

**AMERICAN BAR ASSOCIATION
TASK FORCE ON CORPORATE RESPONSIBILITY**

**Stanford, California
November 11, 2002**

**Statement of the Bar Association of San Francisco
in Response to Preliminary Report of the
ABA Task Force on Corporate Responsibility
dated July 16, 2002**

The Bar Association of San Francisco appreciates the opportunity to appear at the Public Hearing before the ABA Task Force on Corporate Responsibility and to comment on the recommendations of the Task Force in its preliminary report, dated July 16, 2002.

The Bar Association of San Francisco (the "Association") is a not-for-profit membership organization of over 9,900 legal professionals in the San Francisco Bay Area. Our Association promotes high ethical standards of integrity, excellence, and respect in the practice of law. An important part of our mission is to provide assistance in the development of rules of professional conduct for lawyers which serve and protect the public, preserve the attorney-client relationship, and promote the administration of justice.

The San Francisco Bay Area is the home of many of the nation's businesses and was the center of enterprise and innovation in the 1990s. Members of our Association have substantial experience in representing businesses in IPOs, public offerings, and mergers and acquisitions. Many lawyers in our Association regularly practice before the

SEC and advise businesses of varying size, including publicly held corporations with operations throughout the country and the world. Our Standing Committee on Legal Ethics has been heavily involved in the work of the ABA Ethics 2000 Commission and in the revision of the California Rules of Professional Conduct.

This Association joins with the ABA in expressing concern about the role of professionals in the Enron collapse and other recent business failures characterized by the perpetration of fraud against investors and the public. We support the charge of the Task Force to examine "systemic issues relating to corporate responsibility." We endorse the need to restore confidence in American business and to provide greater integrity, independence, and effectiveness in the services rendered both by in-house and outside counsel to publicly held companies.

The Task Force's report identifies internal corporate governance and the ethics rules by which corporate lawyers carry out their responsibilities as the two principal areas in which the Task Force believes that the ABA can make a meaningful contribution to the current public debate on corporate responsibility. We focus primarily on the second of these areas, with particular attention to the proposed amendments to the ABA Model Rules of Professional Conduct.¹ We believe that assisting lawyers in the understanding of their responsibilities when presented with an organizational client's engagement in or

countenance of criminal behavior is an important undertaking in order to improve public confidence in corporate legal representation and in the governance of public companies.

General Observations

Without question the legal profession needs to do more to insure compliance with ethical principles that govern lawyers in situations such as those which gave rise to the Task Force's mandate. However, the proposed changes to the ABA Model Rules represent a significant departure from accepted norms of practice, and it is not clear at this point that the dramatic changes to the Model Rules are either warranted or would achieve the intended result.

Although the recent collapse of Enron and other businesses is shocking, incidents of corporate securities fraud and other lapses of corporate responsibility, unfortunately, are not new. The O.P.M. Leasing, Inc. scandal of the 1970s involved fraud and deception in the computer-leasing business that resulted in millions of dollars in bogus loans. In the 1980s, several hundred savings and loan associations failed, many of which had been engaged in improprieties on a grand scale. The savings and loan scandal rocked the financial world and the country. In the early 1990s, the Office of Thrift Supervision took action against the law firm representing Lincoln Savings & Loan in a highly publicized case that led to the firm's settling the charges for a forty-one million dollar fine. Major

scandals illustrating the breakdown of corporate governance have also occurred in the banking business² and in the securities markets.³

Each of these monumental scandals and failures involves specific systemic issues, causes, and consequences. However, in almost every instance, one of the questions asked by the public and by the media has been, "What were the lawyers doing?"⁴ This question does not lend itself to a simple answer. Clearly, there have been situations, such as that of the BCCI scandal, in which lawyers were directly involved in the deception. In others, such as the oft-cited O.P.M. Leasing case, lawyers clearly were engaged in the conscious avoidance of the client's fraudulent activities. In other situations the lawyers have been innocent of wrongdoing, but were still exposed to claims of civil liability⁵.

