply be calling, as you summarize in your recommendation on page 45, for reporting a matter to higher authority in the corporation only “where other efforts fail to prevent or rectify the problem.” Of course, such referral is clearly permitted today and, indeed, “if warranted by the seriousness of the matter,” it might be required today in appropriate cases under the “best interest” standard. I know of no informed lawyers who believe – as you suggest on page 45 – “that disclosure of confidential client information to higher authority within the corporation \* \* \* [might] violate Rule 1.6.” I certainly would have no objection to a sentence in the Comments that negated such an inference, but it simply is not a significant part of the issues before you.

The approach that would not be appropriate would be one requiring mandatory referral to the board of directors of all matters that come to a lawyer’s attention. It might be appropriate for your Task Force to recommend a reporting channel to an independent compliance office as part of your corporate governance proposals. Lawyers could then be required to comply with whatever reporting requirement that office establishes. You already propose a report from the general counsel to the outside directors, for example, that could be a conduit for such reporting.

But I urge you to try to focus concerns through such a funnel rather than making every individual lawyer responsible for personally taking every concern to the board of directors.

Indeed, imposing a requirement of mandatory referral of all suspicious matters to the client's board of directors would eliminate perhaps the most effective tool in the lawyer's possession today, namely, the threat of going to the board if the conduct cannot be corrected at a lower level.

*Question 6. What degree of knowledge should trigger the authority or obligation?*

This again turns out to be an important question, more difficult than many might expect. Most would agree that a lawyer need not investigate every hunch, but defining the point at which evidence of wrongdoing is compelling enough that action is appropriate is a subtle task.

The answer to this question in the Model Rules and Restatement is again consistent. The lawyer is only required to act when he or she "knows" the triggering facts. That is a requirement of "actual knowledge;" it is not enough that the lawyer "reasonably should know" something.

Your Preliminary Report proposes adding a "reasonably should know" standard to the "actual knowledge" standard now in Model Rules 1.2(d), 1.13 and 4.1. As you discuss the change on pages 33 - 35 of your Preliminary Report, you imply that it is a small step. In fact, it is a far more revolutionary proposal than you acknowledge.

In both the Model Rules and the Restatement, "knowledge" is understood more broadly than a lay person might imagine. "Knowledge" is not wholly subjective; a lawyer may not consciously avoid obtaining it. A lawyer's "knowledge" may be "inferred from circumstances," i.e., from other facts that it can be later shown the lawyer knew at the time in question.

The "reasonably should know" standard, on the other hand, requires the lawyer to be suspicious, indeed to become something of a detective. The phrase "denotes that a lawyer of reasonable prudence and competence would ascertain the matter in question." A move to a

“reasonably should know” standard would render a lawyer responsible for information that the lawyer by definition did not know and could not have “inferred from circumstances.” It would require the lawyer to affirmatively “ascertain” (Model Rule 1.0(j)) information about client conduct that would often by its nature be hidden. In short, it would turn the lawyer into a client’s auditor, a role that would transform the ordinary lawyer-client relationship from helper to critic.

I have done a search of the new Model Rules for the phrase “reasonably should know” and I believe it appears in only eight rules. By far its most common use is to require that a lawyer be sure that the person with whom the lawyer is dealing does not misapprehend whom the lawyer represents or the limits of the lawyer’s role. See Model Rule 1.2, Comment [13] (client who expects illegal help); Model Rule 1.13(d) (corporate officer who thinks corporate lawyer represents officer individually); Model Rule 2.4(b) (party to ADR who misunderstands neutral’s role); Model Rule 4.3 (unrepresented person who misunderstands lawyer’s role). The other four uses are Model Rule 1.0, Comment [10] (fact that conflict requires screening); Model Rule 2.3(b) (fact that evaluation may be adverse to client); Model Rule 3.6(a) (fact that statement likely to be disseminated by public media) and Model Rule 3.6, Comment [5](5) (fact that evidence will be inadmissible at trial); and Model Rule 4.4 (likelihood that document inadvertently sent).

