

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

**Stanford, California
November 11, 2002**

**Supplemental 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.

At the hearing on September 20, 2002, ALAS submitted a written preliminary statement to the Task Force detailing its position on two of the Task Force's recommendations. A summary of ALAS's views on these two important issues is set out below, followed by its supplemental submission further explaining its position and responding to certain questions posed during the September 20 hearing.

SUMMARY OF PRIOR TESTIMONY

1. ALAS opposes revision of Model Rule 1.6 to make lawyer disclosure of client confidences mandatory, even under the limited circumstances proposed in the Task Force's preliminary recommendations, because mandatory disclosure will:

erode the relationship of trust between a client and a lawyer that is built on assurances of confidentiality, which is necessary to encourage clients to confide in their lawyers;

impair lawyers' ability to use potential disclosure to dissuade a client from engaging in unlawful conduct;

impose an inflexible requirement in situations that are inherently ambiguous and where the lawyer's knowledge is virtually always imperfect;

expose innocent lawyers to claims of third parties injured by a client's wrongful conduct, and thereby deter some lawyers from engaging in securities law representations; and

contravene the ABA Ethics 2000 Commission's recommendations, the law in most states

(See 67 of the *Restatement of the Law Governing Lawyers*), and the ethics rules of all but four U.S. jurisdictions.

2. ALAS opposes changing the standard of knowledge from "knows" to "reasonably should know" in Model Rules 1.2(d), 1.13(b) and 4.1(b) because the "reasonably should know" standard in these contexts will:

constitute an over-reaction to a few lawyers who may try to "ignore the obvious," because the Model Rules, particularly Model Rule 1.0(f), already provide that what a person knows "may be inferred from the circumstances" and do not permit lawyers to avoid knowledge by "turning a blind eye" to client misconduct;

affect *every* lawyer in *every* representation rather than addressing alleged misconduct in a relatively small number of high profile corporate failures;

require lawyers to act as monitors and investigators rather than advocates and advisors, prompting some to make decisions based on their own liability exposure rather than their clients' interests, thereby changing the traditional relationship of trust and confidence between lawyers and their clients;

require lawyers to draw definitive conclusions about possibly improper client conduct, when distinctions between what is forbidden and permitted often are unclear except with the benefit of hindsight; and

create rules that are inconsistent with state ethics rules and well-recognized legal standards described in the *Restatement of the Law Governing Lawyers*.

ADDITIONAL COMMENTS

A. What Problem Is the Task Force Addressing?

The problem facing corporate America is not that outside lawyers regularly disregard evidence of wrongdoing by their clients.

In the wake of the high profile financial failures and related financial reporting irregularities of the last two years, what conduct of outside lawyers representing these or other large U.S. companies should be the focus of this Task Force's recommendations? In other words, before you decide on your recommended solutions, you should agree on what you believe is "the problem."

Although all of the evidence is not in, and will not be for many months or years, ALAS believes that "the problem" is *not* that outside lawyers for public companies have conceived of,

designed, and executed massive corporate frauds, or actively aided and abetted managers of their corporate clients to do so. Nor is it that many outside lawyers had actual knowledge of client conduct that was fraudulent, but took no action to discourage or prevent such conduct by their clients.

A few commentators -- usually those with little or no experience in representing large corporate clients in complex financial transactions -- have argued that outside lawyers should be gatekeepers for large corporations. Everything that happens in such corporations, they assert, must pass through a lawyer. Under this view, any reasonably alert outside lawyer will necessarily become aware of any fraudulent conduct intended or engaged in by officials of the lawyer's corporate client. But, these commentators argue, many such outside lawyers for corporations are wilfully ignoring obvious evidence of client fraud so they can avoid preventive action.

Based on ALAS's experience over many years, we believe that this last version of what outside lawyers "must" know about the activities of their clients is simply wrong. As Professor Morgan pointed out in his September 20 testimony, the reality is that any given outside lawyer for a large corporation usually works on only a part of a client's legal matters, and will never have as much knowledge of all of the facts related to any particular transaction as the company's management. Often, as specifically contemplated by the Model Rule 1.2(c), the client engages the lawyer to give attention to only limited aspects of a transaction, and never gives the lawyer information, or asks the lawyer's legal advice, on aspects of the transaction unrelated to the lawyer's particular assignment. Thus, there is often no single outside lawyer who is asked, or who has enough information, to evaluate or assess the overall legal consequences of the client's proposed conduct.

