United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Hearing on The Role of Attorneys in Corporate Governance
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Testimony of Professor Thomas D. Morgan[1]

Mr. Chairman and Members of the Subcommittee:

I begin with a proposition that should not be controversial: No attorney has any right knowingly to assist a client to commit a crime or fraud. There are a number of serious questions about exactly how an attorney should act in particular concrete situations, but the basic limitation should be clear. The boundary of zealous representation ends where knowingly assisting crime or fraud begins.

My testimony this morning makes four points. First, a comprehensive body of state regulation of attorneys already exists and renders doubtful the need for additional federal legislation or regulation. Second, the role of corporate attorneys in formulating corporate policy tends to be small and their responsibility for corporate wrongdoing is not likely great. Third, federally-mandated noisy withdrawal in the face of possible wrongdoing would potentially create problems rather than solve them. Fourth, if Congress and the S.E.C. do decide to regulate the conduct of securities attorneys, they have the constitutional authority to do so.

Taking these one at a time: First, some critics of attorney conduct seem to assume that there was virtually no effective regulation of corporate attorneys prior to the federal Sarbanes-Oxley legislation. That is simply not true. The sources of professional regulation of corporate

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attorneys prior to the Sarbanes-Oxley Act and the SEC regulations that implement it were primarily found in the rules of the state supreme courts that license attorneys. Most of the state rules, in turn, are based in large part on the American Bar Association (A.B.A.) Model Rules of Professional Conduct. At least seven such rules, taken individually and together, define what state law has understood to be a corporate attorney's duties in dealing with possible corporate crime or fraud.

First, A.B.A. Model Rule 1.2(d) says simply: "A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent * * *." That was the proposition with which I began this testimony. There was no dispute before Sarbanes-Oxley – and no more clarity today – about the fact that an attorney's knowing involvement in, or giving advice that assists, a client's crime or fraud is no part of any attorney's legitimate role.

Second, turning specifically to corporate attorneys, A.B.A. Model Rule 1.13(a) makes clear: "A lawyer employed or retained by an organization represents the organization * * *." It would be hard to say more concisely or unmistakably that an attorney represents the corporation itself, not its officers, directors or prominent shareholders.

Third, Model Rule 1.4(b) establishes a duty to take information about the matter on which any attorney is working to duly authorized constituents of the client "to the extent reasonably necessary to permit the client to make informed decisions regarding the representation." That is also unambiguous. It is important to understand that, even before Sarbanes-Oxley, corporate attorneys had no right to keep information about corporate crime or fraud to themselves.

Fourth, if Model Rule 1.4(b) leaves any ambiguity about the attorney's duty to keep the client informed, Model Rule 1.13(b) makes it unambiguous that an attorney has a duty to take steps to protect a corporate client, saying:

> (b) If a lawyer for an organization knows that an officer, employee or other person associated with the organization is engaged in action, intends to act or refuses to act in a matter related to the representation that is a violation of a legal obligation to the organization, or a violation of law that reasonably might be imputed to the organization, and that is likely to result in substantial injury to the organization, then the lawyer shall

proceed as is reasonably necessary in the best interest of the organization. Unless the lawyer reasonably believes that it is not necessary in the best interest of the organization to do so, the lawyer shall refer the matter to higher authority in the organization, including, if warranted by the circumstances, to the highest authority that can act on behalf of the organization as determined by applicable law.

(c) Except as provided in paragraph (d), if

(1) despite the lawyer's efforts in accordance with paragraph (b), the highest authority that can act on behalf of the organization insists upon or fails to address in a timely and appropriate manner an action or a refusal to act, that is clearly a violation of law, and

(2) the lawyer reasonably believes that the violation is reasonably certain to result in substantial injury to the organization,

then the lawyer may reveal information relating to the representation whether or not Rule 1.6 permits such disclosure, but only if and to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization.

(d) Paragraph (c) shall not apply with respect to information relating to a lawyer's representation of an organization to investigate an alleged violation of law, or to defend the organization or an officer, employee or other constituent associated with the organization against a claim arising out of an alleged violation of law.