I would suggest that each of those uses of “reasonably should know” deals either with a situation in which a lawyer is being required to ascertain the understanding of someone whom the lawyer might otherwise mislead, or where what it is reasonable to know will be easily ascertained. None of the situations asks a lawyer to undertake an investigation of complex facts

or possibilities of wrongdoing.

In the context of your discussion on pages 33 - 35, your real concerns seem to be lawyers' "limiting their advice and/or services to a narrowly defined scope" and "turning a blind eye to the natural consequences of what they observe." Those are legitimate issues, although it surely is not fraudulent for a lawyer to limit her advice to tax questions, for example, as Model Rule 1.2(c) expressly sanctions. Insofar as the "narrowing" or "blind eye" are designed to avoid obviously damaging facts, however, a lawyer can be deemed to "know" the facts under the current standard.

As footnote 34 of your Preliminary Report suggests some members of your Task Force have proposed, it might indeed be possible to add a sentence to the Comment to Model Rule 1.13 reiterating that "turning a blind eye" does not prevent a lawyer's being deemed to know information that "should have been obvious \* \* \* given the facts actually known to the lawyer." Dropping a "reasonably should know" standard into Model Rules 1.2(d), 1.13 and 4.1, however, would be a very serious mistake.

*Question 7. Must the lawyer's knowledge be personal or may it be imputed?*

Whatever the standard of lawyer knowledge that a rule prescribes, one might ask whether the lawyer must personally have that knowledge or whether lawyers should be deemed to know whatever any other lawyer in his or her firm, practice group, or corporate office knows. Clearly, no lawyer will in fact be able to respond on anything other than personal knowledge; imputation can only create a duty for lawyers to compare notes and share information. Whether one believes such sharing is practical or desirable will thus likely determine one's answer to this question.

Neither the Model Rules nor the Restatement addresses this question directly today, but

the most reasonable reading of both is that only personal knowledge gives the lawyer a duty to act. Suppose, for example, that a litigator in a law firm's St. Louis office knows a fact about a client that seems innocent in itself, while a transactional lawyer in the firm's Boston office knows another, seemingly equally innocent fact. If the two lawyers had happened to share the two facts, however, they might have learned something about ongoing corporate wrongdoing.

We implicitly say for purposes of conflicts of interest that all lawyers in a firm are assumed to know whom that firm represents, but that is because firms maintain client lists and can effectively do a conflicts check. In the situation of random information that I have described, however, imputing information from one lawyer to another would be utterly fictional. Again, the Rules do not and should not countenance willful blindness, but neither should they subject a lawyer to a professional duty to act upon information the lawyer would have no reason to know in the course of his or her ordinary work for a client.

Perhaps because the current Rules do not address it, this question is not addressed in your Preliminary Report at all. I suggest, however, that it be made clear in your report that knowledge must be personal. If lawyers share files in a matter and regularly read each other's memoranda, for example, it might be appropriate to say from those circumstances that each should be deemed to have actual knowledge of what is in the files. It should not be possible, however, to attribute knowledge among people who ordinarily would have no reason to exchange it.

*Question 8. On what factual representations and legal judgments may a lawyer rely?*

This may well be the most important and least examined question facing the modern corporate lawyer. When one is in a hospital, even facing a life and death situation, one is struck by the reliance doctors and nurses place on the work done and judgments made by others. If a

test determines that a patient does not have a given condition, for example, it is not routine to repeat the test.

In a world in which many lawyers are typically at work on different aspects of a corporate client's activities, the analogous question is the degree to which a lawyer may rely on the opinion of another lawyer that given facts are true or that a given course of conduct is lawful. It would seem obvious that a lawyer should not have to reassess the apparently-reliable opinion of the company engineer that a machine works as advertised, for example, or the opinion of a company researcher that the results of an experiment were as reported. The failure of the Model Rules to clarify that same point, however, in the case of lawyers working with the product of other professionals, seems to underlie a big part of the current debate about corporate lawyer conduct.