The Task Force's recommendations regarding the conduct of lawyers raise a basic question concerning whether the purported actions or inactions by attorneys involved in the recent corporate failures are symptomatic of inadequacies in the Model Rules, or rather expose a problem more properly addressed within the substantive law of publicly registered securities. The current ABA Model Rules are grounded in years of experience and dialogue concerning the lawyer's responsibilities in performing various functions as a representative of clients. We believe that, by and large, the ABA has achieved a proper balance between the interests of the client and protection of the public. We also believe that achieving greater harmony and consistency in the rules governing lawyers is an

important objective of our profession, particularly in a time of increased use of technology, the advent of multi-jurisdictional practice, and an increasingly global economy.

The Task Force Proposals Would Have Too Broad an Impact on the Legal Profession

The Model Rules apply to all lawyers in various areas of practice. The application of the Rules in a particular context depends on a number of factors, including the specific function performed by the lawyer and the client's objectives and obligations under the law. The proposed changes to the Model Rules — ostensibly intended to help business lawyers comply with their duties to corporate clients who have securities disclosure obligations — would reach far beyond their stated goals and would apply across the board, to all attorneys. Changing the Model Rules in this manner to address the concerns of members of Congress, academics, and commentators would not, in our opinion, be warranted and could lead to a diminishing of the role of the lawyer and undermining the attorney-client relationship in situations unrelated to corporate financial malfeasance.

Greater Attention Should be Given to Educating Lawyers on Professional Responsibilities Relating to the Representation of Corporate Clients

The loss of confidence in the legal profession as a result of recent corporate failings can best be restored by better educating lawyers and effectively enforcing existing rules. The legal profession at all levels should be more proactive in requiring lawyers to provide organizational clients with an informed understanding of the organization's legal obligations and the consequences of violating the law.

In California, less than 5% of the annual state bar dues is earmarked for professional competence and education.⁶ Ethics training in law schools, while improved since Watergate, remains less than adequate to deal with the complexities and challenges facing new lawyers in modern practice. Continuing legal education, while mandatory in many jurisdictions, should provide better training on the specific issues raised by the report in light of the recent corporate scandals. For example, business lawyers representing corporations with publicly registered securities should be afforded more training in the understanding of financial reporting. The ABA and state and local bar associations should work together to provide more resources and better information which will help lawyers discharge their professional responsibilities to organizational clients.

The Role of the Lawyer Representing Publicly Held Companies Must be Clarified

Another solution would be to better inform the public about the role of a lawyer who is representing a publicly held company . ABA President A.P. Carlton's open letter to the U.S. Chamber of Commerce illustrates the need to clarify the lawyer's role in the representation of businesses, in contrast to that of accountants and other professionals. The U.S. Chamber of Commerce advertising campaign impugning lawyers demonstrates that there is a serious misconception, as President Carlton points out, of the function and role which a lawyer performs when representing businesses. Lawyers, for example, generally are not considered "gatekeepers" in the same sense as are, for example, independent auditors and security analysts.⁷ Depending on a client's disclosure obligations, in a particular regulatory context, a lawyer might assume responsibilities analogous to those of a gatekeeper, but this is not lawyer's usual role.⁸

The Current Rules are Adequate and Must be Followed

The Task Force's goal of restoring confidence in the legal professional can best be achieved by lawyers adhering to the professional responsibilities reflected in the *current* rules. These existing rules, which include the duty of undivided loyalty (the "best interest of the organization" standard in Model Rule 1.13(b)), avoiding conflicts of interest, preserving client confidential information, exercising independent professional judgment, competence, diligence, and candor, will, if followed, protect the public interest. Therefore, the adherence to the current rules rather than the adoption of dramatically

different ones should be the goal both of the ABA and of the state and local bar associations.