(e) A lawyer who reasonably believes that he or she has been discharged because of the lawyer's actions taken pursuant to paragraphs (b) or (c), or who withdraws under circumstances that require or permit the lawyer to take action under either of those paragraphs, shall proceed as the lawyer reasonably believes necessary to assure that the organization's highest authority is informed of the lawyer's discharge or withdrawal.

There is simply no question that an attorney is required to take action ("shall proceed") if the attorney knows of serious crime or fraud committed by – or against – the corporate client. The action taken is to be whatever is necessary given the nature and seriousness of the offense, but the action may include referring the matter to the client's board of directors for action. Indeed, the duty to act must include that step if the conduct is serious enough and if lower-level corporate management refuses to deal with the problem the attorney has identified.

Fifth, Model Rule 1.16(a)(1) requires a corporate attorney to withdraw from any case in which the “representation will result in violation of the rules of professional conduct or other law.” Thus, while the attorney need not withdraw from representing the client if the attorney’s own work would not involve counseling or assisting criminal or fraudulent conduct – for example, because the improprieties involve the work of some other attorney or law firm – when the attorney’s own services are involved, withdrawal is mandatory now and long has been so.

Sixth, and sometimes seen as a problematic exception from the above rules, Model Rule 1.6(a) provides that “a lawyer shall not reveal information relating to the representation of a client * * * .” Thus, while an attorney may or must report misconduct to persons within the corporation who can do something to correct it, the attorney seems to be expressly forbidden to reveal the information to persons outside the corporation.

Model Rule 1.6(b) does have exceptions to the confidentiality requirement, including one permitting attorney disclosure to prevent “death or substantial bodily harm” that the client or someone else is “reasonably certain” to cause. However, at the time Sarbanes-Oxley and the SEC regulations implementing it were adopted, there was no corresponding provision permitting disclosure of criminal financial fraud.

On the other hand, state laws actually governing the conduct of corporate attorneys tended not to follow the A.B.A. on this issue. The A.B.A. Model Code of Professional Responsibility that had preceded the Model Rules, and that all states but California had incorporated into state law, permitted disclosure of otherwise confidential information about “the intention of [the lawyer’s] client to commit a crime and the information necessary to prevent the crime.” When the time came to consider Model Rule 1.6, over 40 states retained the Model Code exception, or something close to it, instead of the narrower version in the Model Rules.[2]

Thus, while one would not know it from reading only the A.B.A. Model Rules, in the

[2]The Attorneys’ Liability Assurance Society, Inc., has kept abreast of these state rules for many years and reports them in a table reprinted in annual editions of Thomas D. Morgan & Ronald D. Rotunda, Selected Standards on Professional Responsibility, Appendix A [to the Model Rules]. See,e.g, the 2004 Selected Standards at 144.

vast majority of American jurisdictions even prior to Sarbanes-Oxley, attorneys were authorized to disclose the intention of their corporate client to commit a criminal financial fraud and the information necessary to prevent it. Summarizing the current state of U.S. law on the issue, the American Law Institute said in its Restatement Third, The Law Governing Lawyers § 67:

> "(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:
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> > "(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."
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> "(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.

Now, after reconsideration of its Model Rule 1.6(b) in August 2003, the A.B.A. has caught up with the states and has adopted largely the same rule as that described in the Restatement.

Seventh and finally, Model Rule 4.1(b) makes clear that sometimes an attorney not only may – but must – disclose seemingly confidential information. Rule 4.1(b) requires an attorney not to "knowingly fail to disclose a material fact when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by Rule 1.6." At the time Sarbanes-Oxley was adopted, looking only at the four corners of the Model Rules themselves, the reference to Rule 1.6 swallowed up the rest of Rule 4.1(b). However, given the actual state law versions of Rule 1.6, that limitation was not applicable in a majority of jurisdictions, and given the A.B.A.'s new Rule 1.6(b)(2) & (3), it is clearly not true. Thus, corporate attorneys are now – or soon will be – *required* by Model Rule 4.1(b) to disclose outside the corporation any "material fact * * * necessary to avoid assisting a criminal or fraudulent act by a client." It would be hard to make the point much more clearly.

