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# The Ethical Obligation of Transactional Lawyer to Act as Gatekeepers

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**THE ETHICAL OBLIGATION OF TRANSACTIONAL LAWYERS TO  
ACT AS GATEKEEPERS\***

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*Recent examples of managerial misconduct at major corporations have called into question the adequacy of the gatekeeper role provided by transactional lawyers representing corporations. That role is governed by Model Rule 1.13(b), which obligates the lawyer for a corporation to take remedial action if the lawyer knows that corporate managers are engaged in actions that amount to a “violation of a legal obligation” to the corporation or that are unlawful and likely to result in substantial injury to the corporation. In addition, Model Rule 1.2(d) forbids a lawyer from lending assistance to any action by corporate managers “that the lawyer knows is criminal or fraudulent.” In this article, the authors focus on the substantive standards within these rules that both trigger the lawyer’s duty to take action within the corporation to protect the corporate client from harm and restrict the lawyer’s participation in the corporate manager’s misconduct.*

*The authors conclude that, even after the American Bar Association’s 2003 amendments to the Model Rules, the ethical rules making up the gatekeeper role of transactional lawyers provide insufficient guidance, mask various conflicts of interest, and offer too much latitude for lawyers to assist managerial misconduct. The authors propose amendments to those rules heightening the standards demanded of lawyers representing corporations. Further, as a way to address the conflict in which corporate lawyers find themselves—a conflict generated by the fact that lawyers are chosen by managers but should represent the interests of shareholders—the authors propose that the*

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corporation's lawyers should be chosen by the company's independent audit committee.

TABLE OF CONTENTS

- I. INTRODUCTION..... 10
- II. BACKGROUND ..... 14
  - A. *Lawyers as "Gatekeepers" for Corporate Conduct* ..... 14
  - B. *Corporate Representation and the Gatekeeper Role Under the Model Rules* ..... 15
    - 1. The Entity Theory of the Corporate Client..... 16
    - 2. Responding to Constituents' Misconduct..... 21
    - 3. The Outer Limit on Advocacy and Advice..... 28
- III. ASSESSING THE PRESENT APPROACH..... 30
  - A. *The Failure of the Entity Theory*..... 30
    - 1. The Duty to Pursue the Best Interests of Shareholders ..... 31
    - 2. Recognizing, Reducing, and Resolving Conflicts..... 38
      - a. Structural conflicts ..... 38
      - b. Intra-Shareholder Conflicts..... 46
  - B. *Protecting the Client and Society from Managers' Misconduct*..... 50
    - 1. The Lawyer's Knowledge of Wrongdoing ..... 51
    - 2. The Reach of the Duty to Act ..... 58
  - C. *Limits on Lawyers Furthering Clients' Wrongdoing*..... 61
- IV. CONCLUSION..... 69

I. INTRODUCTION

Revelations of mismanagement and fraud at Enron focused attention on the role transactional lawyers play as gatekeepers of their corporate clients' conduct. Scrutiny of lawyers' involvement in this tragedy is warranted. By facilitating and effectuating the transactions through which corporations act, lawyers are positioned to be suspicious of and to discourage the misconduct those transactions can disguise. Thus, the question is again relevant: What should we expect transactional lawyers representing corporations to do when they learn of managers' misconduct?

That question is being asked in three legal arenas. One is the regulatory process. Under section 307 of the Sarbanes-Oxley Act,<sup>1</sup> enacted by Congress in response to a number of recent corporate outrages, the Securities and Exchange Commission was directed to promulgate rules pertaining to lawyers' duty to take action in response to managers' misconduct. Responding to this statutory directive, the Commission published a far-reaching and controversial

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1. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784.

proposed rule on November 21, 2002.<sup>2</sup> This triggered a hurried debate,<sup>3</sup> as the American Bar Association<sup>4</sup> and other lawyers' groups<sup>5</sup> criticized the Commission's aggressiveness in and the breadth of its proposal.<sup>6</sup> Complying with a tight congressional deadline, the Commission then issued a more limited final rule<sup>7</sup> but gave notice that it would continue a more deliberative consideration of further demands on lawyers.<sup>8</sup> The debate in the regulatory arena thus continues.

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2. Implementation of Standards of Professional Conduct for Attorneys, 67 Fed. Reg. 71670-01 (proposed Dec. 2, 2002) (to be codified at 17 C.F.R. pt. 205).

3. Section 307 of the Sarbanes-Oxley Act required the SEC to promulgate its rule within 180 days of the enactment of the Act. Sarbanes-Oxley Act § 307. The SEC received 167 comments on the proposed rule between November 21, 2002, and its issuance of the final rule on January 23, 2003. Implementation of Standards of Professional Conduct for Attorneys, 68 Fed. Reg. 6324-01 (proposed Feb. 6, 2003) (to be codified at 17 C.F.R. pt. 205). Numerous comments were received after the Commission's issuance of the final rule as well. *Id.* For a list of comments received by the SEC, see SEC, COMMENTS ON PROPOSED RULE: IMPLEMENTATION OF STANDARDS OF PROFESSIONAL CONDUCT ON ATTORNEYS, <http://www.sec.gov/rules/proposed/s74502.shtml> (last visited Mar. 6, 2004).

4. For the electronic mail submission of Alfred P. Carlton, Jr., President, American Bar Association, offered in response to Securities and Exchange Commission request for comments on proposal for Implementation of Standards of Professional Conduct for Attorneys, see Letter from ABA to Jonathan G. Katz, Secretary, SEC (Dec. 18, 2002), available at <http://www.sec.gov/rules/proposed/s74502/apcarlton1.htm> [hereinafter ABA Letter]. The views of the ABA contained in this correspondence were drafted by the ABA's Task Force on Implementation of Section 307 of the Sarbanes-Oxley Act of 2002. *Id.* at 1-2.

5. See, e.g., Letter from Amer. Trial Lawyers to Jonathan G. Katz, Secretary, SEC (Dec. 17, 2002), available at <http://www.sec.gov/rules/proposed/s74502/amercollege.htm>; Letter from Karen L. Barr, General Counsel, Inv. Counsel Ass'n of Amer. to Jonathan G. Katz, Secretary, SEC (Jan. 16, 2003), available at <http://www.sec.gov/rules/proposed/s74502/klbarr1.htm>; Letter from Kenneth Artin, Chairman, Nat'l Ass'n of Bond Lawyers, to Jonathan G. Katz, Secretary, SEC (Dec. 18, 2002), available at <http://www.sec.gov/rules/proposed/s74502/kartin1.htm>; Letter from Marcia L. Proctor, Prof'l Responsibility Counselors, to Jonathan G. Katz, Secretary, SEC (Dec. 16, 2002), available at <http://www.sec.gov/rules/proposed/s74502/prc121602.htm> (last visited Sept. 25, 2003). All of these organizations filed what could be described as negative comments in response to the SEC's proposed rule.

6. Two of the major criticisms leveled at the proposed rule by the American Bar Association targeted the scope of the persons covered by the proposed rule and its inclusion of a noisy withdrawal requirement. ABA Letter, *supra* note 4, at Part I.

7. Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8185 [2002-2003 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,823, at 87,069 (Jan. 29, 2003).

8. Most notably, the final rule did not include the controversial "noisy withdrawal" requirement, inviting further comment on that proposal. Press Release, SEC, SEC Adopts Attorney Conduct Rule Under Sarbanes-Oxley Act (Jan. 23, 2000), at <http://www.sec.gov/news/press/2003-13.htm>. See *infra* text accompanying notes 68-71 for further discussion of the SEC's proposed rule's noisy withdrawal provision.

While much public attention is focused on the important regulatory battlefield, the obligation of lawyers to take action in the face of managers' misconduct is also of interest in the corporate governance arena. A task force of the American Bar Association<sup>9</sup> has focused on the Enron tragedy and other corporate disasters with this subject in mind. The report of the so-called Cheek Commission<sup>10</sup> includes changes in expectations of corporate counsel<sup>11</sup> among its recommendations addressing the intra-corporate practices, pressures, and structures that allowed these outrages to occur.

The third arena in which the role of lawyers in reacting to managers' misconduct is being debated is that of professional ethics. The American Bar Association's 1983 Model Rules of Professional Conduct, the prevalent state rules of professional ethics at the time of the Enron incidents and currently<sup>12</sup> do expect lawyers to take

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9. The American Bar Association's Task Force on Corporate Responsibility was appointed by ABA President Robert Hirshon on March 28, 2002. American Bar Association Task Force on Corporate Responsibility, *Report of the American Bar Association Task Force on Corporate Responsibility* (Mar. 31, 2003), at [http://www.abanet.org/buslaw/corporateresponsibility/final\\_report.pdf](http://www.abanet.org/buslaw/corporateresponsibility/final_report.pdf) [hereinafter *Cheek Commission Final Report*]. Prior to its final report, the Cheek Commission also issued a preliminary report. American Bar Association Task Force on Corporate Responsibility, *Preliminary Report of the American Bar Association Task Force on Corporate Responsibility*, 58 BUS. LAW. 189 (2002) [hereinafter *Cheek Commission Preliminary Report*].

10. The task force has been referred to as the Cheek Commission in honor of its Chair, James H. Cheek, III. See, e.g., American Corporate Counsel Association, Written Submission of the American Corporate Counsel Association (ACCA) to the ABA Task Force on Corporate Responsibility (The "Cheek Commission"), at [http://abanet.org/buslaw/corporateresponsibility/hearings02/20021111/mcguckin\\_testimony.pdf](http://abanet.org/buslaw/corporateresponsibility/hearings02/20021111/mcguckin_testimony.pdf) ((Nov. 11, 2002)) [hereinafter *ACCA Submission*].

11. The importance of the role of corporate lawyers as gatekeepers is evident in the Cheek Commission's view of the meaning of "corporate responsibility." *Cheek Commission Final Report*, *supra* note 9, at 4. That body notes that the term "[should be understood] to include, at the very least, behavior by the executive officers and directors of the corporation that conforms to law and results from the proper exercise of the fiduciary duties of care and loyalty to the corporation and its shareholders." *Id.* The Commission also notes that "our system of corporate governance has long relied upon the active oversight and advice of the key participants in the corporate governance process, including the directors, auditors and counsel." *Id.* at 12. Furthermore, the Commission's "core conclusion" is that "the exercise by . . . independent participants of active and informed stewardship of the best interests of the corporation has in too many instances fallen short." *Id.* at 19-20. The Cheek Commission also points to lawyers as among those responsible for "spectacular failures of corporate responsibility." *Id.* at 18. They note that "[k]nowledgeable observers have asserted that through inaction, inattention, indifference or, in some cases, conflicting personal interests or loyalties, some of these participants bear significant responsibility for these failures, and lawyers have not been excluded from such assertions." *Id.* at 18-19.

12. MODEL RULES OF PROF'L CONDUCT (1983). At the time of this writing, versions of the 1983 Model Rules have been adopted in 42 states and the District of Columbia.

action to counter such misconduct under certain circumstances.<sup>13</sup> The Enron tragedy, however, served as a dramatic warning that these rules may be inadequate to protect corporate clients, innocent constituents of corporations, such as employees and creditors, and the investing public from even serious managerial abuses. As a result, in August 2003, the ABA adopted controversial amendments to its rules governing confidentiality and the representation of organizations.<sup>14</sup> The debates on these issues will now shift to the states as they consider adoption of these new amendments.

While government agencies, reformers, and the public may focus on the conduct of the lawyers at Enron and other major corporations making the evening news, the organized bar should perceive more widespread concerns.<sup>15</sup> The questions raised by these infamous cases differ only in degree from issues of professional responsibility confronted regularly by transactional lawyers representing corporations. If the current state professional rules fell short in governing the lawyers at Enron, it is likely that they are also inadequate when applied to the less dramatic, but cumulatively more significant, daily work of corporate lawyers across the country. The ABA's 2003 amendments were intended to respond to the inadequacies of the former treatment, but it remains to be seen whether those amendments will be up to the task.

The Enron scenario and the broader implications it raises lead us to question in this article the sufficiency of the existing and newly amended professional rules governing transactional lawyers who represent corporations. In particular, we focus on the substantive standards that trigger lawyers' duties to take remedial action in response to managers' misconduct and that limit lawyers' participation in that misconduct. We leave for now consideration of the interesting questions of what those remedial actions should be,

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Lawyers' Manual on Prof'l Conduct (ABA/BNA) 01:3-8 (Mar. 26, 2003) [hereinafter *Lawyers' Manual*]. Three states (Illinois, New York, and Oregon) merge the Model Rules with some provisions of the ABA's prior body of ethical rules, the MODEL CODE OF PROF'L RESPONSIBILITY. *Id.* 01:4-7. California does not adhere to either the Model Rules or Model Code. *Id.* 01:3. Four states (Iowa, Maine, Nebraska, and Ohio) retain their pre-Model Rules treatment of legal ethics. *Id.* 01:4-6.