Generalizations are always suspect, and there may be a few isolated situations in which a few lawyers have wilfully ignored obvious criminal or fraudulent conduct. But neither the reported cases nor the decisions of lawyer disciplinary authorities reflect that such conduct is common. What we do know, as Professor Stephen Gillers pointed out to you on October 25, is that remarkably few lawyers have been proven, or even alleged, to have been directly involved in the corporate wrongdoing that has generated so many headlines in the last two years. Surely there is no empirical basis for concluding today that "the problem" this Task Force should address is intentional outside lawyer involvement in corporate wrongdoing, or wilful lawyer blindness to corporate conduct that was obviously illegal. Although lawyers do advise clients on disclosure obligations in connection with proposed transactions, they usually rely on client personnel to provide the financial and other information on which to base their disclosure advice. Even in situations where outside lawyers are retained specifically to perform "due diligence" reviews in connection with a proposed transaction, the information about which the lawyer becomes aware is still limited by the scope of the assignment.

We suggest that the "problem" this Task Force should address is the fact that lawyers' services have been misused by dishonest clients. In some cases, the lawyers services may have been used to document transactions that were structured by other professionals and later

determined to be fraudulent. But lawyers are not financial advisors. They are not trained in GAAP or GAAS, and they are rarely in a position to make judgments about whether the particular proposed accounting treatment for a transaction is proper. Lawyers are dependent on client sources for information about the proposed transaction and its financial impact on the company and can rarely make wholly independent judgments about whether particular facts are or are not material. Attempting to force lawyers to evaluate the financial merits of client transactions will not solve this problem.

Whatever changes this Task Force recommends in the Model Rules, if any, those changes should be based on a realistic assessment of the role of outside counsel in business transactions. We suggest that there is as yet little, if anything, in the history of recent corporate financial failures that shows that different legal ethics rules would have, or could have, made any difference in the conduct of the outside lawyers involved in representing those clients, or that could have put those lawyers in a better position to prevent the client conduct that caused those failures.

B. “Reasonably Should Know” in Model Rules 1.2(d), 1.13(b) and 4.1(b)

Existing rules provide no shelter for a lawyer who ignores the obvious. Outside lawyers should not face potential liability under a new ambiguous standard of “knowledge” for facts that they did not know or have reason to know, and facts that indeed may have been purposefully kept from the lawyers by their client.

1. Clarification of Model Rule 1.0(f)

Although we oppose changing the knowledge standard in Model Rules 1.2(d), 1.13(b) and 4.1(b), a concern was raised at the September 20 hearing about the ability of a lawyer to “turn a blind eye” to information and thereby avoid “knowing” about it. To address this concern and to provide additional guidance on the meaning of “knowledge” of a particular fact, the Task Force may wish to consider recommending the addition of the following comments to Model Rule 1.0(f):

[new] The terms “knowingly,” “known” or “knows” denote actual knowledge of the fact in question; they do not refer to knowledge that merely could be imputed to the lawyer. Nor do they imply a duty on the lawyer’s part to investigate statements made by a client or the client’s agent or to inquire further unless the circumstances would lead a reasonable lawyer to mistrust the accuracy of the statements.

[new] A person’s knowledge may be inferred from the circumstances. Thus, a lawyer cannot avoid knowledge by wilfully ignoring the obvious. In assessing whether a person “knew” a particular fact, it is appropriate to consider other relevant facts that the person can be shown to have known at the time. However, the fact that a lawyer worked

on the legal aspects of a matter for a client would not normally support an inference that the lawyer knew everything about the matter that the client knew, or knew that the conduct of others, such as accountants or investment bankers who advised the client about the matter, violated professional standards applicable to those advisers.