My point in discussing these seven rules is to make clear that any need for additional regulation – particularly federal regulation – is far less clear than critics of the conduct of the conduct of particular attorneys might suggest. Most informed critics of pre-Sarbanes-Oxley regulation have known about those rules, of course, so they have had to center their principal concern on the rules' alleged under-enforcement.

It is true that few if any attorneys for major corporations have been disbarred or otherwise disciplined for violations of state professional standards. However, that is not because corporate attorneys have been granted special immunity from compliance. One unfortunate reality about the legal profession has been the general breakdown of the attorney disciplinary process nationwide. Even according to the A.B.A., a traditional defender of state regulation, a charge filed with a state attorney disciplinary agency has a 70% chance of being dismissed without serious investigation. Of the remaining 30% of complaints, 5 out of 6 will be investigated but not tried. Thus, only 5% of the original total will be brought to trial, and of those, only 2% will produce significant professional discipline.[3] Many complaints are frivolous, of course, but not all of them. The cases that result in discipline tend to be ones in which the offense is clear and the facts unambiguous, features not common in most cases involving corporate attorneys.

But while a corporate attorney is not likely to receive professional discipline for a failure to prevent or disclose a client's crime or fraud, statistics about professional discipline alone ignore the fact that civil liability has long replaced professional discipline as the principal means of enforcement of professional standards in the corporate context. And in the liability arena, judgments and settlements have been substantial enough to throw fear into the heart of the least risk-averse corporate attorney.

[3]A.B.A. Center for Professional Responsibility, Standing Committee on Professional Discipline, 1995 Survey on Lawyer Discipline Systems (1997).

During the savings and loan scandals of the 1990s, for example, in FDIC v. Mmahat, 907 F.2d 546 (5th Cir. 1990), cert. denied 499 U.S. 936 (1991), the damage award was $35 million. In re American Continental Corporation/Lincoln Savings and Loan Securities Litigation, 794 F.Supp. 1424 (D.Ariz. 1992), led to a reported $51 million settlement, and earlier, another firm representing Charles Keating's family of companies reportedly settled for $41 million.

Those concerned that ordinary malpractice liability – even at damage levels such as those just cited – is not enough to deter misconduct correctly note that the availability of suits for attorney liability under the securities laws was put in doubt by Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994). The bank had not itself committed fraud, but its failure to act had arguably "aided and abetted" the fraud of the borrower. The Supreme Court held that § 10(b) of the Securities Exchange Act of 1934 imposed private civil liability for an actual manipulative or deceptive act (a "primary"violation), but not for aiding and abetting such an act (a "secondary" violation). Most attorneys saw their own role as, at worst, likely to involve "aiding and abetting" and thus not subject to securities law liability.

Newby v. Enron Corporation, 235 F.Supp.2d 549 (S.D.Tex. 2002), however, has cast doubt on even that assumption by saying that attorneys can be found to have committed a primary violation of the securities laws if they have affirmatively participated in preparation of disclosure documents on which investors had arguably relied. The *Newby* litigation has a long way to go before its understanding of what is required to impose primary liability is universally accepted, but the case casts doubt on any easy assumption that attorneys cannot be liable under the securities laws for work done on behalf of their clients

My purpose in making the above points has been to be sure the Subcommittee's record is clear that any legislation is considered in a context of existing regulation that is comprehensive in scope and intended to achieve the same results that you undoubtedly hope to achieve. The fact that existing regulation in any area of life fails to prevent a catastrophic event – including the Enron meltdown and similar corporate scandals – does not mean that the regulation was nonexistent or insufficient. There will always be some people who will violate any law: witness the inability of even the death penalty to eliminate murder.

Or, it may turn our that particular corporate calamities have had causes unrelated to the conduct of the company's attorneys. Only pending litigation will determine whether that was true in cases such as those involving Enron, for example. It is to that possibility that I next turn.