13. This obligation is found in Model Rule 1.13(b), 1.13(c). MODEL RULES OF PROF'L CONDUCT R. 1.13(b)-1.13(c) (1983). See discussion *infra* Parts II.B.2, III.B, for further analysis of the obligation.

14. See MODEL RULES OF PROF'L CONDUCT R. 1.6, 1.13 (2003).

15. Professor Roger Cramton notes that "the problems we now face are systemic in character and not merely a problem of a few executives, auditors, and lawyers who are 'bad apples.'" Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, 58 BUS. LAWYER 143, 145 (2002). Using the same metaphor, he also notes that the conduct of major law firms was implicated in the Enron scenario, indicating that this is not merely "a 'bad apples' problem requiring greater vigilance on the part of prosecutors or regulators." *Id.* at 173 n.134.

including whether they should include disclosures of confidential information beyond the corporation's confines.<sup>16</sup>

We conclude that those rules continue to offer transactional lawyers for corporations insufficient guidance as to the proper focus of their loyalty, tend to obscure troublesome conflicts of interest, and are too lenient in permitting lawyers to assist managerial wrongdoing. We propose ways to address these concerns. In order to invigorate the transactional lawyer's role as gatekeeper further, we also propose certain structural changes in corporate governance to address present obstacles to lawyers responding to managers' misconduct.

## II. BACKGROUND

### A. Lawyers as "Gatekeepers" for Corporate Conduct

Lawyers play a critical role in the actions of corporations. They help plan, structure, negotiate, draft, and implement the transactions through which business is done. Indeed, legal assistance is essential to the completion of most significant transactions in the complex, regulated world of modern corporate enterprise. Through the rendition of legal services to corporate clients, transactional lawyers thus serve as gatekeepers, overseeing the ultimate passage of their clients' transactions from planning to fruition.

Allegations regarding Enron provide a sobering backdrop for reflecting on this gatekeeper role of lawyers.<sup>17</sup> To the extent that related party transactions were used by managers to hide corporate debt, overstate the value of the company's stock, and effect unwarranted wealth transfers, lawyers may have opened the gates for that conduct, perhaps unwittingly, through the legal services they provided in furtherance of those transactions. Indeed, it is doubtful that Enron managers could have accomplished their deeds without the assistance of lawyers in completing the transactions utilized by

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16. Our reasons for so limiting our inquiry are discussed *infra* at notes 69-72 and accompanying text.

17. For a press account of the Enron transactions, see Ellen Joan Pollock, *Limited Partners: Lawyers for Enron Faulted Its Deals, Didn't Force Issue*, WALL ST. J., May 22, 2002, at A1; see also "The Fall of Enron: How Could It Have Happened?," Hearing Before the Senate Comm. on Governmental Affairs, 107th Cong. (Jan. 24, 2002) (statement of Frank Partnoy, Professor of Law, Univ. of San Diego Law School), available at <http://govt-aff.senate.gov/hearings02.htm> (discussing why key gatekeepers failed to discover Enron's problems); Cramton, *supra* note 15, at 158-67 (discussing the role played by lawyers for Arthur Andersen and the law firm of Vinson & Elkins, which represented Enron in some of the questioned transactions and performed an investigation of allegations of its wrongdoing).

the managers.<sup>18</sup> Perhaps as much as the company's auditors, who, it has been alleged, stretched accounting standards to legitimize the corporation's practices through public financial reporting, lawyers were in a position to question and attempt to discourage the managers' misconduct before it was achieved.

The Enron episode and its aftermath also make clear the stakes involved. A range of corporate constituencies suffered from the misdeeds of the managers at Enron, including shareholders, employees, and creditors. On a broader scale, the revelations of managers' deliberate efforts to hide their company's debt and inflate its profitability shook investors' confidence in the markets' valuation of corporate stock generally. To the extent transactional lawyers, acting as effective gatekeepers, can play a part in discouraging such misconduct by managers, the societal consequences would be substantial. Given the importance of the role transactional lawyers play in furthering their corporate clients' conduct, increasing the demands on lawyers as gatekeepers would accomplish more than elevating the profession's own standards of behavior; it would also serve to reduce the level of corporate misconduct itself.<sup>19</sup>

#### B. Corporate Representation and the Gatekeeper Role Under the Model Rules

The American Bar Association's Model Rules of Professional Conduct, the predominant treatment of legal ethics in this country,<sup>20</sup> give substance to the lawyer's gatekeeper role primarily through two rules. The first is Model Rule 1.13, which identifies the "client" in the representation of an organization, including corporations.<sup>21</sup> It also dictates action for lawyers who know of significant misconduct by a corporate client's managers.<sup>22</sup> The second rule defining a lawyer's role

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18. See Cramton, *supra* note 15, at 144 ("[C]ompliant lawyers as well as greedy executives, lazy directors and malleable accountants are necessary for large corporate frauds to come to life and persist long enough to cause major harm. The assistance of inside and outside lawyers is required to structure and report on corporate transactions.").

19. Indeed, reform of corporate lawyers' behavior may well be essential to the success of broader corporate reforms. *Id.* at 144 ("Other reforms will not suffice unless lawyers who violate legal and ethical rules are held accountable.").

20. See *supra* note 12 for a discussion of the dominance of the ABA's pre-2003 Model Rules in the states' regulation of lawyers' conduct.

21. This is true under the original version of Model Rule 1.13 and the 2003 amendments of the rule. MODEL RULES OF PROF'L CONDUCT R. 1.13(a) (2003); MODEL RULES OF PROF'L CONDUCT R. 1.13(a) (1983).

22. Under the original version of Model Rule 1.13, such actions were governed by subpart (b). MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (1983). Under the 2003 amendments of the rules, the actions are covered by subparts (b) and (e). MODEL RULES OF PROF'L CONDUCT R. 1.13(b), 1.13(e) (2003).



as gatekeeper is Model Rule 1.2(d), which restricts lawyers from knowingly assisting their clients in certain wrongful conduct.<sup>23</sup>

Together, Model Rule 1.13 and Model Rule 1.2(d) work well to define proper conduct for lawyers in a wide array of contexts in corporate representation. In certain problematic situations, however, including some alleged to have occurred in the Enron scenario,<sup>24</sup> these rules fail to offer sufficient guidance for lawyers and fall short of defining a defensible professional role for those representing corporations. In this section we examine the intended operation of Model Rules 1.13 and 1.2(d), deferring discussion of the more troubling situations until Part III.

### 1. The Entity Theory of the Corporate Client

Under Model Rule 1.13(a),<sup>25</sup> an organization's lawyer is to consider her "client" to be the organization itself.<sup>26</sup> This "entity theory"<sup>27</sup> of representation, requires the lawyer to conceptualize the client by employing a fiction and to separate the interests of that

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23. Concerning the gatekeeper role of lawyers, other writers have noted the importance of Model Rule 1.6, governing the lawyer's duty to maintain the confidentiality of information relating to the representation of a client, and Model Rule 4.1, which pertains to disclosures that may be necessary to avoid assisting in the crime or fraud of a client. For example, the Cheek Commission's Preliminary Report focuses on both of these rules in its discussion of lawyers' independent role in corporate governance. See *Cheek Commission Preliminary Report*, *supra* note 9, at 205-08. That body's Final Report recommends that Model Rule 1.6 be amended to permit disclosures to prevent a client from committing a crime or fraud that could injure the financial interests of others if the lawyer's services have been used to further the client's conduct or to rectify the effects of such crimes or fraud in which the lawyer's services had been used to further that conduct. See *Cheek Commission Final Report*, *supra* note 9, at 77. Indeed, the 2003 amendments to Model Rule 1.6 adopted these recommendations. MODEL RULES OF PROF'L CONDUCT R. 1.6(b)(2), 1.6(b)(3) (2003). Our discussion in this article, however, is limited to actions of lawyers within the corporation and does not include actions by lawyers to make disclosures beyond the confines of the corporate client. See *infra* notes 69-72 and accompanying text.

24. For a brief account of the transactions resulting in the Enron debacle, see *supra* note 17.

25. The 1983 version of Model Rule 1.13(a) was not amended by the 2003 action of the ABA. Compare MODEL RULES OF PROF'L CONDUCT R. 1.13(a) (2003) with MODEL RULES OF PROF'L CONDUCT R. 1.13(a) (1983).

26. Model Rule 1.13(a) provides that "[a] lawyer employed or retained by an organization represents the organization acting through its duly authorized constituents." MODEL RULES OF PROF'L CONDUCT R. 1.13(a) (2003).

27. The Comment to Model Rule 1.13 describes the rule's approach as being one in which the client is the "legal entity." MODEL RULES OF PROF'L CONDUCT R. 1.13 cmt. 1 (2003). For an interesting discussion of the development of the entity theory of corporate representation and its adoption in the Code of Professional Responsibility and Model Rules, see James R. McCall, *The Corporation as Client: Problems, Perspectives, and Partial Solutions*, 39 HASTINGS L. J. 623, 626-27 (1988).

fictional being from the interests of the individual constituents<sup>28</sup> who invest in, manage, finance, or do the work of the organization. Thus, a lawyer representing a corporation, the organization of our concern here,<sup>29</sup> represents the corporate entity itself and does not, by virtue of her representation of the corporation, represent any of the constituents of the corporation such as the directors, officers, employees, or shareholders.<sup>30</sup> This distinction is abstract and difficult for the corporation's lawyer to maintain, given that the entity must act and speak through individuals with whom the lawyer develops close professional and personal relationships.<sup>31</sup>

Despite the difficulties in its practical application, the entity approach provides corporate lawyers with a crucial frame of reference for much of their work both outside and within the corporation. Outside of the corporation, it aids the lawyer in discriminating for himself and accurately representing to others both the identity of the client and the reach of his authority.<sup>32</sup> Within the corporation, the entity theory also helps lawyers navigate tricky professional waters. For example, the entity theory gives useful

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28. The Comment to Model Rule 1.13 specifically identifies "officers, directors, employees, [and] shareholders" as "constituents" of a corporation, while not limiting the term to those actors. MODEL RULES OF PROF'L CONDUCT R. 1.13 cmt. 1 (2003). Modern corporate scholarship takes a broader view of the constituents relevant to a corporation. See, e.g., Rutheford B Campbell, Jr., *Corporate Fiduciary Principles for the Post-Contractarian Era*, 23 FLA. ST. U. L. REV. 561, 577-80 (1996) (describing constituencies: as "money investors," which include stockholders and creditors; "human capital investors," which include employees and managers; and "remote constituencies," which include suppliers and the community in which the corporation operates). For further discussion of the interests of various constituents in describing those of most concern in this article, see *infra* notes 84-87 and accompanying text.

29. Model Rule 1.13 also governs the representation of non-corporate organizational clients, such as partnerships, associations, and government organizations. MODEL RULES OF PROF'L CONDUCT R. 1.13 cmts. 1,9 (2003).

30. The same approach is adopted by the American Law Institute in the Restatement of the Law Governing Lawyers, which provides that a lawyer representing a corporation "represents the interests of the organization as defined by its responsible agents acting pursuant to the organization's decision-making procedures" and "must follow instructions . . . given by persons authorized so to act on behalf of the organization." RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 96(1) (2000) [hereinafter RESTATEMENT]. The Comments to that provision note that "[t]he so-called 'entity' theory of organizational representation . . . is now universally recognized in American law, for purposes of determining the identity of the direct beneficiary of legal representation of corporations . . ." *Id.* § 96 cmt. b.

31. For a discussion of complications arising from this aspect of the lawyer-corporate client relationship, see *infra* Part III.A.2.a.