2. Further Clarification of the Meaning of “Knowledge”

Section 94 of the *Restatement of the Law Governing Lawyers* addresses the legal duties of lawyers providing advice to clients. In particular, 94(2) states that for purposes of professional discipline, a lawyer may not counsel or assist a client in conduct that the lawyer “knows” to be criminal or fraudulent. For these purposes, what is relevant is what the lawyer knew at the time in question. Actual knowledge is the standard rather than mere suspicion of what might be the facts. As stated in Comment g to 94(2):

When a lawyer’s state of knowledge is relevant, in the absence of circumstances indicating otherwise, a lawyer may assume that a client will use the lawyer’s counsel for proper purposes. Mere suspicion on the part of the lawyer that the client might intend to commit a crime or fraud is not knowledge. Under the actual knowledge standard of Subsection (2), a lawyer is not required to make a particular kind of investigation in order to ascertain more certainly what the facts are

Further, a lawyer in such circumstances is under no duty to investigate. Again, the *Restatement of the Law Governing Lawyers* provides useful guidance. In the context of discussing duties based on knowledge of a breach of fiduciary duty owed by a client, Comment h to 51 says, “The ‘know’ terminology should not be confused with ‘should know’ As used in Subsection (3) and (4) ‘knows’ neither assumes nor requires a duty of inquiry.”

C. Mandatory Disclosure Under Model Rule 1.6

It is no accident that confidentiality has been a cornerstone of the lawyer-client relationship. Existing rules allow exceptions when they are truly warranted. A mandatory disclosure standard would have serious adverse consequences, and is not at all warranted by recent events.

1. “No-Win” Situations

In the daily practice of law, mandatory disclosure under Model Rule 1.6 consistently will put conscientious lawyers in a “no-win” situation. As noted by Professor Morgan in his September 20 testimony, because the facts and circumstances of client malfeasance are most often unclear (if not unknown) to the lawyer except with the benefit of hindsight, a lawyer without definitive information of client wrongdoing will be put in an untenable position.

Consider the lawyer faced with a suspicion about client misconduct but without certainty as to whether the client actually will act or whether the conduct itself will be illegal. If this lawyer makes no disclosure and, after all the facts and circumstances are revealed, the client

turns out to have engaged in illegal conduct, the lawyer is likely to be sued by third parties for failure to make a disclosure that the ethics rules describe as “mandatory.” Alternatively, if a lawyer suspects a problem with client conduct, discloses it, and later is found to have been wrong in his or her suspicions, the lawyer risks being sued by the client.

Consequently, mandatory disclosure in Model Rule 1.6 could result in liability regardless of what course a lawyer chooses based solely on a retrospective attribution of the lawyer’s knowledge rather than on any unethical lawyer behavior.

2. Encouraging Premature Withdrawal

A predictable consequence of imposing a mandatory disclosure obligation on lawyers under Model Rule 1.6, as noted by a Task Force member on September 20, is that some lawyers will withdraw prematurely from a representation any time they have the slightest suspicion that the client may be contemplating illegal conduct. Because lawyers will have no discretion on how to deal with the situation once they could be charged with “knowledge” that a client crime is planned or underway, they will never let the situation get that far. Lawyers will withdraw before the point at which anyone could argue that they “knew” of any intended crime.

As a result, mandatory disclosure will deprive at least some corporate officials (the ones not participating in the illegal activity) of the advice of long-serving, trusted, knowledgeable counsel just when they and the client corporation need it most.

3. Lack of Clarity

The Task Force’s Preliminary Report indicated that one of the goals in proposing changes to the Model Rules was to provide lawyers with clear and precise guidance in light of the aberrant conduct by corporate officers and insiders. More specifically, at the hearing on October 25, it was suggested that mandatory disclosure under Model Rule 1.6 would give lawyers a clear duty that would aid them in dealing with dishonest clients. We agree that clarity is a laudable goal. Unfortunately, a mandatory disclosure rule will not achieve that result.

As Professor Morgan points out in his September 20 testimony, “... 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 signs of wrongdoing. Unfortunately, however, life is not that simple, particularly when one has access to only some of the relevant facts.” In the world of complex transactions, where numerous parties are involved and multiple lawyers frequently work on various parts of a matter, any individual lawyer will not typically have all the facts.

Assuming a lawyer is in possession of sufficient facts about a client’s plans, it often will be unclear whether the conduct in question will result in fraud or illegality. For example, as Professor Morgan points out, “... it is often difficult to anticipate securities law violations in otherwise innocent acts.”