Even though neither the Model Rules nor the Restatement addresses the point directly, however, both recognize the principle that a subordinate lawyer may rely upon a supervisor's "reasonable resolution of an arguable question of professional duty." Model Rule 5.2(b); Restatement §12(2). Further, in footnote 33 on pp. 34-35 of your Preliminary Report, you correctly quote ABA Formal Opinion 335 (1974), dealing with a lawyer's role in the sale of unregistered securities, that points directly to what a lawyer may rely upon. I would remind you that it says in part:

“\* \* \* [A]ssuming that the alleged facts are not incomplete in a material respect, or suspect, or in any way inherently inconsistent, or on their face or on the basis of other known facts open to question, the lawyer may properly assume that the facts as related to him by his client, and checked by him by reviewing such appropriate documents as are available, are accurate.

“\* \* \* [A] practitioner need not conduct an audit or independent verification of the asserted facts, or assume that a client’s statement of the facts cannot be relied upon, unless he/she has reason to believe that any relevant facts asserted to him/her are untrue.”

Obviously, neither of these is a definitive answer to the question of whose representations and judgments a lawyer may rely upon, but I would suggest that both agree that the present law should be said to be that a lawyer may accept as true the facially reasonable resolution of factual and legal questions by persons who are apparently in a position to make those judgments correctly. That is what corporate officials do all the time in dealing with reports from others in the company. Indeed, in a world with as many issues as typically are involved in the life of a large corporation, any other rule would be unthinkable.

The lawyer considering whether a client’s conduct is illegal surely cannot be said to have an obligation of greater skepticism with respect to other representations that the lawyer has no special reason to doubt. If it were every lawyer’s duty to revisit every other professional’s opinion, for example; there would be no end to the cycle of review and the cost and dislocation it would represent.

Again, your Preliminary Report does not deal with this issue at all. Any concern that lawyers might deliberately avoid looking behind representations could be addressed by requiring that the reliance be “reasonable.” Whether reliance was reasonable in any given situation would, in turn, be a fact question that would be judged in context of the facts actually known by the lawyer. In any event, it would be a helpful contribution of your report to make clear that reasonable reliance on the findings and opinions of apparently reliable colleagues is inherent in

the process of providing legal services.

Closely related to this issue, on pages 33 - 36, your Preliminary Report analogizes the lawyer's proposed duty to investigate under Model Rules 1.2(c), 1.13 and 4.1, to the lawyer's duty to investigate prior to issuing a formal third-party opinion in a securities or tax matter. I respectfully suggest that the analogy is inapt. The whole point of a third party opinion is that in giving it the lawyer has undertaken to investigate the relevant facts and law for the benefit of the third party. That is why the Model Rules and the Restatement deal with such opinions in separate places from organizational representation in general. See Model Rule 2.3 and Restatement § 95.

However, even if one were to say that ordinary representation of a corporation requires a lawyer to act as if the lawyer were rendering an opinion to third parties, ABA Formal Opinion 335, quoted above, makes clear that even then the lawyer expressly is not required to become the client's auditor. The lawyer may rely upon facts stated by the client unless the circumstances genuinely suggest that the client representations are unreliable.

*Question 9. What follow-up should be required of the lawyer, and when must it occur?*

In a world of individual lawyers representing individual clients, it is natural to say that a lawyer must follow each matter through from beginning to end. In a great deal of corporate representation, on the other hand, lawyers work on parts of several matters and may or may not ever know how the matters ultimately turn out. Another side of the "on whom can a lawyer rely" question, then, becomes whether once a lawyer has raised appropriate concerns about a course of corporate conduct, the lawyer must also determine how it is resolved. That answer, in turn, might again depend on the lawyer's role in the corporation – a corporate general counsel perhaps might

have greater follow-up duties, for example, than local counsel in particular litigation would have.

Again, the most reasonable reading of the Model Rules and the Restatement would say that a lawyer has no individual duty to verify that a client has accepted the lawyer's advice to act consistent with legal requirements. Model Rule 1.2(d), for example, permits giving counsel about the legality of proposed conduct, but Comment [10] makes clear that if the client does not take the advice, the lawyer is not thereby made "a party to the course of action." If the lawyer in fact knows the client is engaged in a crime or fraud, the lawyer will likely be required to withdraw, but that requirement does not in itself create a duty to inquire about the client's conduct. See Model Rule 1.2, Comment [11]; Model Rule 4.1, Comment [3]; Restatement § 96, Comment *f*.