The title of this hearing is "The Role of Attorneys in Corporate Governance." One author has put the case for new regulation of attorneys most urgently: "No major corporate transaction goes forward without an lawyer's okay," the author says; "no securities documents get filed without an lawyer's review * * *."[4] Thus, if a corporation gets into serious financial or legal difficulty, the argument goes, it must be because the company's attorney was inattentive, incompetent, dishonest or cowed into silence. No one can disagree with the first step in that argument, but in my view, the second step does not follow.

Indeed, data from the SEC itself tends to confirm the relatively minor role attorneys have played in significant instances of corporate failure and professional misconduct over recent years. The Commission was required by Section 703 of Sarbanes-Oxley to report on cases in which it had brought enforcement actions against securities professionals between the years 1998 and 2001. The SEC identified 1713 cases in which securities professionals were found guilty of a primary violation of the securities laws or of aiding and abetting such conduct. Of the 1713, only 48 (2.8%) of the violators were attorneys.[5] That is 48 too many, but the data tends to confirm that in the overall picture of securities fraud and corporate wrongdoing, the role of attorneys is largely peripheral.

In part, I think the difference between the critics' perception and observed reality is that corporate attorneys are victims of an attractive mythology. The myth is that in an idyllic past,

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[4]Susan P. Koniak, Corporate Fraud: See Lawyers, 26 Harv. J.L. & Pub. Pol'y 195, 227 (2003).

[5]The report can be found at http://www.sec.gov/news/studies/sox703report.pdf. One might argue that the low number is because the SEC relies on state authorities to discipline attorneys. The context of the study, however, was not discipline cases which the SEC has eschewed, but actions directly to enforce the securities laws.

attorneys were all knowledgeable, trusted advisers to corporate titans. They sat at the right arm of corporate chief executives, helping think through corporate strategy and details of corporate conduct. For most corporate attorneys, however – if they even think there was such a day – that day is long gone. A few inside general counsel might have such a corporate role, but not many. Even fewer outside counsel do.

The problem is one of incomplete information. At today's rates of compensation, it is expensive for a client to "educate" an attorney about more than the attorney needs to know to address a problem. Most often, attorneys both inside a corporation and in private firms do assigned tasks following at least general guidelines. An attorney may be directed to negotiate and close corporate real estate transactions, for example. She will know what price the company will not exceed, by what date the property is needed, and other requirements the client wants met in the purchase. She will not necessarily know, however – or think relevant to the assigned task – what overall strategic objective the company hopes to serve with a particular acquisition.

Similarly, an attorney may be directed to write a patent application or defend the patent in subsequent litigation. Another attorney may counsel the company on its hiring or other human resources practices. Each may know enough to do his or her assigned job effectively, but neither is likely to know whether the patented product is being illegally tied to an unpatented product, for example, or whether the employees being hired will be used in a project that violates the securities laws. Divided responsibilities and partial information are characteristic of modern practice, no matter how much attorneys might like to think of ourselves as wise and all-knowing.

Hindsight may accurately show that an attorney's work at some stage of the process played a part in allowing a fraudulent scheme to be perpetrated. The attorney may have closed a commercial sale that turns out to have been part of a money laundering scheme, for example. The reality is, however, that the attorney may have been a victim of the dishonesty, not one of its perpetrators. In a world of incomplete information, the observation that dishonest people had attorneys does not amount to a legitimate condemnation of those attorneys. It thus would be a mistake for Congress to think that further regulation of attorneys would be an effective way to better regulate their corporate clients.

Third, attorneys should not be required to make a "noisy withdrawal" from representation of a corporate client even if the client does not adequately respond to the attorney's concerns about corporate wrongdoing. No one can predict who will first become aware of corporate misconduct, and it may seem hypertechnical to excuse an attorney with possibly valuable information about the client from the duty to make that information available to the public.