Finally, even in a situation where lawyers have the requisite facts and can make a determination that the conduct will be illegal, they still will be required (without the benefit of

hindsight) to correctly predict whether the conduct is “reasonably certain” to result in “substantial economic loss.” Thus, even in this rare, best case scenario, the most conscientious lawyer will not be able to make a disclosure decision with certainty. The duty of mandatory disclosure, therefore, cannot provide clarity in inherently ambiguous scenarios.

4. Inconsistent Exceptions

Imposing a mandatory disclosure requirement would be inconsistent with the values reflected in the Model Rules. Model Rule 1.6(b)(1) permits, but does not require, a lawyer to reveal confidential client information “to prevent reasonably certain death or substantial bodily harm.” By mandating disclosure to prevent a known client crime that threatens substantial financial injury, the Task Force will be treating economic harm as more important than death and substantial bodily harm. Such a distinction is morally and ethically unjustified, and is impossible to explain or defend.

D. The Model Rules Do Affect Lawyer Liability

Anyone claiming that the Model Rules are irrelevant to civil liability is ignoring daily events in courtrooms throughout the country. Improvident changes to the Rules might produce crippling liability for lawyers whose behavior could be questioned only with the benefit of hindsight.

Several statements to this Task Force (including ALAS’ preliminary statement on September 20) have noted the relationship of the Model Rules to standards for lawyer liability. Some of that testimony may have confused what “should be” with what has happened in lawyer liability cases. ALAS, which has defended thousands of lawyer liability claims in its 23 year history, wants to set the record straight on this relationship.

The drafters of the original Model Rules clearly did not wish or intend the rules to be a basis for lawyer civil liability. Paragraph [20] of the scope section that precedes the current Model Rules (Paragraph [18] in the original 1983 version) states in part:

[20] Violation of a Rule should not itself give rise to a cause of action against a lawyer nor should it create any presumption in such a case 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. . . . Nevertheless, since the 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.

Unfortunately, in practice, the Model Rules *have* become a basis for civil liability in actual lawyer professional liability cases. In some states the legal ethics rules themselves may be introduced as evidence of the standard of care for lawyers. In almost all states, expert testimony based on the legal ethics rules is admissible on this issue. Time after time lawyer defendants in such cases find themselves in jeopardy because an expert witness, often an academic lawyer who does not normally represent clients, uses the ethics rules to support a conclusion that the

lawyer's conduct fell below the applicable standard of care.

When Professor Gillers stated to this Task Force on October 25 that “[t]he Model Rules . . . are not a repository for civil liability standards,” and that their involvement in civil liability determinations is only “incidental,” he was certainly expressing the view of the Model Rules drafters as to what they intended, and as to how they hoped the law of lawyer liability would develop. Unfortunately for lawyers (and as Professor Gillers himself acknowledges later in his testimony), that is not what has happened. The courts of this country repeatedly use the ethics rules as a measure of lawyer civil liability.

The Task Force should not propose changes in those rules in the mistaken belief that those changes will not affect lawyer liability. The Task Force simply cannot ignore the additional exposure it will create for innocent lawyers who actually knew nothing of their client's wrongdoing, but who -- with the benefit of hindsight -- may be held to a “reasonably should have known” standard of conduct, or who may be faulted for not having made a disclosure that -- with the benefit of hindsight -- a jury determines was mandatory rather than discretionary. These are decisions that will profoundly affect the professional careers, reputations, and liability of practicing lawyers for years to come.

RESPONSES TO INQUIRIES OF THE TASK FORCE

1. Separate Rules for Public Company Representations

At the September 20 hearing, ALAS was asked whether there should be different rules for lawyer behavior articulated in the Model Rules when lawyers represent public companies as opposed to private company clients.

Our view is that the Model Rules should not contain different provisions for the representation of public versus private companies. The ethical standards set out in the Model Rules, particularly Model Rule 1.13, should be sufficiently broad to cover the whole range of organizations and representations. In any event, it would be premature to recommend additional rules for public company representations until the SEC's rules adopted pursuant to Section 307 of the Sarbanes-Oxley Act are finalized.

2. Actual Knowledge and Reckless Lawyer Conduct

We also were asked on September 20 whether the Model Rules should sanction a lawyer who recklessly ignores information about possible client wrongdoing.