Again, this is an issue you do not address directly. I believe it would be helpful to make clear that once a lawyer has made whatever report about a matter that the circumstances demand, the lawyer may properly leave the matter in others' hands. I say this because, as you may know, the recent Sarbanes-Oxley legislation would require that a lawyer also determine whether the response to the referral was "appropriate." If not, the lawyer would be required to take further action.

In my opinion, such a requirement is a serious mistake. As your Preliminary Report correctly recognizes, a lawyer's duties should be seen in a context of corporate governance generally. If a client has an apparently reliable system for dealing with alleged misconduct, the lawyer should be entitled to rely on it. That is not because we want to minimize lawyer responsibilities. It is because, under such a rule, lawyers can better focus their attention on the

matters for which they were retained, better work on preserving relationships with the persons within the corporation whom they advise, and properly rely upon designated corporate officials to do their own jobs well.

*Question 10. When should disclosure to other than the client be permitted or required?*

This has long been seen as among the most controversial questions of all. Clearly, corporate counsel may report wrongdoing to company managers and other company lawyers, but company shareholders, for example, have often been seen as outside the zone of disclosure even when the information is important to their welfare. Attention to this question too, then, must be a part of any comprehensive analysis of proper corporate representation.

On this question, the position of the ABA has been unbending. In 1983, the House of Delegates defeated a proposal that Rule 1.6(b) allow disclosure reasonably necessary

“to prevent the client from committing a criminal or fraudulent act \* \* \* likely to result in \* \* \* substantial injury to the financial interests or property of another, [or]

“to rectify the consequences of a client’s criminal or fraudulent act in the furtherance of which the lawyer’s services had been used.”

It also defeated an attempt to have Model Rule 1.13(c) state that in cases serious enough to require action under Model Rule 1.13(b):

“When the organization’s highest authority insists upon action, or refuses to take action \* \* \* [to correct the wrongdoing], the lawyer may take further remedial action that the lawyer reasonably believes to be in the best interest of the organization. Such action may include revealing information otherwise protected by Rule 1.6 only if the lawyer reasonably believes that:

“(1) the highest authority in the organization has acted to further the personal or financial interests of members of that authority which are in conflict with the interests of

the organization; and

“(2) revealing the information is necessary in the best interest of the organization.”

Finally, when the Ethics 2000 Commission came back with another proposal to amend Model Rule 1.6 in August 2001, the House of Delegates defeated it as well. That proposal would have said that a lawyer may reveal confidential client information if the lawyer “reasonably believed” it necessary:

“(2) 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; [or]

“(3) 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.”

There is plenty of reason to believe, however, that current law is in fact consistent with the provisions that the ABA defeated. As your Preliminary Report recognizes, while state rules on these issues are not consistent, a majority would at least permit disclosure by the lawyer in the case of corporate fraud. Restatement § 67 states the prevailing rule as:

“(1) A lawyer may use or disclose confidential client information when the lawyer reasonably believes that its use or disclosure is necessary to prevent a crime or fraud, and:

“(a) the crime or fraud threatens substantial financial loss;

“(b) the loss has not yet occurred;

“(c) the lawyer’s client intends to commit the crime or fraud either personally or through a third person; and

“(d) the client has employed or is employing the lawyer’s services in the matter in which the crime or fraud is committed.”

“(2) If a crime or fraud described in Subsection (1) has already occurred, a lawyer may use or disclose confidential client information when the lawyer reasonably believes its use or disclosure is necessary to prevent, rectify, or mitigate the loss.”

On pages 30 - 32, and again on page 45, of your Preliminary Report, you say the ABA House of Delegates should go back and adopt the provisions of Rule 1.6 that it rejected in 1983 and 2001, provisions that Restatement § 67 makes clear are the current law. You are clearly correct in that recommendation. The ABA’s failure to adopt the Ethics 2000 proposals confuses lawyers’ understanding of what the state law that governs them already requires, and it thereby possibly discourages disclosures that would otherwise be appropriately made.