32. The Comments to Restatement section 96 note that "the lawyer for an organization does not possess, solely in that capacity, power to act for officers as their lawyer. Thus, third persons may not reasonably conclude, solely from that capacity, that a lawyer for the organization represents officers individually." RESTATEMENT, *supra* note 30, § 96 cmt. b.

guidance to a corporation's lawyer in applying the attorney-client privilege to communications with individuals associated with the corporation<sup>33</sup> and in determining to whom professional duties extend in conducting the representation.<sup>34</sup>

More importantly for this discussion, the entity theory also allows corporate lawyers to address common intra-organization issues of multiple representation. Keeping in mind that the entity is the client, the lawyer can identify situations in which caution is required because corporate officers or employees, for example, are assuming that the lawyer represents their own individual interests. Since the lawyer represents the corporate entity, he can utilize the

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33. Since the corporate entity is the client, the evidentiary attorney-client privilege applies more narrowly to communications from non-client constituents than if the lawyer had represented the constituents individually. See RESTATEMENT § 73. This is true even under the Supreme Court's broad view of the corporation's attorney-client privilege. See *Upjohn Co. v. United States*, 449 U.S. 383, 386-87 (1981) (holding that the attorney-client privilege protects communications from employees to counsel). Moreover, even though statements of constituents may fall within the privilege, it is the corporation's privilege to assert and to waive. CHARLES W. WOLFRAM, *MODERN LEGAL ETHICS* 422 (1986). The related ethical concept of confidentiality, however, is governed by Model Rule 1.6, which is written broadly to protect all "information relating to representation of a client." MODEL RULES OF PROF'L CONDUCT R. 1.6(a) (2003). Under this broad concept, a corporate lawyer's duty of confidentiality applies to all constituent communications related to the representation. Even so, the Comments to Restatement section 96 properly state that "[a] lawyer representing only an organization does not owe duties of . . . confidentiality . . . to constituents of the organization." RESTATEMENT, *supra* note 30, § 96 cmt. b. This reflects the entity theory of representation. *Id.*

34. The entity theory provides corporate lawyers with some assurance that their professional duty extends only to the corporation and not to the individuals they deal with in representing it, thus limiting the lawyers' malpractice liability exposure. *Lawyers' Manual*, *supra* note 12, at 91:2003-05. The courts have been generally consistent in refusing to hold a corporation's lawyer liable to corporate constituents, even when a lawyer's negligent representation of the corporation has a negative effect on the constituents' individual interests, unless the lawyer has led the constituents to believe that she represents them individually. *Id.* at 301:616-17. The drafters of the Restatement note that "[a] lawyer representing only an organization does not owe duties of care . . . [or] diligence . . . to constituents of the organization." RESTATEMENT, *supra* note 30, § 96 cmt. b. This approach to corporate lawyers' duty also carries over to their fiduciary duties. *Lawyers' Manual*, *supra* note 12, at 91:2004. Since the lawyer represents the entity and owes it a fiduciary duty, the lawyer does not owe a fiduciary duty to the various constituents. WOLFRAM, *supra* note 33, at 735. This is not to say, however, that the lawyer is absolved from liability if he or she knowingly assists the constituents in violating their own fiduciary duties to others, such as the shareholders. In this situation, however, the courts would be applying the concept of liability resulting from tort and agency law rather than that of fiduciary duty of the lawyer to the shareholders themselves. *Lawyers' Manual*, *supra* note 12, at 91:2005; see Geoffrey C. Hazard, Jr., *How Far May a Lawyer Go in Assisting a Client in Legally Wrongful Conduct?*, 35 U. MIAMI L. REV. 669, 677-82 (1981) (discussing lawyer liability for a client's tort).

analysis provided by the Model Rules<sup>35</sup> to determine whether simultaneous representation<sup>36</sup> of the constituent's interests would be permissible.<sup>37</sup> Model Rule 1.13(a)'s adoption of the entity theory, however, ensures that the lawyer's first loyalty is to the corporate entity, not to any individual constituents, in engaging in this analysis.<sup>38</sup>

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35. That analysis is provided by Model Rule 1.7, which generally prohibits the simultaneous representation of two clients when the representation of one would be "directly adverse to" or "materially limited by" the representation of the other, unless the lawyer is able to make a reasonable determination that there will be no adverse effect on the representation and the clients consent. MODEL RULES OF PROF'L CONDUCT R. 1.7 (2003). In utilizing this analysis in the corporate situation, the lawyer would be required to focus on the effect the representation of the constituent would have on the representation of the corporate client and vice versa.

36. Issues of subsequent representation can also be raised in the corporate setting. For example, a lawyer might represent a corporation in negotiating a contract with a third party, working primarily with the corporate client's then-president. Several years later, the corporation might sue the now former president because of conduct related to the negotiation of the contract. The lawyer from the prior transaction might be called upon to represent the corporation in the litigation against the former president. If the former president objects to the lawyer's representation against her, the question would be whether she was a former client of the lawyer. The entity theory would require a negative conclusion, unless the lawyer had also established an attorney-client relationship with the president at the time. Conflicts of interest arising from instances of subsequent representation are governed by Model Rule 1.9, which generally prohibits representations adverse to former clients in the same matter or a matter substantially related to the prior representation, unless the former client consents. MODEL RULES OF PROF'L CONDUCT R. 1.9 (2003).

37. The on-going need to be mindful of such conflicts is reflected by subpart (d) of the original version of Model Rule 1.13 and subpart (f) of the 2003 amendment of the rule, which call upon the lawyer to clarify for a constituent the identity of the client (that is, the entity) when it is clear that the interests of the corporation and the constituent are adverse. MODEL RULES OF PROF'L CONDUCT R. 1.13(f) (2003); MODEL RULES OF PROF'L CONDUCT R. 1.13(d) (1983). It is also underscored by subpart (e) of the original version of Model Rule 1.13(e) and subpart (g) of the 2003 amendment of the rule, which expressly acknowledge that there are situations in which a lawyer could represent both the corporation as the entity client and the constituent as an individual client, assuming the proper multiple representation analysis is done. MODEL RULES OF PROF'L CONDUCT R. 1.13(g) (2003); MODEL RULES OF PROF'L CONDUCT R. 1.13(e) (1983). For further discussion, see *supra* note 35.

38. It is instructive to note that the entity theory makes the representation of a corporation analogous to two other types of representations specially addressed in the Model Rules. The first is one in which a lawyer is paid by one person to provide representation for another, a situation permitted by Model Rule 1.8(f) so long as the lawyer (1) receives informed consent from the client; (2) the lawyer maintains his loyalty to the client and not to the third party paying for the services; and (3) the lawyer complies with Rule 1.6. See MODEL RULES OF PROF'L CONDUCT R. 1.8(f) (2003). While the analogy is not perfect, both situations require the lawyer to keep in mind who the client is and to avoid allowing any other non-client (in our corporate scenario, the constituents of the corporation) to interfere with the lawyer's professional judgment on behalf of the actual client (the corporate entity). In this sense, the entity

The entity theory also plays a role in the lawyer's response to the business decisions of the corporation's managers, an issue of particular relevance here. Generally, the lawyer is expected to accept the business decisions of the corporate client's managers, even when those decisions strike the lawyer as unwise.<sup>39</sup> The lawyer must be candid in rendering advice to the client regarding the decisions<sup>40</sup> and is even encouraged by the Model Rules to refer to a wide range of non-legal considerations in doing so.<sup>41</sup> In practice, of course, corporate managers often welcome and even seek out the lawyer's judgment regarding the wisdom of their business decisions. Under the entity theory, however, the lawyer is generally expected to provide representation for the fictional corporate being, although the constituents lawfully empowered to speak for it may make imprudent choices.<sup>42</sup>

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theory makes the corporate representation a triangular professional relationship made up of the lawyer, the entity client, and the entity's constituents. Similar triangular relationships arise in a number of lawyering contexts, for example, when a lawyer represents an insured while being paid by an insurer; when a public defender employed by a public agency represents an indigent person accused of a crime; or when a government lawyer is required by statute to represent a private claimant in civil litigation. For further exploration of these triangular professional relationships, see Eugene R. Gaetke & Robert G. Schwemm, *Government Lawyers and Their Private "Clients" Under the Fair Housing Act*, 65 GEO. WASH. L. REV. 329, 356-68 (1997).

The second situation analogous to the representation of a corporation is the representation of a disabled client. See George C. Harris, *Taking the Entity Theory Seriously: Lawyer Liability for Failure to Prevent Harm to Organizational Clients Through Disclosure of Constituent Wrongdoing*, 11 GEO. J. LEGAL ETHICS 597, 637 (1998) ("[T]he lawyer who represents a ward owes her duties to her client, the ward, not to the guardian, and the lawyer who represents an organization owes her duties to the organizational entity, not to its officers or other representatives."). This situation is governed by Model Rule 1.14. See MODEL RULES OF PROF'L CONDUCT R. 1.14 (2003). When a lawyer represents a client whose judgment is impaired due to youth or a mental disability, the lawyer is to attempt to maintain a normal relationship with the client. *Id.* The client's inability to act for herself is akin to the fictional corporate client's similar inability. Others may try to speak for the disabled client or the corporate client, but the lawyer must keep the identity of the client in mind in dealing with these other, even well-intending, persons, and exercise his professional judgment solely for the benefit of that client.

39. The drafters' comments to both the original and 2003 amended version of the Model Rules declare that "[w]hen constituents of the organization make decisions for it, the decisions ordinarily must be accepted by the lawyer even if their utility or prudence is doubtful." MODEL RULES OF PROF'L CONDUCT R. 1.13 cmt. 3 (2003); MODEL RULES OF PROF'L CONDUCT R. 1.13 cmt. 3 (1983).

40. MODEL RULES OF PROF'L CONDUCT R. 2.1 (2003).

41. *Id.* Non-legal considerations specified in Model Rule 2.1 include "moral, economic, social and political factors." *Id.*

42. See discussion *infra* Part II.B.2 (discussing the limits on a lawyer's deference to imprudent managerial decisions under the present language of Model Rule 1.13(b)).

To this point in our discussion, the entity theory can be seen as providing a helpful but intuitive sense of the client in the corporate setting. The assistance offered the lawyer by this intuition begins to deteriorate, however, when managers' business decisions create conflicting interests between, or even within, constituent groups. In these situations, Model Rule 1.13(a)'s blithe reference to the client's identity under the entity theory, as if the corporate entity can be divorced from the interests of any and all individual persons,<sup>43</sup> offers little help to the corporation's lawyer who must decide how to act in the face of these conflicts.<sup>44</sup> We will return to these difficult issues in assessing the soundness of the present approach to the client's identity under the entity theory in Part III.

## 2. Responding to Constituents' Misconduct

Both the 1983 and the 2003 versions of Model Rule 1.13(b) prescribe the duties of a lawyer who learns that a constituent is engaging in or is about to engage in serious misconduct related to the corporate client. The relevance of this aspect of the rule to the Enron scenario is apparent.

As noted above,<sup>45</sup> the entity theory requires that a lawyer generally defer to the business decisions of the managers who are lawfully authorized to act and speak for the corporate client. At times managers will make business decisions that are imprudent in the eyes of the lawyer and yet must be furthered by her in providing legal representation to the corporation. Some decisions or actions of managers, however, can be so unwise and so injurious to the entity that the lawyer must overcome her usual deference in order to fulfill her duty to pursue the best interests of the corporate client in providing legal services to it.<sup>46</sup>

The original and 2003 versions of Model Rule 1.13(b) capture this concept by requiring the lawyer to take preventive action to protect the interests of the corporate client in certain situations. These are when the lawyer knows that a constituent of the corporate client "is engaged in action, intends to act or refuses to act in a

43. Professor Wolfram makes the point directly by stating "[a]n ultimately absurd extension of the corporation-as-entity approach would be to argue that a corporate lawyer indeed has no living principal in the lawyer's principal-agent relationship with the corporation." WOLFRAM, *supra* note 33, at 733.

44. *Id.* at 732 ("The answers to the question of relationship given in the lawyer codes tend to be pat and satisfyingly high-minded but insufficient in dealing with the complex texture of real corporate life.").

45. See *supra* note 39 and accompanying text.

46. WOLFRAM, *supra* note 33, at 735. Professor Wolfram notes "the lawyer's duty to act on occasion as the corporate nag, or conscience" stating that "[w]hat is good for business and what the law requires may be very different things." *Id.* at 739.

matter related to the representation,<sup>747</sup> when that action is “a violation of a legal obligation to the organization,”<sup>748</sup> or is “a violation of law that reasonably might be imputed to the organization, . . . likely to result in substantial injury to the organization.”<sup>749</sup> Thus, Model Rule 1.13(b) sets a limit on the general deference a lawyer for a corporation may show a corporate client’s managers. When managers’ actions and decisions reach beyond imprudence and attain a level of impropriety that would cause them to violate a duty to the corporation or would be unlawful and cause substantial harm to the corporation, the lawyer must act.