The Model Rules are disciplinary rules. They are not intended to punish lawyer negligence or recklessness. In most circumstances, they are intended to apply to knowing conduct. We address the issue of “turning a blind eye” in our suggested Comment to Model Rule 1.0(f) above.

3. “Turning a Blind Eye” as “Knowledge”

We were asked whether ALAS is aware of cases where “turning a blind eye” has been held to be covered by the definition of “knowledge.”

There are indeed cases that demonstrate that existing rules deal adequately with situations when lawyers are less than innocent in failing to detect client misconduct. Several criminal cases for example (one of which involved a lawyer’s obligation of candor to a court), indicate that when lawyers deliberately attempt to avoid learning additional information that would make them aware of a client’s illegal conduct, it may be sufficient to be considered “knowledge.” For example, where the lawyer was aware of a high probability of the existence of illegal conduct and there was evidence of *purposeful contrivance by the lawyer to avoid learning of illegal conduct*, there was sufficient evidence of knowledge to give a jury instruction in the prosecution of the lawyer. (*United States v. Cavin*, 39 F.3d 1299, 1310 (5th Cir. 1994)) Quoting the district court, the court explained that, “The element of knowledge may be satisfied by inferences drawn from proof that a defendant deliberately closed his eyes to what otherwise would have been obvious to him.” (*Id.*)

Similarly, in a case dealing with a lawyer charged with using transcripts of illegally intercepted telephone conversations, the Sixth Circuit, quoting the district court in that case, stated that “You may find that the defendant acted knowingly if you find that he acted with a conscious purpose to avoid learning the truth. Stated another way, a defendant’s knowledge of a fact may be inferred from his wilful blindness to the existence of a fact.” (*United States v. Wuliger*, 981 F.2d 1497, 1503 (6th Cir. 1992))

Finally, the *Restatement* adds that “[i]n the Reporter’s view, the preferable rule is that *proof of a lawyer’s conscious disregard of facts* [emphasis added] is relevant evidence which, together with other evidence bearing on the question, may warrant a finding of actual knowledge.” (*Restatement of the Law Governing Lawyers* 94, Reporter’s Notes to Comment g) Therefore, we believe that the current definition of “knowing” in Model Rule 1.0(f) is broad enough to cover wilfully ignoring the obvious and have suggested comment language to confirm that point.

4. Discretionary Disclosure and Improved Lawyer Conduct

An assertion was made at the September 20 hearing that under a permissive disclosure rule, it is unlikely that lawyers will engage in voluntary disclosure, giving rise to a concern that a permissive disclosure rule will result in no disclosure at all. The question then is how can a permissive disclosure rule improve lawyer conduct?

In ALAS’s experience, lawyers regularly consider withdrawing from representations because of problematic client behavior. Lawyers in this situation sometimes use noisy withdrawal, as described in current Comment [14] to Model Rule 1.6.

In addition, because of the difficulties and risks inherent in assessing and reporting client behavior discussed above, mandating disclosure will not necessarily result in more disclosure. More likely, prudent lawyers will use the other means available to them – such as early

withdrawal – to deal with problematic situations. All that a Model Rule mandating disclosure would accomplish is to increase the potential for lawyer liability.

5. Lawyers As Aiders and Abettors or Co-Conspirators

The question was raised whether a lawyer who learns of client fraud and does nothing would be liable as an aider and abettor or co-conspirator in the fraud.

To incur aider and abettor liability, a lawyer would have to engage in some affirmative conduct to assist or encourage the client in the crime. Merely knowing of the client's wrongdoing is not sufficient. For example, in the context of claims against lawyers for violations of the federal securities laws, the lawyer in question would have to have participated in the violation with the same state of mind, for example scienter, as the underlying violation would require. (*See Restatement of the Law Governing Lawyers* 56, Comment *i.*)

To be subject to disciplinary action, the lawyer must counsel or assist the client in conduct the lawyer knows is unlawful with the intent to facilitate or encourage the action. (*Restatement of the Law Governing Lawyers* 94(2)) Conversely, counseling or assisting a client without knowledge that the client is going to use the lawyer's advice or work for an improper activity does not subject the lawyer to disciplinary action. (*See Restatement of the Law Governing Lawyers* 94, Comment *c.*)