The recent failures of corporate responsibility do not appear to be the result of inadequacies in the ethics rules, but rather of the failure of lawyers properly to conform their professional conduct to already existing rules. For example, the lawyers involved in the questionable transactions antecedent to the collapse of Enron were subject to the Texas Disciplinary Rules, which require that a lawyer practicing in that jurisdiction promptly make reasonable efforts to dissuade a client from committing a crime or fraud, when the lawyer has confidential information clearly establishing that the criminal or fraudulent act is likely to result in substantial injury to the financial interests or property of another.⁹ Likewise, when a lawyer has confidential information which clearly establishes that a client has committed a criminal or fraudulent act in which the lawyer's services have been used, the lawyer must make reasonable efforts under the circumstances to persuade the client to take corrective action.¹⁰ Under the Texas Rules, a lawyer may disclose confidential information when he or she believes that such disclosure is necessary in order to prevent the client from committing a criminal or fraudulent act, or to the extent revelation reasonably appears necessary to rectify the consequences of a client's criminal or fraudulent act in which the lawyer's services had been used.¹¹ The existence of these rules, which contain many of the provisions recommended by the Task Force, did not deter the stunning collapse of Enron.

In the *O.P.M. Leasing, Inc.* case, the law firm failed to take adequate steps to prevent an obvious pattern of client fraud, despite the fact that the ABA Model Code had originally authorized disclosures when the client intended to commit a crime or had perpetrated a fraud.¹² In the highly publicized *National Student Marketing* case in the 1970s, prominent business lawyers were held liable for failing to disclose financial fraud prior to the closing of a merger, at a time when the ABA Model Code obligated lawyers to rectify client fraud by, if necessary, revealing the existence of the fraud to third parties.¹³ These scenarios illustrate the fact that having in place rules that are materially different from the current ABA Model Rules will not by itself deter unethical conduct or restore confidence in the legal profession.

California has, perhaps, the strictest provision on confidentiality in the country.¹⁴ California also has the largest number of practicing attorneys of any jurisdiction. Approximately one-sixth of all lawyers in the country are members of the California Bar. Despite California's strict provision on confidentiality, it cannot seriously be argued that lawyers in California are less responsible in representing organizational clients in circumstances in which corporate officers engage in, or propose to engage in, criminal or fraudulent conduct. Nor does it follow that lawyers in jurisdictions that permit or mandate disclosure of client crime or fraud are better able to meet their professional responsibilities in the same situation.

Model Rule 1.2(d)

Virtually every jurisdiction, including California, provides that a lawyer may not counsel or assist a client in conduct that is criminal or fraudulent and may not further a client's criminal or fraudulent purpose or continue representation that is known to assist the client in the furtherance of criminal or fraudulent conduct.¹⁵ Adherence to this principle is so fundamental to the competent and effective representation of every client, that perhaps it deserves expression in a separate rule, as is the case in California, rather than as a subpart of Rule 1.2.

Model Rule 1.6

The Task Force report urges that the ABA reconsider the recommendations of the Ethics 2000 ABA Commission with regard to the permissive disclosure of confidential information in certain circumstances in which the lawyer's services have been used. The Task Force's proposals, however, go even further and would *mandate*, rather than *permit*, that attorneys disclose confidential information to prevent clients from using their services to commit serious crimes, including violations of the federal securities laws. In our view, this dramatic change in the fundamental duty of confidentiality would undermine the attorney-client relationship and would not serve the public interest or the administration of justice.

There is substantial disagreement among the states with regard to the scope of the lawyer's duty of confidentiality as it relates to client crime or fraud. Confidentiality rules among the various states present an inconsistent patchwork of varying exceptions and demonstrate an absence of consensus on the scope of the duty. Proposed changes to Model Rule 1.6 that would permit, let alone require, attorneys to disclose confidential information where the attorney's services have been used by the client to perpetrate a crime or fraud, have been the subject of extended debate. Requiring counsel to disclose client confidential information to regulatory authorities or third parties could end forever any useful relationship between the lawyer and the corporate client.

The effects of the Task Force's proposed changes to Model Rule 1.6 may be more substantial than are intended. The application of the Rule would not be limited to business lawyers representing publicly held corporations engaged in violations of securities laws, but rather would apply across the board to all clients. The rights of individuals and the constitutional protections of due process, effective assistance of counsel, and the protection against self-incrimination could be jeopardized.