Both the original and amended versions of Model Rule 1.13(b) leave the precise action that must be taken, however, to the discretion of the lawyer, with the lawyer expected to “proceed as is reasonably necessary in the best interest of the organization.”<sup>750</sup> According to the 2003 version of Model Rule 1.13(b), however, the lawyer must reveal the matter to “higher authority within the organization, including, if warranted by the circumstances, to the highest authority that can act” on its behalf, unless the lawyer reasonably believes that it is not necessary in the best interest of the corporation to do so.<sup>51</sup> This approach creates a presumption in favor of referral to a higher corporate authority, while leaving the lawyer the discretion to choose not to make such a disclosure.<sup>52</sup> If the

47. MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2003); MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (1983).

48. MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2003); MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (1983). A constituent's legal obligation to the organization could arise from the fiduciary duties arising out of the law of corporations, from other sources of law, or from the policies of the corporation itself. Professor Wolfram notes that the term “legal obligation” encompasses “all kinds of legal duties, whether they arise from criminal law, statutory law, administrative regulations, or any other legal source.” WOLFRAM, *supra* note 33, at 744.

49. MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2003); MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (1983). For a discussion of the meaning of “violation of law,” see *infra* notes 175-78 and accompanying text. It is generally asserted that the clause requiring the likelihood of substantial harm modifies only the “violation of law” situation and not the prior “violation of a legal obligation to the organization” situation. Lawyers' Manual, *supra* note 12, at 91:2406. Thus, any proposed or actual violation of a legal obligation to the corporation would warrant preventive action by the lawyer.

50. MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2003); MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (1983).

51. MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2003).

52. That the “up-the-ladder” reporting step was viewed as critical to the ABA is shown by its adoption of Model Rule 1.13(e) among its 2003 amendments. That provision requires a lawyer who is discharged for taking action under Model Rule 1.13(b) or (c) or who withdraws in circumstances calling for or allowing action under those sections “shall proceed as the lawyer reasonably believes necessary to assure

responsive actions by the lawyer under Model Rule 1.13(b) fail to arrest the troublesome action, the 2003 amended version of Model Rule 1.13(c) declares that if the individual constituent's action is "clearly a violation of the law . . . reasonably certain to result in substantial injury to the organization" the lawyer may disclose confidential information if she reasonably believes it is necessary to prevent that injury.<sup>53</sup> Thus, the newly amended rule permits, but does not require, lawyers to reveal information outside of the organization in sufficiently serious situations.<sup>54</sup>

The duty to take preventive action imposed by both the original and 2003 versions of Model Rule 1.13(b) can be seen as an extension of the entity theory embraced in subsection (a) of that rule. If the client is to be the entity rather than the constituents of the corporation, it was important for the drafters of the rules to anticipate that constituent misconduct harmful to the entity might come to the attention of the lawyer. In that situation, the lawyer's loyalty to the entity client logically mandates some action to protect it from the harm occurring through or threatened by the constituent's actions.<sup>55</sup> This idea is captured by the requirement that

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that the organization's highest authority is informed of the lawyer's discharge or withdrawal." MODEL RULES OF PROF'L CONDUCT R. 1.13(e) (2003).

Under the prior version of Model Rule 1.13(b), still in force in the vast majority of states, lawyers had even more discretion in reacting to constituent misconduct. The rule provided that in determining how to proceed in the best interest of the organization, the lawyer "shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyer's representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters and any other relevant considerations." MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (1983). Furthermore, the rule required the lawyer to take action "designed to minimize disruption of the organization and the risk of revealing information relating to the representation to persons outside the organization." *Id.* Beyond that, the rule listed several possible and likely sequential responses by the lawyer, including asking that the actor reconsider the proposed action, suggesting that another legal opinion be obtained on the action, and referring the matter to a higher, even the highest, authority within the organization for review. *Id.*

53. MODEL RULES OF PROF'L CONDUCT R. 1.13(c)(1)-1.13(c)(2) (2003).

54. The prior version of Model Rule 1.13(c) permitted the lawyer only to withdraw if his efforts within the organization failed to arrest the misconduct. MODEL RULES OF PROF'L CONDUCT R. 1.13(c) (1983). This approach to responding to corporate wrongdoing has been summarized by one commentator as telling lawyers, "Your responsibility to a corporate client who is being gravely wronged is to be silent and walk away." Stephen Gillers, *Model Rule 1.13(c) Gives the Wrong Answer to the Question of Corporate Counsel Disclosure*, 1 GEO. J. LEGAL ETHICS 289, 304 (1987).

55. The Cheek Commission recognized the relationship between the entity theory and the duty to take remedial action in response to managers' misconduct that is reflected in Model Rule 1.13 by noting that the "premise of Rule 1.13 is that the organization is the lawyer's client and that the lawyer owes that client an obligation of protection from harm." *Cheek Commission Preliminary Report, supra* note 9, at 203.



the lawyer respond in the “best interest of the organization”<sup>56</sup> in such circumstances.<sup>57</sup>

The “whistle-blowing” aspect of Model Rule 1.13 has been controversial since the ABA’s 1983 adoption of the Model Rules.<sup>58</sup> At that time, a number of commentators questioned that organization’s omission of a duty for lawyers to reveal more publicly even the most flagrant constituent misconduct, as the Kutak Commission had urged in its proposed version of the Model Rules.<sup>59</sup> Indeed, a number of states ultimately embraced the earlier position of the Kutak proposal in their final adoption of the Model Rules.<sup>60</sup> Even before the news of the Enron tragedy surfaced, thoughtful scholars urged a reconsideration of the tepid approach to constituent wrongdoing contained in Model Rule 1.13.<sup>61</sup> The ABA’s amendment of that rule is

56. MODEL RULES OF PROF’L CONDUCT R. 1.13(b) (2003); MODEL RULES OF PROF’L CONDUCT R. 1.13(b) (1983).

57. The Restatement takes a similar approach to the problem of constituent misconduct in lawyers’ representation of corporations, although it imposes an obligation that is broader in two respects than that imposed by both the original and amended versions of Model Rules 1.13(b) and 1.13(c). RESTATEMENT, *supra* note 30, § 96(2)-(3). The Restatement does not require that the misconduct at issue be related to the representation as does Model Rule 1.13(b). Compare *id.* with MODEL RULES OF PROF’L CONDUCT R. 1.13(b) (1983) and MODEL RULES OF PROF’L CONDUCT R. 1.13(b) (2003). Further, the Restatement’s obligation applies to past action by a constituent, not just ongoing or proposed action. RESTATEMENT, *supra* note 30, § 96.

58. Harris, *supra* note 38, at 604-06; see STEPHEN GILLERS & ROY D. SIMON, REGULATION OF LAWYER: STATUTES AND STANDARDS 146-52 (1999) (tracing the development of the approach eventually adopted in Model Rules 1.13(b) and (c), as well as noting examples of various state versions of the provisions).

59. See WOLFRAM, *supra* note 33, at 61-62

60. Lawyers’ Manual, *supra* note 12, at 91:2402-03.

61. Gillers, *supra* note 54, at 143-45; Harris, *supra* note 38, at 637-38; McCall, *supra* note 27, at 639-40. Professor Richard Painter and Jennifer Duggan argued that such a result should be imposed through federal legislation. See Richard W. Painter & Jennifer E. Duggan, *Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation*, 50 SMU L. REV. 225 (1996). Professor Painter later made the same assertion to the ABA’s Ethics 2000 Commission in its consideration of proposed amendments to the Model Rules. See Cramton, *supra* note 15, at 179 n.147. Despite these opinions, the ABA’s Ethics 2000 Commission, however, recommended no changes to Model Rule 1.13(b) in its proposals for needed amendments to the Model Rules. See *id.* After the Enron news surfaced, along with approximately 40 law professors, Professor Painter urged the SEC to adopt a more meaningful whistle-blowing role for lawyers in its new regulation of securities lawyers. *Id.*; see also Letter from Susan P. Koniak et al. to Jonathan G. Katz, Secretary, SEC (Dec. 17, 2002), available at <http://www.sec.gov/rules/proposed/s74502/spkoniak1.htm>. The ABA’s comment to the SEC’s proposed rule curiously then asked the Commission to postpone adopting its new rule to give it time to consider possible amendments to Model Rule 1.13(b) and (c), something it’s Ethics 2000 Commission had declined to do only a short time earlier. ABA Comment, *supra* note 4, at Parts III, V.C.

thus likely to rekindle the controversy as the state supreme courts consider the issue yet again.

The debate regarding a lawyer's appropriate response to managers' misconduct has been expanded further by the SEC's promulgation of its new regulation of lawyer conduct as directed by Congress in Section 307 of the Sarbanes-Oxley Act of 2002. That statute required the SEC to issue rules requiring lawyers<sup>62</sup> to report evidence of managers' misconduct<sup>63</sup> to the company's chief legal counsel or its chief executive officer and, if that reporting should fail to result in an appropriate response, to go "up-the-ladder"<sup>64</sup> to the corporation's audit committee, another committee of independent directors, or the board of directors itself.<sup>65</sup> Congress thus envisioned a regulation mandating remedial action by lawyers much like that only conditionally demanded in Model Rule 1.13(b).<sup>66</sup> The final rule issued by the SEC accomplishes the congressional goal, exceeding even the 2003 amended version of Model Rule 1.13(b)'s requirements in several respects.<sup>67</sup> The further issue of what lawyers must do in the event that their disclosures within the corporation fail to arrest the misconduct will be debated further as the SEC gives further consideration to its so-called "noisy withdrawal" provision.<sup>68</sup>

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62. According to the statute, the new rule was to apply to lawyers "appearing and practicing before the Commission in any way." Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 307, 116 Stat. 745, 784 (2002).

63. The misconduct referred to in Section 307 includes "a material violation of securities law or breach of fiduciary duty or similar violation." *Id.*

64. The phrase is used by the SEC in Part III of its release pertaining to the proposed rule. ABA Comment, *supra* note 4, at Part III.

65. § 307, 116 Stat. at 745.

66. That is, Model Rule 1.13(b) requires action by the lawyer in the face of known managerial misconduct, and the rule requires the lawyer to report that misconduct to higher authorities within the corporation, but the rule excuses this reporting up if "the lawyer reasonably believes that is not necessary in the best interest" of the corporation to do so. MODEL RULES OF PROF'L CONDUCT R.1.13(b) (2003). Thus, reporting up is not mandatory in all instances under the 2003 amendment to Model Rule 1.13 as it is in the SEC regulation. For further discussion of this aspect of Model Rule 1.13(b), see *supra* notes 47-52 and accompanying text.

67. For purposes of this discussion, most notable is the fact that the level of certainty the lawyer must have to trigger the obligation to take remedial action is lower under the SEC rule than under Model Rule 1.13(b). See SEC, PROPOSED RULE: IMPLEMENTATION OF STANDARDS OF PROFESSIONAL CONDUCT FOR ATTORNEYS 17 CFR 205, available at <http://www.sec.gov/rules/proposed/33-8150.htm> (last modified Dec. 17, 2002) [hereinafter PROPOSED RULE: 17 CFR § 205]. For a further discussion of this aspect of the SEC's final rule compared to Model Rule 1.13(b), see *infra* text accompanying notes 147-64.

68. PROPOSED RULE: 17 CFR § 205, *supra* note 67, § IC(A). The SEC's proposed rule mandated that in situations involving ongoing or pending misconduct that will "likely result in substantial injury" to the corporation or its investors, outside legal counsel "withdraw from the representation" of the corporation, notify the SEC of the

The outcome of the noisy withdrawal issue in the regulatory context is important to lawyers subject to the SEC rule,<sup>69</sup> their corporate clients, and the public. In this article, however, we have chosen to focus on the point at which all lawyers must take action within the confines of their client corporations when managers engage in misconduct. Our primary concern is with the standards that determine when a lawyer must act to protect her corporate client from managers' misconduct, and we give less attention to the particular remedial actions, including making a noisy withdrawal, that the lawyer must take. We believe that the standards that determine the lawyer's duty to take action and that restrict a lawyer's assistance to a client's misconduct have the most profound impact on the effectiveness of lawyers as gatekeepers. This belief is based on our impression that in the vast majority of instances clients will not pursue a transaction if their lawyers say, "This transaction is inconsistent with our professional ethics and we cannot participate."

We believe that corporate boards of directors are generally inclined to respond appropriately to lawyers' allegations of wrongdoing when made.<sup>70</sup> In the post-Enron world, corporate

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withdrawal, and "disaffirm any submission to the [SEC] that [the lawyer has] participated in preparing which is tinted by the violation." *Id.* § IV(B). The Commission's rule as promulgated did not contain these provisions, but the agency announced that it will continue to consider their adoption at a later time. *See* Press Release, SEC, SEC Adopts Attorney Conduct Rule Under Sarbanes-Oxley Act (Jan. 23, 2003), available at <http://www.sec.gov/news/press/2003-13.htm>.