As I have reported above, existing A.B.A. standards already impose the obligation to report concerns to corporate management and possibly even to the board of directors, at least in matters relating to the attorney's own work for the client. The S.E.C., in 17 CFR § 205.3(b) has now extended that obligation to information obtained from any source, even with respect to issues as to which the attorney has had no personal responsibility or prior knowledge.

The S.E.C. view of the appropriate standard for requiring up-the-ladder internal reporting seems to assume that the costs of such reporting are low and that the more formal reporting that occurs, the better. I believe those assumptions are seriously flawed. In fact, even the internal investigations contemplated by the S.E.C. Final Rule are likely to involve significant costs.

A formal investigation as contemplated by the Final Rule is, at the very least, likely to involve an issuer's soliciting an outside opinion or investigation that will often be expensive. More important, the need for the investigators' detailed access to company records, their need to interview employees who may themselves feel they must hire counsel, and the risk of otherwise creating excessively adversarial relations with corporate officials are all costs that should be taken seriously in determining the desirable frequency of such investigations.

Surely, it is obvious that the risk of uninformed reports will increase significantly when attorneys report matters outside the field of their practice or experience. Imagine, for example, that Attorney provides tax advice to the issuer. She prepares tax opinions that she knows will be filed with the Commission in connection with a required disclosure obligation. She, in short, "appears and practices before the Commission" and she does her tax work honestly and well.

Now suppose Attorney hears from a friend in the company that the company's newly issued patent is subject to challenge based on prior art in the field that was not disclosed to the Patent Office. That information, if true, would be material to investors because both corporate officers and financial analysts have based predictions of the company's future success on the strength of that patent. If the friend had told Attorney about facts relating to a possible tax position, Attorney could relatively easily make the § 205.2(e) evaluation about whether the information was "credible" and whether a similarly situated reasonable attorney would "conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur." But how will Attorney make that judgment about an issue of patent law she does not understand? In particular, how can she do so when the issue requires a judgment about prior scientific literature that Attorney would likely be unable even to comprehend even if she were to read it?

The likely answer is that, as a matter of self-protection, Attorney will simply make a formal report and shift the problem to the company's Chief Legal Officer (CLO) as long as the Final Rule continues to require reports that do not relate to the attorney's representation of the issuer. If one thought that such reports were costless, that would be fine. As discussed above, however, reports will often involve real costs to the issuer and to the attorney-client relationship with that issuer. Clearly, investigation is essential where the risk of wrongdoing is real and the facts or law are unclear. My point is simply that formal reporting should not be seen as inherently desirable; the goal should be optimal reporting, not maximum reporting.

The problem described here is only likely to get worse as the process required by the S.E.C. Final Rule continues. When the CLO gets back to Attorney with a response that the charge is baseless, Attorney will have little more basis upon which to evaluate the "adequacy" of that answer. She may know that a new attorney has concluded that all is well, but her own evaluation of the "adequacy" of the conclusion will add little or nothing to its reliability.

Now add a system of mandatory "noisy withdrawal" to the mix. Presumably in the above illustration, under the Proposed Rule now pending before the SEC, Attorney plausibly might think she would have to resign. What message would withdrawal by a tax attorney send to the

Commission and to investors? I suggest that it would be a message about non-existent tax problems rather than problems with the important patent.

Noisy withdrawal, in short, is the professional equivalent of "charades," the parlor game in which participants seek to read substantive content into otherwise ambiguous gestures. The problems of restoring investor confidence – and the role of good legal advice in that process – are too serious to be transformed into such a game.

First, an attorney's withdrawal is costly for any client. Clients may fire their attorneys, of course, but when an attorney walks away in the middle of a representation, it is the client who gets hurt. Thus, attorney professional rules such as A.B.A. Model Rule 1.16 properly place significant limits on an attorney's right to withdraw without client consent.