Model Rule 1.13

ABA Model Rule 1.13 is substantially similar to California Rule of Professional Conduct 3-600. Both rules correctly provide that the client is the organization itself,

acting through its highest authorized officers, and that the lawyer must conform his or her representation accordingly. Model Rule 1.13(b) makes it clear that when the lawyer knows of serious misconduct relating to the lawyer's representation, the lawyer must proceed as is reasonably necessary in the best interests of the organization. The Rule provides measures, taking into consideration the best interests of the entity, by which the lawyer may proceed in light of wrongdoing by the corporate client. The measures outlined are not exclusive, and the rule makes clear there may be others.

Lawyers need the flexibility inherent in the Rule to proceed in a way appropriate to the particular client in the particular situation. The "best interest of the corporation" standard in Rule 1.13(b) should therefore be retained to allow the lawyer such flexibility. The fact that the Rule provides that "[a]ny measures taken shall be designed to minimize disruption of the organization . . . ," should not deter a lawyer from reporting misconduct, but should instead reiterate the lawyer's duty to act in the best interest of his or her client and allow lawyers to effectively communicate with the organization's decision makers.

Requiring rather than authorizing lawyers to report misconduct in certain situations will not necessarily result in more effective representation. Lawyers must have the ability to disclose information in a well thought out manner in order to inform the organizational client of its legal obligations and of the consequences of failing to abide by the law. In addition, we have reservations concerning the Task Force's proposal that *any*

level of misconduct should trigger an obligation to report. Rule 1.13 should retain the requirement that the misconduct be substantial before a lawyer's obligation or authorization to act is triggered. Changing the rule to require lawyers to report any level of misconduct would substantially alter the role of the lawyer from that of legal advisor to that of investigator, one forced to question or challenge the decisions of the client.

We also are concerned with the recommendation that the Rule be changed to hold a lawyer responsible for reporting any misconduct whether it actually is related to the representation or is merely "learned through the representation." Lawyers perform various and multiple functions for corporations, particularly in large and complex organizations. Holding a lawyer responsible for reporting any misconduct learned through the representation would impose a burden on both the lawyer and corporate management that is likely to impair the lawyer's effectiveness in carrying out his or her professional responsibilities.

For many of the same reasons, we believe that the "actual knowledge" standard should be retained in Rule 1.13 as opposed to the "reasonably should know" standard recommended by the Task Force. This latter standard is more easily applied in hindsight after all the facts and circumstances are known. Making a lawyer responsible for every fact that he or she "reasonably should know" through the representation of a particular

client will not lead to a more effective reporting of corporate misconduct, but may instead result in greater liability exposure both for the lawyer and for the client.

We share the Task Force's concern that too many lawyers engage in conscious avoidance and fail to report violations by corporate clients of its legal obligations or violations of law which are likely to result in substantial injury to the organization or to the public at large. We do not believe, however, that Model Rule 1.13 currently permits a lawyer to "turn a blind eye" to violations of the securities laws or other serious misconduct. At most, a comment should be added to the Rule, or an ethics opinion on the subject should make clear, that lawyers for the corporation cannot remain deliberately ignorant of known misconduct, but rather that they must respond appropriately in the best interests of the organization.

Model Rule 4.1

Model Rule 4.1(a) provides that, in the course of representing a client, a lawyer may not knowingly "make a false statement of material fact or law to a third person."

Model Rule 4.1(b) provides that a lawyer may not knowingly "fail to disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client."

As expressed in connection with the proposed changes to Rule 1.13, we are similarly concerned with the Task Force's proposal to expand Rule 4.1 to reach beyond the actual knowledge standard to the "reasonably should know" standard. The "reasonably should know" standard would alter the fundamental lawyer-client relationship and, again, would force lawyers to become suspicious investigators. Furthermore, making a lawyer responsible for consideration of all facts of which he or she "should reasonably be aware" during his or her representation is likely to expose lawyers to civil liability after the fact if corporate malfeasance eventually does come to light.