69. The rule is broad, purporting to reach lawyers "appearing and practicing before the Commission," which means:

- (i) Transacting any business with the Commission, including communications in any form;
- (ii) Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request, or subpoena;
- (iii) Providing advice in respect of the United States securities laws or the Commission's rules or regulations thereunder regarding any document that the attorney has notice will be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission, including the provision of such advice in the context of preparing, or participating in the preparation of, any such document; or
- (iv) Advising an issuer as to whether information or a statement, opinion, or other writing is required under the United States securities laws or the Commission's rules or regulations thereunder to be filed with or submitted to, or incorporated into any document that will be filed with or submitted to, the Commission . . . .

17 C.F.R. § 205.2(a) (2003); *see also* SEC, FINAL RULE: IMPLEMENTATION OF STANDARDS OF PROFESSIONAL CONDUCT FOR ATTORNEYS, available at <http://www.sec.gov/rules/final/33-8185.htm> (last modified Jan. 21, 2003) (discussing the implementation of 17 C.F.R. § 205).

70. In its response to the Cheek Commission's Preliminary Report, the American Corporate Counsel Association notes that "[i]n the vast majority of cases, the mere

directors should be increasingly conscious of the potential for their company's and their own misconduct, liability, and criminality. In the present milieu, it is doubtful whether all of the members of a board of directors, particularly the outside directors, would themselves choose to remain silent in the face of a lawyer's disclosures regarding managerial misconduct even if the board voted to do nothing in reaction.<sup>71</sup> Therefore, we believe the more pressing concern is to focus on the standards that trigger the lawyer's duty to take remedial action within the corporation<sup>72</sup> and to refrain from assisting managers' misconduct.

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prospect that the lawyer may go to the board is enough to get even the most recalcitrant managers to reform their thinking." *ACCA Submission, supra* note 10, at 4.

71. In its response to the SEC's proposed rule, the ABA notes that "it is important to recognize that a sea change has taken place in corporate governance since the failures that contributed to the corporate scandals." ABA Comment, *supra* note 4, at Part VI.C.

72. In this article, therefore, we do not address the interesting issue of disclosure of confidential information beyond the corporate confines when necessary to address client fraud. This issue is intertwined with the broader and still controversial treatment of confidentiality under the Model Rules. Those rules, as adopted by the ABA in 1983, have provided lawyers only limited grounds for disclosure of confidential information. See MODEL RULES OF PROFESSIONAL CONDUCT R. 1.6(b) (1983) (permissive disclosure of information relating to representation allowed when necessary to prevent a client from committing a crime "likely to result in imminent death or substantial bodily harm" or for the lawyer to be able to defend himself or establish a claim in a dispute with a client or to respond to allegations about the lawyer's representation). The proper reach of confidentiality, particularly the matter of disclosure when client fraud may have or has occurred, were among the most controversial provisions of the Model Rules as evidenced by the wide variety of state approaches to confidentiality, most rejecting the ABA's provisions. For example, currently forty-one states have exceptions to the duty of confidentiality to prevent a client from committing criminal fraud, a disclosure not permitted by the ABA's 1983 version of Model Rule 1.6. *Cheek Commission Final Report, supra* note 9, at 49. Recently, renewed efforts to restrict the protection of confidentiality in the Ethics 2000 process resulted in only modest amendment of Model Rule 1.6. That group recommended the addition of three exceptions to the duty of confidentiality, but the ABA House of Delegates approved only one, rejecting two that pertained to preventing or rectifying fraud. A.B.A. COMMISSION ON EVALUATION OF THE RULES OF PROFESSIONAL CONDUCT, REPORT WITH RECOMMENDATION TO THE HOUSE OF DELEGATES 42 (Aug. 2001), available at [http://www.abanet.org/cpr/e2k-whole\\_rpt.doc](http://www.abanet.org/cpr/e2k-whole_rpt.doc). The Cheek Commission recommended adoption of these two proposed exceptions among its recommendations for improving lawyers' role in corporate governance. *Cheek Commission Preliminary Report, supra* note 9, at 205-07. In August 2003, the ABA House of Delegates approved an amendment to Model Rule 1.6 incorporating these two exceptions permitting disclosures of confidential information pertaining to client crimes or fraud in which the client has used the lawyer's services. See *Lawyers' Manual, supra* note 12, 19 Current Reports 467-69 (Aug. 13, 2003) (description of ABA House of Delegates action on Model Rule 1.6). The ABA also amended Model Rule 1.13(c) by including a permissive disclosure provision when a lawyer's remedial actions within the corporation have

If the rules of legal ethics would demand that lawyers provide better representation within the confines of their corporate clients, the interests of shareholders, employees, creditors, and the public will be better protected as well, even without expecting lawyers to reveal managerial wrongdoing beyond the corporation itself. In this regard, the standards by which the profession measures the lawyers' duty to react within the corporation to actual or pending managerial misconduct seem troubling, a subject to which we will return in Part III.

### 3. The Outer Limit on Advocacy and Advice

Lawyers for corporations, like other lawyers, must be mindful of another limit on their duty to pursue their clients' interests. While all lawyers are expected to represent their clients competently, zealously, and loyally, Model Rule 1.2(d) prohibits a lawyer from counseling or assisting a client "in conduct that the lawyer knows is criminal or fraudulent."<sup>73</sup> This rule provides the outer limit on the lawyer's discretion to act in pursuit of a client's interests.<sup>74</sup> For corporate lawyers, this limit also serves as part of their gatekeeper duties.

The restriction on lawyers' conduct presented by Model Rule 1.2(d) can be viewed as a public interest obligation of lawyers to act to protect society by refusing to assist, and thereby discouraging, their clients' misconduct. The obligation also can be viewed as something less noble,<sup>75</sup> merely exhorting lawyers to avoid being participants in their clients' crimes<sup>76</sup> or fraud.<sup>77</sup> Regardless of one's

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failed to arrest managers' misconduct and substantial injury to the corporation is reasonably certain. *Id.*

73. MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2003). No change was made in the 1983 version of Model Rule 1.2(d) by the 2003 amendments.

74. Lawyers have the discretion to refuse to assist clients in questionable activities. For example, lawyers may withdraw from representing a client who "insists upon taking action that the lawyer considers repugnant or with which the lawyer has a fundamental disagreement." MODEL RULES OF PROF'L CONDUCT R. 1.16(b)(4) (2003). Even if a lawyer doesn't "know" that a client is engaged in a crime or fraud, she may withdraw if she "reasonably believes" this is so. *Id.* R. 1.16(b)(2). Model Rule 1.2(d), however, defines the point at which a lawyer must refuse to assist a client's wrongful conduct.

75. One of the co-authors of this article so views Model Rule 1.2(d). See Eugene R. Gaetke, *Lawyers as Officers of the Court*, 42 VAND. L. REV. 39, 65-68 n.140 (1989) (The obligation to avoid assisting clients in criminal conduct and fraud under Model Rule 1.2(d) is "coextensive with legal duties of persons other than lawyers.").

76. Professor Wolfram notes that lawyers enjoy no immunity from the criminal law, even while engaged in performing an "otherwise traditional lawyerly function, such as advice-giving or legal drafting." WOLFRAM, *supra* note 33, at 693 (citations omitted). Thus, he concludes that a "lawyer's conduct that facilitates a client's commission of a crime comes comfortably within the definitions of accomplice . . ." *Id.*

glass-half-full or half-empty perspective, however, the provision does draw an important line beyond which lawyers may not go in providing representation to their clients.

For the corporate lawyer, Model Rule 1.2(d) works in tandem with Model Rule 1.13. The lawyer represents the corporate entity under Model Rule 1.13(a) rather than any of the constituents making up the corporation. When any of those constituents act or propose to act in violation of their duties to the corporation or unlawfully in such a way as to harm the corporation, under Model Rule 1.13(b), the lawyer must take remedial action to protect the best interests of the corporate client. Should those remedial actions fail to stop the misconduct, the lawyer is free, but is not required, to withdraw from the representation under Model Rule 1.16, thus ending participation in the constituent's and the corporation's misconduct. In sufficiently serious situations, the 2003 amended version of Model Rule 1.13(c) also permits the lawyer to reveal confidential information to prevent substantial injury to the corporation.<sup>78</sup>

For the lawyer concerned about a constituent's actions, who concludes that remedial action is not warranted or who chooses not to withdraw when his remedial actions have failed to arrest the misconduct, Model Rule 1.2(d) stands as the outer limit on the lawyer's appropriate participation in the client's wrongdoing. If the lawyer knows that the client's course of action is a crime or fraud, the lawyer may not assist the client in the conduct. For lawyers representing corporations, this generally would mean that the lawyer would be unable to provide legal assistance in transactions that the lawyer knows will further the client's criminal or fraudulent conduct.<sup>79</sup>

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77. See Hazard, *supra* note 34, at 677-82 (discussing the sources of a lawyer's liability for a client's torts).

78. MODEL RULES OF PROF'L CONDUCT R. 1.13(c) (2003).

79. In some situations, it could be said that Model Rule 4.1 would require the lawyer to take the additional step of making disclosures to third parties in order to avoid assisting the client's crime or fraud. See MODEL RULES OF PROF'L CONDUCT R. 4.1 (2003) (discussing disclosures to third parties). As adopted by the ABA in 1983, however, the effectiveness of that rule's obligation is questionable because of the exception it provides for disclosures prohibited by Model Rule 1.6. MODEL RULES OF PROF'L CONDUCT R. 4.1(b) (1983). In Professor Wolfram's opinion, that exception results in "the apparent utter irrelevance of Rule 4.1(b)." WOLFRAM, *supra* note 33, at 672. This results from the failure of the ABA to include within the exceptions to the confidentiality provisions of Model Rule 1.6 permission to disclose confidential information when required by other law. *Id.* As a result of the Ethics 2000 review of the Model Rules, Professor Wolfram's concern has been addressed by adding the 2002 revision adding the exception to Model Rule 1.6(b). MODEL RULES OF PROF'L CONDUCT R. 1.6(b)(6) (2003). Thus, under the ABA's current version of Model Rules 1.6 and 4.1, a lawyer may be required to make disclosures necessary to avoid assisting a client's criminal or fraudulent conduct, although most states have yet to adopt this change.

Model Rule 1.2(d) may provide a useful limit on lawyers assisting their clients in crimes or defrauding others.<sup>80</sup> The question remains, however, whether it provides sufficient protection to corporate clients and society against the sort of managerial misconduct that a corporation's transactional lawyer might confront, a question we will address in Section III.

While strengthened by the ABA'S 2003 amendments, the treatment of the lawyer's gatekeeper role by the Model Rules could still be best described as restrained. Under these rules, in representing their corporate clients lawyers are required to react to situations involving clear misconduct by managers but only by raising concerns and seeking reconsideration within the corporation itself. In addition, in all situations, corporate lawyers are to refrain from knowingly assisting their clients in engaging in crimes or fraud. Given the backdrop of the Enron scenario, we now examine whether more should be expected of transactional lawyers in their role as gatekeepers.

### III. ASSESSING THE PRESENT APPROACH

The present rules of professional ethics resolve a range of issues arising in the ordinary course of lawyers' representation of corporate clients. They do not, however, articulate a suitable gatekeeper role for those lawyers, especially in circumstances when managerial conduct approaches impropriety. In part, this is because of the shortcomings of the entity theory in addressing the conflicts that complicate corporate representation. In addition, the expectations for lawyers who do face managerial misconduct are simply too low.

#### A. *The Failure of the Entity Theory*

The entity theory is appealing for its very simplicity, but it fails to account for the complex mix of interests among corporate constituencies. Much of this failure can be corrected by better merging the entity theory with corporate fiduciary principles that obligate corporate managers to pursue the best interests of shareholders. Even with this shift in perspective, however, other persistent conflicts will remain unaddressed by the entity theory. These include structural conflicts arising from the natural alliance between lawyers and the corporate managers who hire them and the conflicts that arise within the ranks of the shareholders themselves. Elevating the gatekeeper role of transactional lawyers will thus

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Because this article is limited to the subject of the lawyer's duty to act within the corporation in response to managers' misconduct, a detailed discussion of the obligation to disclose to third parties under Model Rules 4.1 is not offered.

80. *Id.* R. 1.2(d).

require both an elaboration of the entity theory and recognition of its limits.