As discussed above, attorney withdrawal is already required by Model Rule 1.16(a)(1) when a failure to withdraw would involve the attorney in knowingly assisting a client's crime or fraud. In adopting a federal standard going that far, Congress or the Commission would be building upon an established principle. I thus encourage adoption of the triggering standard now proposed for § 205.3(d)(1) – the "attorney reasonably believes that a material violation is ongoing or is about to occur and is likely to result in substantial injury to the financial interest or property of the issuer or of investors." That is a step beyond the "knowing" standard in the Model Rules, but it requires that the attorney in fact believe the facts to be true and requires that the belief be reasonable. That comes quite close to the view of "knowing" now used in the A.B.A.'s Model Rule 1.13(b), and it seems a fair articulation of the kind of circumstance that should require attorney withdrawal.

However, such a withdrawal standard requires an important qualification. In my earlier hypothetical, Attorney, the tax attorney, would have no right or obligation under Model Rule 1.16 to stop giving tax advice because she thought the client might have a doubtful right to a patent. Surely, that is the right result. At least, the federal standard should make clear that any requirement of attorney withdrawal should be limited to withdrawal from the representation that involves a "material violation" as defined in § 205.2(i). The S.E.C.'s Proposed Rule, for example, should not require that the attorney sever all ties with the allegedly offending client.

Second, the harder question becomes disclosure of the fact of, or reasons for, the withdrawal. I begin with the observation that disclosure of information to securities markets is not an unvarnished good. Accurate, easily-understood information makes markets work better. However, confusing, ambiguous information can make markets work less well. If investors are led to believe they know facts but later find they are untrue or less significant than they appeared, real dollars of real Americans will be lost unnecessarily. Charades may be funny in the family room, but securities markets process clear and accurate information best.

Furthermore, in § 205.3(c)(2) of its already-adopted Final Rule, the Commission has adopted a provision for explicit permissive disclosure of the problem creating a perceived "material violation." An attorney may "reveal to the Commission, without the issuer's consent, confidential information related to the representation to the extent the attorney reasonably believes necessary" to prevent or rectify a "material violation" causing "substantial injury to the financial interest or property of the issuer or investors." In short, the Commission already has approved a method of disclosure to provide the kind of accurate, helpful information that "noisy withdrawal" never will.

To be sure, under the Final Rule, disclosure is permissive rather than mandatory. I have heard it said that permissive disclosure would result in too little disclosure to the Commission, but I believe that view is mistaken. Mandatory versus permissive disclosure was extensively examined in preparation of Restatement Third, The Law Governing Lawyers § 67, which found permissive disclosure to be the prevailing rule and the right result. Comment *k* explained that any such disclosure "would inevitably conflict to a significant degree with the attorney'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 attorney must decide on an appropriate course of action." Making disclosure mandatory in such circumstances "would be unwarranted."

Further, attorneys will have significant incentives to make permissive reports where they are justified in doing so. An attorney would need several lifetimes to overcome the damage to his or her reputation caused by failing to disclose something that later causes serious public harm. Thoughtful professionals will not let clients put them in that position.

Make no mistake, furthermore, pressures on the attorney-client relationship will be equally great whether it is the lawyer or the company that is required to disclose. The possibility that information about attorney withdrawal will create more market “noise” than understanding makes the S.E.C.’s proposed requirement that the issuer immediately issue a Form 8-K a more precipitous step than necessary.

I would favor what I understand may be an alternative proposal whereby an issuer would be required to describe to the Commission the controversy leading to the attorney’s withdrawal in a confidential manner that would go to the securities markets only if the Commission believed it would be appropriate to release it. Honest reporting is critically important; ambiguous or even misinformation present a genuine problem. Caution in dealing with information an issuer discloses is essential.

Fourth and finally, I do not believe there is any serious doubt that Congress – or the SEC acting consistent with clear Congressional authority – may impose requirements of disclosure on attorneys for publicly-traded companies. I will not spend much time on this point. The effect on interstate commerce of the attorney conduct is clear, and federal requirements can be clearly tailored to address an important federal concern. As indicated above, I believe that imposing such requirements will often be a bad idea, but while I recognize the Subcommittee will be hearing from others whose views on this question differ from my own, the authority to impose federal rules that preempt state attorney regulation on questions relating to compliance with the federal securities laws seems to me clear.