New Rules and Laws Relating to Corporate Responsibility Should be Allowed to Take Effect before New Rules are Added

The SEC is in the process of adopting professional conduct rules for lawyers representing publicly held companies and "practicing before the SEC". These rules are to include requirements for reporting evidence of material violations of the securities laws and other serious misconduct to senior managers and then, if necessary, to the Board of Directors.¹⁶ The Sarbanes-Oxley Act, which has been characterized as the most significant securities legislation in more than a generation, establishes a corporate governance and oversight structure and expands the authority and enforcement powers of the SEC over lawyers as well as over other professionals. It is important that the ABA

strive for uniformity and consistency in the law governing lawyer in this area. We recommend that the ABA defer recommending changes in Rules 1.6, 1.13, and 4.1 until the SEC attorney conduct rules are known, and the implications of such rules are understood.

Thank you for your consideration of the points raised by our Association in response to the Task Force's Preliminary Report.

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END NOTES

1. The evaluation of the Task Force's preliminary report has been the work of members of our Standing Committee on Legal Ethics. The contact person for this report is Mark L. Tuft, a partner with the firm of Cooper, White & Cooper LLP, in San Francisco. Mr. Tuft is a former chair of the Committee on Legal Ethics of the Bar Association of San Francisco, a former chair of the California State Bar Committee on Professional Responsibility and Conduct and is currently a vice chair of the California Commission for the Revision of the Rules of Professional Conduct. Mr. Tuft can be reached at (415) 433-1900 or at mtuft@cwclaw.com.
2. Examples include the \$2.5 billion in bad loans made by Penn Square and The Bank of Credit & Commerce International (BCCI), which generated losses of \$10.5 billion.
3. See, e.g., *United States v. Milken*, 759 F.Supp. 109 (S.D.N.Y. 1990).
4. See, e.g., Schmidt, "Where Were the Lawyers During S&L Crisis?," Washington Post, March 23, 1991.
5. See *Federal Dept. of Ins. Corp. v. O'Melveny & Meyers*, 969 F.2d 744 (9th Cir. 1992), *rev'd. on other grounds*, 512 U.S. 79 (1994). (Securities counsel owed client duty of care in performance of professional services which could be violated by failure to report fraud by insiders in connection with a private placement memorandum for a real estate partnership which ultimately failed.)

6. See *In re Attorney Discipline System*, 19 Cal.4th 582 (1998).
7. The concept of "gatekeepers" is discussed in Coffee, "Understanding Enron: It's About The Gatekeepers, Stupid," The Business Lawyer, Vol. 57, No. 4 (ABA Section of Business Law) 1403.
8. The *Kaye Scholer* case illustrates the different functions of lawyers serving as advocates or litigation counsel and as advisors for clients with federal regulatory disclosure obligations. See Koniak, "When Court's Refuse to Frame the Law and Others Frame it to Their Will," 66 S.Cal.L.Rev. 1075 (1993).
9. Texas Disciplinary Rule of Professional Conduct 1.02(d).
10. Texas Disciplinary Rule of Professional Conduct 1.02(e).
11. Texas Disciplinary Rule of Professional Conduct 1.05(c)(7) and (8).
12. ABA Model Code DR 4-101(C)(3); DR 7-102(B)(1).
13. *SEC v. National Student Marketing Corp.*, 457 F.Supp. 682, (D.D.C. 1978). As a result of the SEC's reliance on DR 7-102(B)(1) the ABA amended its rules to preclude disclosure of client fraud "when the information is protected as a privileged communication." ABA Code DR 7-102(B)(1)(1974).
14. Bus. & Prof. Code §6068(e).
15. ABA Model Rule 1.2(d); California Rule of Professional Conduct 3-210 (a member shall not advise the violation of any law . . .")
16. Sarbanes-Oxley Act of 2002 (Pub. Law. 107-204).