### 1. The Duty to Pursue the Best Interests of Shareholders

The rules of professional conduct demand that all lawyers act in the best interests of their clients.<sup>81</sup> As defined by the entity theory, this obligation means that transactional lawyers representing corporations must pursue the best interests of the corporate entity as a whole.<sup>82</sup> Interpreting and fulfilling this obligation to the corporation, however, are often difficult tasks for the lawyer due in large measure to the conflicting interests among the various parties that have investments in the corporation and are thus impacted by the outcomes of corporate transactions.<sup>83</sup>

Modern corporate scholarship has parsed the corporate entity<sup>84</sup> and identified a number of constituencies that have interests in the

81. The Model Rules direct lawyers to act with competence, Model Rule 1.1, and diligence, Model Rule 1.3, on behalf of a client. Those rules require lawyers to “act with commitment and dedication to the interests of the client and with zeal in advocacy upon the client’s behalf.” MODEL RULES OF PROF’L CONDUCT R. 1.3 cmt. 1 (2003). The Restatement states that “a lawyer must, in matters within the scope of the representation . . . proceed in a manner reasonably calculated to advance the client’s lawful objectives . . .” RESTATEMENT, *supra* note 30, § 16. Comment c to that provision states that a “lawyer’s efforts in representation must be for the benefit of the client . . .” *Id.* cmt. c.

82. See discussion *supra* Part II.B.1.

83. Professor Gillers notes that “[t]he triangular relationship between a corporate lawyer, the client’s agents and the client itself accounts for many of the ethical complications in corporate representation.” Gillers, *supra* note 54, at 294.

84. Reference to a body of scholarship generally referred to as the nexus of contract theory may be helpful. Although he questions the worth of the concept, Professor Eisenberg defines the concept to mean “that the corporation is a nexus of reciprocal arrangements.” Melvin A. Eisenberg, *The Conception That the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm*, 24 J. CORP. L. 819, 822 (1999). Thus, for example, under the nexus of contracts theory, common shareholders, when they contribute capital, make arrangements with managers, preferred shareholders, creditors, and workers to have voting control over the business and to get everything that is left for distribution after the employees have been paid their wages and senior investors have been paid their interest and preferred dividends. Managers arrange to accept capital from investors and to run the company in an honest and efficient manner. Workers arrange to work for wages that will be paid subject to arrangements they have with other constituencies such as common stockholders. The “nexus” for all of these parties and their arrangements is the corporation.

This simple description of the nexus of contract approach to a corporation may help illuminate the different groups that have an interest in a corporation and its success. It may also help illuminate the point that the groups may in some cases have interests that are parallel to one another while in other instances the interests of the groups may be different.



corporation and its success.<sup>85</sup> While some attention has been given to more remote constituencies,<sup>86</sup> legal and economic literature has focused primarily on shareholders, creditors, employees and managers.<sup>87</sup>

In many corporate transactions, these four constituencies have interests that are parallel, as when the company reduces its operating expenses by replacing an important but aging machine with one that is more efficient. All four of the noted constituencies have an interest in the transaction, and all benefit from the reduction in operating expenses that flow from the acquisition of the new machine.<sup>88</sup> In such transactions—where a proposed corporate transaction affects all constituencies similarly—the entity theory

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Professor Eisenberg credits Michael Jensen and William Meckling with the first formulation of the concept, although Eisenberg ultimately traces the concept to Ronald Coase. *Id.* at 819-21.

85. See, e.g., Campbell, *Corporate Fiduciary Principles*, *supra* note 28, at 577-80 (describing constituencies as "money investors," which include stockholders and creditors; "human capital investors," which include employees and managers; and "remote constituencies," which include suppliers and the community in which the corporation operates).

86. See *id.* at 586-88.

87. Much of the literature has dealt with what, if any, obligation corporate managers may owe to creditors and employees of the corporation. For a discussion of the applicability of fiduciary duty protection for corporate creditors, see, e.g., Albert H. Barkey, *The Financial Articulation of a Fiduciary Duty to Bondholders with Fiduciary Duties to Stockholders of the Corporation*, 20 CREIGHTON L. REV. 47, 67-72 (1986); William W. Bratton, Jr., *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92, 106-13; Ruthford B. Campbell, *Limited Liability for Corporate Shareholders: Myth or Matter-of-Fact*, 63 KY. L.J. 23, 55-71 (1975); Thomas R. Hurst & Larry J. McGuinness, *The Corporation, the Bondholder and Fiduciary Duties*, 10 J. L. & COMM. 187 (1991); Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 BUS. LAW. 413 (1986); Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205 (1988); Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165 (1990).

For a discussion of the applicability of fiduciary duty protection for corporate employees, see, e.g., Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189 (1991); Katherine Van Wezel Stone, *Employees as Stakeholders under State Nonshareholder Constituency Statutes*, 21 STETSON L. REV. 45, 48-53 (1991); Katherine Van Wezel Stone, *Policing Employment Contracts Within the Nexus-of-Contracts Firm*, 43 U. TORONTO L.J. 353, 363-69 (1993). For a different view of employees and their need for fiduciary protection, see Richard Epstein, *In Defense of the Contract at Will*, 51 U. CHI. L. REV. 947, 953-55 (1984).

88. Perhaps one imagines that shareholders will benefit most here, but the increased strength of the going concern and its profit generating prospects resulting from the increased efficiency will help creditors, making it more likely that the company can repay its debt, and its managers and employees, whose future salaries become more secure.

continues to be functional. The lawyer is able to define his professional responsibility by considering the entity as a whole.

Other corporate transactions, however, affect the various constituencies differently and at times put their interests in conflict. In these transactions - where one constituency gains at the expense of another - it remains imperative that the lawyer act in the best interests of the client. An attempt to define the identity of the client solely by reference to the interests of the corporate entity as a whole, however, is not helpful in such circumstances.<sup>89</sup>

Consider, for example, the following situation, based loosely on some of the reported problems at Enron.<sup>90</sup> Assume that a lawyer representing Alpha Co. is requested by senior officers to provide the legal work for Alpha to form and launch a special purpose entity. The senior officers of Alpha will personally invest in and manage the entity and, as a result, reap immense and unwarranted profits.<sup>91</sup> Assume further that the lawyer knows the arrangement will put the interests of one constituency, the senior officers, in a conflicted position with the interests of Alpha's shareholders and other important constituencies<sup>92</sup> and will violate the corporation's own conflict of interest policy.

While we may intuit that the lawyer for the corporation should not lend assistance to this transaction, the entity theory by itself, at least if literally applied, does little to define the permissible limits of the lawyer's conduct. This is because one important part of the corporation, the managers, will benefit from the transaction, while another important constituency, the shareholders, will be hurt as a result of the excessive management fees and investment returns extracted by the management group. It is impossible, therefore, to define the lawyer's obligations in this case solely by reference to the entity as a whole.

89. See, e.g., Rutheford B Campbell, Jr., *A Positive Analysis of the Common Law of Corporate Fiduciary Duties*, 84 KY. L.J. 455, 460-69 (1996) (describing, with the assistance of graphs, the way in which various corporate transactions impact the corporate constituencies).

90. For a brief description of the relevant Enron transactions, see *supra* notes 17-19 and accompanying text.

91. Reports indicate that a senior manager at Enron received "\$40-plus million . . . from his partnerships . . . that had lucrative deals with Enron." Kathryn Kranhold & Mitchell Pacelle, *Enron Paid Top Managers \$681 Million, Even as Stock Slid*, WALL ST. J., June 17, 2002, at B1.

92. Obviously, the conflict is due to the fact that the senior officers gain personally from these transactions by diverting as much corporate wealth to themselves as possible. Shareholders, employees and creditors, on the other hand, lose as a result of those acts, since the diversion of assets to senior officers leaves less corporate wealth available to satisfy the claims of the other constituencies.

Consider now a more difficult transaction with varying impacts on other corporate constituencies. Assume that Target Co. is hit with an unsolicited takeover bid from Aggressor One to acquire all the outstanding common stock of Target in a highly leveraged transaction at a price of two times the present market value of Target's common stock. Assume for now that Target has debentures but no preferred stock outstanding. A successful acquisition of Target by Aggressor One in this case, let us assume, will be in the best interests of Target's shareholders, who will receive a substantial premium for their shares. On the other hand, we assume here that the acquisition will be detrimental to Target's debenture holders and employees, since the additional leverage will depress the market value of the debentures, and many employees will lose their jobs as a result of the consolidation of the two companies.<sup>93</sup>

If Target's managers enlist the assistance of the corporation's lawyer to facilitate the acquisition, a literal application of the entity theory once again fails to define the lawyer's professional duties in the situation. The lawyer's attempt to determine whether he is able to lend assistance to the transaction, as requested by corporate management, or instead must take remedial steps, cannot be determined solely by reference to the interests of the entity as a whole. This is because the acquisition will harm two of the corporate constituencies—creditors and employees—but will benefit one constituency—shareholders.

Consider now a variation of these facts. Assume that Aggressor Two emerges as a second bidder for Target and that the managers of Target demonstrably have determined to sell Target. Aggressor Two offers a per share bid for Target that is only one-half of Aggressor One's bid, but the acquisition by Aggressor Two will fully protect and perhaps enhance the interests of Target's debenture holders and workers. Aggressor Two, assume, is a very strong company that will add no leverage in the acquisition and fire no workers but instead will increase workers' salaries as it blends Target's workforce into its own.<sup>94</sup>

Management actions facilitating the acquisition by Aggressor Two, of course, will lead to an outcome that reverses the impacts on the constituencies in the preceding example, since the acquisition by Aggressor Two benefits debenture holders and workers but harms shareholders. Therefore, a lawyer asked by Target managers to lend

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93. See, e.g., Campbell, *supra* note 89, at 460-69 (offering a graphic representation of the impact of such transactions on the constituencies).

94. The example is based on the facts of *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 178 (Del. 1985), in which the board of Revlon attempted to justify its preference for a particular favored bidder by reference to the promise of that bidder to support the value of the company's debt instruments.

assistance to that transaction is once again unable to define his professional obligations by reference to the entity as a whole.

The Model Rules, however, provide assistance with these problems by referring to the law of corporations, which offers a helpful and sensible gloss for the entity theory. The gloss dictates that in transactions involving conflicts among corporate constituencies or possible managerial misconduct, the “entity” or the “client” for the corporate lawyer must be identified by reference to the interests of the corporation’s shareholders.

Specifically, both the 1983 and the 2003 versions of Model Rule 1.13(b) require that the lawyer for a corporation take remedial action if, in connection with the lawyer’s representation, an “officer, employee or other person associated with the organization” engages in a transaction “that is a violation of a legal obligation to the organization.”<sup>95</sup> For our purposes, the relevant “legal obligation” is the fiduciary duty owed by corporate managers to their corporation.

In the corporate legal literature, much has been written about the nature and the appropriate beneficiaries of managers’ fiduciary obligation to the corporation.<sup>96</sup> The core of this duty, however, is the obligation of corporate managers to act in the best interests of the company’s shareholders.<sup>97</sup> Normally, this means that corporate

95. MODEL RULES OF PROF’L CONDUCT R. 1.13(b) (1983); MODEL RULES OF PROF’L CONDUCT R. 1.13(b) (2003).

96. For a brief summary of that literature, see *supra* note 87.

97. As a positive matter—what the law is today—f we come down firmly on the side of measuring managers’ obligations by reference to the best interests of shareholders. While it is beyond the scope of this paper to offer extensive support for our position on this matter, the following distinguished commentators reach or assume similar conclusions: Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 468 (2001) (“The triumph of the shareholder-oriented model of the corporation over its principal competitors is now assured . . . . [That model has] duties to serve the interests of shareholders alone . . . . [T]he standard model of shareholder primacy has always been the dominant legal model in the . . . the U.S. . . .”); Roberta Romano, *A Cautionary Note on Drawing Lessons from Comparative Corporate Law*, 102 YALE L.J. 2021, 2031 (1993) (recognizing that U.S. corporation law seeks “to maximize shareholder welfare.”); Stephen M. Bainbridge, *Director v. Shareholder Primacy in the Convergence Debate* (2002), available at [http://papers.ssrn.com/sol3/delivery.cfm/SSRN\\_ID299727\\_code020217630.pdf?abstractid=299727](http://papers.ssrn.com/sol3/delivery.cfm/SSRN_ID299727_code020217630.pdf?abstractid=299727) (last visited Mar. 24, 2003) (“Despite occasional academic arguments to the contrary, the shareholder wealth maximization norm . . . indisputably is the law of the United States.”). For a contrary view on the positive law, see Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1203 (2002) (“The courts have chosen between the property and the entity models of the public firm, and they have opted for the latter.”).