Where I believe you go wrong, however, is in assuming on page 32 of your Preliminary Report that if “authority” to disclose is good, a “requirement” of disclosure is better. That simply does not follow. It conflates two concepts – requirement and authority – that the current rules correctly recognize as separate. Indeed, probably the most persuasive argument for having the authority to disclose is that one may be able to use that authority to get a corporate official to change the conduct that would otherwise be reported. A rule of mandatory disclosure eliminates that important combined carrot and threat.

The Restatement makes clear that the prevailing rule on disclosure to other than corporate officials is *discretionary* disclosure, not mandatory. Restatement § 66, Comment *g* explains:

“[Disclosure] would inevitably conflict to a significant degree with the lawyer’s customary role of protecting client interests. Critical facts may be unclear, emotions may

be high, and little time may be available in which the lawyer must decide on an appropriate course of action. Subsequent re-examination of the reasonableness of a lawyer's action in light of later developments would be unwarranted; reasonableness of the lawyer's belief at the time and in the circumstances in which the lawyer acts is alone controlling."

That analysis is surely as applicable to corporate representation as any other.

Your Task Force may be trying to say that, because of egregious conduct and imminent risk of loss involved, there might be conditions under which the only reasonable exercise of the authority to disclose would in fact be disclosure. I would concede that that is possible. The duty described in your Preliminary Report on pages 32 and 45, however, would be automatic. In my opinion, that approach to disclosure should not survive your final review.

### *Conclusion*

When a Task Force confront events that your Preliminary Report calls "stunning," "notorious" and "traumatic," there is an understandable tendency to want to solve them in a dramatic ways. What I have tried to do in this testimony is suggest that your Preliminary Report may undervalue the work that other serious groups have put into these issues before you and fail to take advantage of what are important distinctions and insights already reflected in the Model Rules and Restatement.

In summary, my recommendations are that you:

1. Propose amendment of Model Rule 1.6 to authorize but not require a lawyer to go outside the corporation to reveal a crime or fraud that threatens substantial financial loss, in the circumstances and under the conditions proposed by the Ethics 2000 Commission.

2. Propose retaining the approach of Model Rule 1.13 that:
  - a. Identifies the triggering condition for required lawyer conduct as an act by the corporate client or its agents that either violates a legal obligation to the corporation or violates a law in a way that reasonably might be imputed to the corporation;
  - b. Requires that the triggering condition be likely to result in “substantial” injury to the corporation;
  - c. Requires lawyer response only to a situation about which the lawyer “knows.”
  - d. “Requires” action in general but gives lawyers “authority” to decide what action is reasonable in the situation; and
  - e. Illustrates possible responses the lawyer might make to misconduct without requiring any specific response.
3. Propose that the Comments to Model Rule 1.13 be amended to recognize that:
  - a. A lawyer’s required response is triggered only by actual knowledge, not imputed knowledge;
  - b. A lawyer may rely on factual representations or legal conclusions from persons within the corporate client or retained by it, unless the lawyer has an independent reason to doubt the accuracy of the representations or conclusions;
  - c. If the corporate client has an established, apparently-reliable system for reporting suspected misconduct, a lawyer may report through that system without being required to then evaluate the action taken by the corporation based on the report.
4. Propose that ABA go on record in support of the *Central Bank* rule that rejects “aiding and abetting” liability for lawyers under the securities laws.

I recognize that these proposals are not dramatic, indeed that they may seem to ignore the public outcry around the events that led to establishment of your Task Force. I am also not asking you to assume a defensive tone in your report that proclaims that lawyers can do no wrong. I believe you will find on serious reflection, however, that today's legal ethics rules are not a significant source of the problems observed in management of U.S. corporations. I suggest that if you seriously ask yourselves the ten questions around which this testimony is structured, you will be likely to come up with proposals that appropriately balance the legitimate concern that lawyers not counsel or assist wrongdoing against the equally appropriate concern that lawyers focus their primary attention on delivering the valuable and honorable professional service that they have been retained to provide to their corporate clients.