As a normative matter, however, one of the authors is on record as favoring an expanded view of fiduciary duties, which would require corporate managers to act in a manner consistent with fiduciary duties owed to other constituencies. See Campbell, *supra* note 28, at 599-615 (arguing in favor of fiduciary duties running in favor of

managers are obligated to act in ways that maximize the wealth of corporate shareholders.<sup>98</sup>

Under the original and amended Model Rule 1.13(b), the ethical obligation of the lawyer for the corporation is derivative of this fiduciary obligation of the corporation's managers under substantive corporate law to act in the best interests of the corporation's shareholders. The Rule, therefore, as informed by the law of corporations, obligates lawyers to take remedial action if the corporate manager proposes a course of conduct that the lawyer knows is not in the best interests of shareholders.<sup>99</sup>

Using this analysis, the lawyer for the corporation in the first of our three above examples may be obliged to take remedial action in response to the senior officers' proposal to set up a special purpose entity through which they would receive unwarranted benefits from the corporation.<sup>100</sup> This conclusion is based on our assumption that these transactions transfer an unwarranted amount of corporate wealth to the senior officers and, thus, would violate the senior officers' fiduciary duty to act in the best interests of shareholders.

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corporate creditors and employees); Campbell, *supra* note 87, 55-71 (arguing in favor of fiduciary duties for creditors of corporations).

98. See, e.g., *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end.").

Although under today's laws, the obligations of corporate managers are generally judged against the best interests of shareholders and the maximization of shareholder wealth, certain carve-outs from this principle exist. See, e.g., PRINCIPLES OF CORPORATE GOVERNANCE §§ 2.01, 6.02(b)(2) (1994). Perhaps these carve-outs are best demonstrated by the right managers have to make reasonable contributions to charities even if such gifts are unconnected to maximization of shareholder wealth. See, e.g., *id.* § 2.01(b) (authorizing gifts of a "reasonable amount of resources to public welfare . . . and philanthropic purposes", even though "corporate profit and shareholder gain are not thereby enhanced"). Illustrations 19 and 20 to Section 2.01 also provide examples in which a manager makes transfer payments to employees who are to be discharged as a result of a shift in the business fortunes of the corporation. *Id.* § 2.01 illus. 19-20. Such transfer payments to employees are legally permissible as "humanitarian" even though not tied to the wealth maximization of shareholders. *Id.* The Illustrations make clear, however, that this humanitarian carve-out for employees must be reasonable and thus should not be considered as a rejection of the principle of the general obligation of managers to act in the best interests of shareholders. *Id.*

99. MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2003); MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (1983).

100. This example is very close to an Illustration provided in the Restatement in which the president of a corporate client enlists the assistance of the company's lawyer in making an unwarranted corporate gift to the president's friend. RESTATEMENT, *supra* note 30, § 96 cmt. e, illus. 1. Based on the assumption that the lawyer in the case "concludes that such a gift would cause financial harm to" the corporation, the Illustration states that the "[l]awyer may not draft the documents" necessary to facilitate the gift. *Id.*

The Model Rules also indicate that in the second example—the proposal to facilitate a highly leveraged acquisition—the lawyer would not be obliged to take remedial action. That transaction, although detrimental to both corporate employees and creditors, benefits shareholders and thus is consistent with today's corporate fiduciary duties.<sup>101</sup>

The third example—the proposal to facilitate the acceptance of a significantly inferior bid for the company's common stock—may obligate the lawyer for the corporation to take remedial steps.<sup>102</sup> This is because, under our assumptions, accepting the significantly inferior bid would be harmful to shareholders, although benefiting creditors and employees, and thus might amount to a breach of the obligation of managers to act in the best interests of shareholders.<sup>103</sup>

These three examples demonstrate the benefit of the gloss provided by the law of corporations in applying the entity theory

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101. See Campbell, *supra* note 89, at 502 (managers “not only . . . were permitted to engage in the wealth-transferring transaction [from creditors to stockholders], but also . . . were required to do so”). The article goes on to point out, however, that “courts had more trouble here.” *Id.* at 503.

102. In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985), the board of Revlon attempted to justify its preference for a particular favored bidder by reference to the promise of that bidder to support the value of the company's debt instruments. *Id.* at 181. The Court rejected that argument, stating that when “it became apparent to all that the break-up of the company was inevitable”, the duty of the Revlon board was then “to the maximization of the company's value at a sale for the stockholders' benefit.” *Id.* at 182. Obviously, this is consistent with the obligation of managers to act in the best interests of shareholders.

103. For example, the Principles of Corporate Governance state that a board of directors facing an unsolicited tender offer may deploy defensive measures “if the action is a reasonable response to the offer.” PRINCIPLES OF CORPORATE GOVERNANCE § 6.02(a) (1994). The Principles go on to state that in determining whether the action is “reasonable” the board may “have regard for interests or groups (other than shareholders) . . . if to do so would not significantly disfavor the long-term interests of shareholders.” *Id.* § 6.02(b)(2) (emphasis added).

The Restatement provides an Illustration that, unfortunately, is more confusing than enlightening on this matter. RESTATEMENT, *supra* note 30, § 131 cmt. h, illus. 6. In the Illustration, the board of Company A determines to deploy defensive tactics in order to resist an offer to acquire the company “at a price 20 percent above current market value of the stock.” *Id.* The illustration concludes that “the Board of Directors, not Lawyer [for the company] has the legal responsibility to determine whether or not [deploying defensive tactics] . . . is in the best interests of [the company]”, *id.*, which is clearly a correct statement in the sense that the board is the correct decision-maker regarding that particular matter. The Illustration continues by further concluding that a “[l]awyer may advise the Board of Directors concerning the proposed [deployment of defensive tactics]”, *id.*, and this latter statement may or may not be accurate. If the lawyer knows that the defensive tactics amount to a violation of the board's fiduciary obligations to the company's shareholders (thus amounting to “a violation of a legal obligation to the organization,” under Model Rule 1.13(b)), the lawyer is obligated to take remedial action in the best interests of the company's shareholders.

embraced by Model Rule 1.13. In each case this gloss clarifies the lawyer's professional obligation by defining the "client" or the "entity" in terms of the interests of the corporation's shareholders. The gloss also promotes a sensible outcome in transactions involving conflicts among corporate constituencies or possible managerial misconduct.<sup>104</sup>

## 2. Recognizing, Reducing, and Resolving conflicts

Even considering the interests of shareholders to be the proper focus of a corporate lawyer's loyalty under the entity theory leaves a number of problematic conflicts unresolved. First, lawyers for corporations face significant "structural" conflicts in that the source of the lawyer's economic and non-economic benefits is senior officers, whose interests may often conflict with those of shareholders.<sup>105</sup> Second, lawyers for corporations may face situations in which there are intra-shareholder conflicts, where some shareholders benefit from a corporate transaction at the expense of other shareholders.<sup>106</sup> Thus, even with a view of the entity theory properly enlightened by the law of corporations, the potential for serious conflicts confronts the transactional lawyer.

### a. Structural Conflicts

Lawyers for corporations face an inherent structural conflict because they depend on senior corporate officers for financial rewards while being obliged by ethical standards to pursue the best interests of corporate shareholders.<sup>107</sup> Thus, a corporation's lawyer

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104. In light of substantive corporate rules respecting the obligations of corporate managers, we consider it appropriate to define the professional obligations of lawyers by reference to the interests of shareholders. *See* discussion *supra* note 97. It would be chaotic and counterproductive to expand professional conduct rules to obligate the company's lawyers to act on behalf of other constituencies, such as creditors and employees, while substantive corporate rules define the obligations of corporate managers by reference to the interests of shareholders. Whatever managers' obligations are, the obligations of the lawyer for the corporation need to be parallel.

However, one of the authors is on record as favoring the expansion of corporate fiduciary duties to protect other constituencies. *See* Campbell, *supra* note 28, at 599-615 (arguing in favor of fiduciary duties running in favor of corporate creditors and employees).

105. *See* discussion *infra* Part III.A.2.a.

106. *See* discussion *infra* Part III.A.2.b.

107. Professor Cramton puts it succinctly when he notes that "[t]he managers, who hire and fire lawyers, rather than the corporate entity itself, become the client." Cramton, *supra* note 15, at 175. Professor Hazard, equally succinctly, notes that "[i]n the practicing lawyer's 'understanding,' the people they talk to in serving the client - the corporate officers, directors, and other personnel - are their clients. But the law is otherwise." Geoffrey C. Hazard, Jr., *Lawyers and Client Fraud: They Still Don't Get It*, 6 GEO. J. LEGAL ETHICS 701, 708 (1993) (emphasis in original). The Cheek Commission also notes that "the competition to acquire and keep client business, or the desire to

has a personal, financial interest in currying favor with senior managers by facilitating any corporate transaction that enhances their wealth, even if the transaction is not wealth enhancing for corporate shareholders.

Senior managers' control over a corporation's lawyer's employment is significant. Corporate counsel is almost always selected by senior officers, not shareholders. In some cases, the board may approve the selection of counsel for a particular undertaking, but in such cases it likely selects counsel proposed by senior officers. Thereafter, the pay, hours of work, additional assignments, evaluation, and, if necessary, termination of corporate counsel are normally determined by senior officers.<sup>108</sup> Pleasing senior officers, therefore, can have valuable economic and other career consequences for the corporate lawyer.

One also should not overlook the importance of non-financial relationships that in many instances bind corporate counsel to senior officers. Lawyers for the corporation and senior corporate officers work closely together and often gain respect and feelings of friendship for one another. In addition, senior officers and counsel for the corporation are often in a position to help one another in various non-financial, personal ways. Professional recommendations, access to membership in clubs, and letters of recommendation for a child seeking admission to a desirable school are all examples of the types of benefits that may flow between senior corporate officers and lawyers for the corporation and that enhance the bond that often develops between them.

Enron, as the facts have so far been reported, provides a vivid example of lawyers mired in this sort of deep structural conflict and the way the conflict can be manipulated by senior officers. A *Wall Street Journal* article<sup>109</sup> describes a web of economic and non-

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advance within the corporate executive structure, may induce lawyers to seek to please the corporate officials with whom they deal rather than to focus on the long-term interest of their client, the corporation." *Cheek Commission Final Report, supra* note 9, at 14-15.

108. In our experience as law professors, lawyers, and members of corporate boards, the board of directors typically exercises little or no control over the selection of counsel. Certainly this is true in the selection of day-to-day matters requiring legal counsel. In infrequent instances involving special situations, however, the board may be made aware of or even approve the lawyer or law firm retained by the company. Examples of these situations may include counsel retained to advise the company in the face of an unsolicited takeover bid or regarding a large public offering. Even in these instances, however, it is likely that the board will choose counsel recommended by senior officers and then essentially leave it to senior officers to deal with evaluation, use, and, if required, termination of counsel. In all events, therefore, our experience suggests that senior managers essentially control the economic fate of the corporation's lawyers.

109. Pollock, *supra* note 17, at A1.



economic relationships, which included annual legal fees paid to the law firm in the tens of millions of dollars<sup>110</sup> and friendships and mutual interests shared among the senior officers of Enron and the senior partners in the company's law firm.<sup>111</sup> The same article also reports the pressures certain senior managers put on the company lawyers to facilitate transactions that effected wealth transfers from shareholders to the senior officers.<sup>112</sup> These transactions may have violated Enron's own conflict of interest policies and transferred millions of dollars in wealth to the senior officers at the expense of shareholders and other constituencies.<sup>113</sup>

Situations such as Enron and the other recent high visibility cases involving unchecked, egregious management misconduct<sup>114</sup> may

110. "Enron was . . . [the firm's] biggest client, pouring roughly \$35.6 million into the firm's coffers in 2001, 7.8% of its revenue." *Id.*

111.

The firm's partners and Enron were intertwined in Houston's corporate community. They shared causes ranging from the United Negro College Fund to electing George W. Bush. . . . [Enron's CEO and his wife] traveled the Houston social and charity circuit with [the law firm's managing partner] and his wife . . . . The friendship dated from a case [the law firm's managing partner] . . . handled in 1976 for a [former employer of the Enron CEO].

*Id.*

112. *Id.*

113. See Kathryn Kranhold & Mitchell Pacelle, *Enron Paid Top Managers \$681 Million, Even as Stock Slid*, WALL ST. J., June 17, 2002, at B1; Pollock, *supra* note 17, at A1.

114. The popular and financial press has reported extensively on these situations. See David Armstrong & Laurie P. Cohen, *Tyco Is Pressing For Repayment Of Loans, Bonuses*, WALL ST. J., Sept. 17, 2002, at A3 (describing the attempts of Tyco shareholders to compel executives to repay benefits received during the tenure of a former CEO and were allegedly not authorized); James Bandler & Jerry Guidera, *Tyco Ex-CEO Threw \$2.1 Million Party for Wife*, WALL ST. J., Sept. 17, 2002, at A6 (describing that half of the expenses for a \$2.1 million birthday party for the wife of a former Tyco CEO were paid by the company); Charles Gasparino, *et al.*, *Salomon Made IPO Allocations Available to Ebbers, Others*, WALL ST. J., Aug. 28, 2002, at A1 (describing allegations of wrongdoing against the former CEO and CFO of Worldcom); Mark Maremont & Jerry Markon, *Former Tyco Executives Are Charged - New York Prosecutors Say Ex-CEO, Finance Officer Ran 'Criminal Enterprise'*, WALL ST. J., Sept. 13, 2002, at A3 (describing allegations of wrongdoing against the former CEO and CFO of Tyco); Mark Maremont & Laurie P. Cohen, *Interior Design On a Budget—The Tyco Way*, WALL ST. J., Sept. 18, 2002, at B1 (describing that the former CEO of Tyco charged the company for decorations and furnishings for his apartment for which there was no business justification); Jerry Markon & Robert Frank, *Five Adelphia Officials Arrested on Fraud Charges—Three in the Rigas Family, Two Other Executives Held, Accused of Massive Looting*, WALL ST. J., July 25, 2002, at A3 (describing allegations of wrongdoing against former senior managers of Adelphia); Julie Rawe, *Heroes to Heels*, TIME, Jun. 17, 2002, at 48 (outlining alleged improprieties of executives of Tyco, Enron, Global Crossing and Adelphia); Jared Sandberg & Deborah Solomon, *Key Officials At WorldCom Going to the Hill*, WALL ST. J., July 8, 2002, at A17 (describing allegations of wrongdoing against the former CEO of Worldcom).

by themselves make the case for reducing the structural incentives for corporate lawyers to pursue the interests of managers at the expense of shareholders. The problem, however, is much deeper than a few bad situations involving large corporations.

Structural conflicts are not limited to large corporations, such as Enron. Instead, a structural conflict arises any time corporate agents, rather than the corporation's owners, control the selection and compensation of corporate counsel. Even in small, closely held corporations, senior officers, and not the shareholders, typically select and monitor corporate counsel.

In addition, the types of transactions that pit the interests of senior officers against those of shareholders are not limited to extreme, morally charged situations, such as those reported from the Enron debacle. Instead, any corporate transaction that may realign the allocation of corporate control or wealth may pit the interests of senior officers against the interests of shareholders and thus pose a conflict for corporate counsel. Such transactions, of course, are common. The highly visible issue of senior officer compensation comes to mind. Senior officers, one assumes, want lucrative salary arrangements, generous perquisites, and large amounts of incentive-based compensation, and such interests may conflict with the interests of shareholders, who would be expected to want more modest compensation arrangements for the officers.<sup>115</sup> Another common example is a hostile takeover bid that offers an attractive premium to shareholders but moves control of the corporation into the hands of new managers.<sup>116</sup> A more subtle example may involve moving a corporation's charter from a state with constitutionally

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115. For example, it is reported that Dennis Kozlowski, former CEO of Tyco who is presently under federal indictment, received a total of \$97 million "in cash, restricted stock and other compensation, and has made \$240 million in paper profits by exercising stock options" over the past three fiscal years. Mark Maremont & John Hechinger, *Questioning the Books: Tyco Stock Rises in Huge Volume as Executives Vow to Buy Shares*, WALL ST. J., Jan. 31, 2002, at A8. Likewise, ousted CEOs and the Boards of Directors from Adelphia and WorldCom have drawn fire for the lucrative severance packages awarded to departing CEOs, even as they left their respective companies in various degrees of turmoil. Joann S. Lublin & John Hechinger, *Forced Exits Can Pay Richly for Some CEOs*, WALL ST. J., June 5, 2002, at B1. Finally, although certainly not involved in any of the corporate scandals that have rocked a number of companies, General Electric's generous retirement package for its retiring CEO, Jack Welch, has also attracted media attention recently. Matt Murray, *SEC Investigates GE's Retirement Deal With Jack Welch*, WALL ST. J., Sept. 17, 2002, at B1.

116. Courts have recognized that managers faced with hostile bids may be conflicted by their desire to maintain control of their corporation. *See, e.g.*, *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (stating that a board fighting off an unsolicited bid raises "the omnipresent specter that [it] may be acting primarily in its own interests, rather than those of the corporation and its shareholders").

mandated cumulative voting<sup>117</sup> to a state without mandatory cumulative voting,<sup>118</sup> as a way to make it harder for insurgents to gain a foothold on the corporation's board.

These examples demonstrate that the implications of the structural conflict in which lawyers for corporations find themselves go well beyond the few egregious cases so far reported in the financial press. The elements of the structural conflict exist in nearly all corporations, and the conflict becomes troublesome in any transaction that involves the allocation of corporate wealth or control. One should not, therefore, consider Enron a case in which some unusual confluence of events subjected lawyers to pressures that are unlikely ever to occur again.

We propose a structural remedy for this structural conflict. The responsibility for the selection of the corporation's lawyer should be moved into the hands of a decision-maker that better represents the interests of shareholders. The most appropriate corporate decision-maker for that responsibility is the corporation's independent audit committee.

The wide-spread use of audit committees is a relatively new occurrence.<sup>119</sup> It grew out of the recognition that auditors could not be counted on to be independent and aggressive in their audit if they were selected by or under the control or influence of senior management. After all, auditors are expected to investigate the performance of senior management and report the results of that investigation to the owners of the corporation. As a result, many corporations, encouraged by the Securities and Exchange Commission and listing requirements of securities exchanges, established audit committees of the board of directors to select or recommend the corporation's auditor and be available to work with

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117. Kentucky, for example, until recently had a constitutional provision mandating cumulative voting. KY. CONST. § 207 (repealed 2002) (requiring cumulative voting in all elections for corporate directors); KY. REV. STAT. ANN. § 271B.7-280 (Michie 1989) (implementing KY. CONST. § 207). In November, 2002, Kentucky amended its constitution to eliminate mandatory cumulative voting, KY. CONST. § 207 (Michie Supp. 2003), and the Kentucky General Assembly amended sections 271B.7-280 of the Kentucky Code to establish straight voting for corporate directors, unless the corporation's articles of incorporation provide for cumulative voting. KY. REV. STAT. ANN. § 271B.7-280 (Michie Supp. 2003).

118. Delaware is an example of a state without mandatory cumulative voting. See DEL. CODE ANN. tit. 8, § 214 (2001) (permitting non-cumulative voting).

119. See, e.g., Helen S. Scott, *The SEC, the Audit Committee Rules, and the Marketplaces: Corporate Governance and the Future*, 79 WASH. U. L.Q. 549, 551-57 (2001) (reporting that the SEC's interest in promoting audit committees goes back to the 1940s, but that it was only in the 1970s that self-regulatory organizations, encouraged by the SEC, first required audit committees as a listing requirement).

the auditor on financial matters growing out of the audit.<sup>120</sup> The obvious theory of the independent audit committee was to eliminate the conflict under which auditors labored when they were selected by senior officers.<sup>121</sup>

We find sufficient similarities between the independent auditors and the lawyers for a corporation to support our recommendation that the audit committee should select the company's lawyers.<sup>122</sup> Both the company's auditors and lawyers are assigned important roles in protecting the constituency of primary concern—the shareholders of the corporation.<sup>123</sup> Also, both are exposed to untoward pressures, if we allow managers to control the selection and monitoring of these two gatekeepers. Notwithstanding the efforts of honest and decent auditors and lawyers, it becomes more difficult for them to perform their duties vigorously on behalf of their corporate clients if they can be fired by managers with economic interests that are not always aligned with the interests of those clients. For the benefit of shareholders, society, and even the professionals involved, we recommend an enhanced utilization of the audit committee as a way

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120. Ira M. Millstein, *Introduction to the Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, 54 BUS. LAW. 1057, 1062 (1999) ("By the mid-1970s, the SEC had solidified its view that some independent internal board mechanism was needed to ensure accountability of management."); *id.* at 551 ("It was, in large measure, with the Commission's encouragement, for instance, that the self-regulatory organizations first adopted audit committee requirements in the 1970s.").

121. See, e.g., *The Overview Committee of the Board of Directors: A Report by the Committee on Corporate Laws*, 34 BUS. LAW. 1837, 1861 (1979) (describing a limited version of the purpose of the audit committee as "providing an opportunity for direct communication with the Board of Directors by the corporation's independent auditors, thereby tending to strengthen their independence and objectivity"); see also Edward F. Greene & Bernard B. Falk, *The Audit Committee—A Measured Contribution to Corporate Governance: A Realistic Appraisal of Its Objectives and Functions*, 34 BUS. LAW. 1229 (1979) (discussing the duties and objectives of the audit committees); see generally Charles B. Tomm, *Director and Audit Committee Responsibilities Relating to Perquisites*, 36 WASH. & LEE L. REV. 83 (1979) (discussing the role and responsibilities of the audit committees).

122. In its Final Report, however, the Cheek Commission states:

The Task Force acknowledges that lawyers for the corporation—whether employed by the corporation or specially retained—are not "gatekeepers" of corporate responsibility in the same fashion as public accounting firms. . . . The auditor is subject to standards designed to assure an arm's length perspective relative to the firms they audit. In contrast, as several commentators pointed out in the public hearings on the Preliminary Report, corporate lawyers are first and foremost counselors to their clients.

*Cheek Commission Final Report*, *supra* note 9, at 22-23. We disagree with any suggestion that lawyers for corporations are not to act as gatekeepers on behalf of the best interests of the shareholders of the corporation they represent.

123. The corporation's auditors and its lawyers also both play a correspondingly important role in protecting society itself.

to ameliorate pernicious pressures<sup>124</sup> on these important corporate gatekeepers.<sup>125</sup>

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124. We appreciate that our prescription is not a complete remedy in all cases. Audit committees are only as effective as their members and, especially, their chair. Thus, our prescription will be ineffective if the audit committee and its chair abdicate their obligations in favor of senior management. As the Cheek Commission notes, even outside directors sometimes defer too much to senior executive officers in selecting professional advisers, *Cheek Commission Final Report, supra* note 9, at 25-26, a product of the "culture of passivity" on many corporate boards of directors. *Id.* at 27. Also, in selecting and evaluating counsel, the audit committee will have to depend to some extent on input from senior management. For example, in determining whether to retain last year's counsel for the next year, the audit committee should seek an evaluation from senior management as to the quality of the counsel's work last year. Thus, corporate counsel will continue to have some incentive to please senior management.

We do not consider these problems sufficient bases to reject our proposal. Most importantly, many audit committees and their chairs will treat these responsibilities seriously and fulfill their obligations in a meaningful fashion. In such cases, the committee, although soliciting input from senior management, will retain control over the lawyers and significantly change the otherwise misaligned incentives of the company's lawyers. Perhaps we might expect corporate boards of directors to "abandon the passive role many have been content to play, and replace it with a new culture stressing constructive skepticism and an active, independent oversight role," as the Cheek Commission hopes, *id.* at 29, in the post-Enron corporate environment.

We also observe that both issues—possible audit committee abdication of responsibilities and contamination from senior officer evaluation input—are present when the audit committee selects the company's auditors. We doubt that anyone would seriously argue at this point that these problems support allowing senior management to select auditors.

125. We anticipate objections to this solution, some of which will undoubtedly be based on practical considerations. We are of the view, however, that if a company's audit committee focuses on the underlying policy supporting our prescription—which is to remove the economic incentives that lawyers have to facilitate transactions that are not in the best interests of shareholders—thoughtful and involved audit committees can develop procedures that will allow them to fulfill their obligations efficiently and in a manner that is consistent with their duty of care.

Consider for example, an extreme situation in which a large insurance company has hundreds of lawyers throughout the world representing it in litigation. In these circumstances, the audit committee, consistent with its duty of care, would be expected to exercise less hands-on management of these trial lawyers, since the cases may often involve relatively small matters. More importantly, these are not the types of transactions in which the self-interests of managers diverge dramatically from those of shareholders. In such instances, the audit committee could appropriately delegate to the company's internal legal department the responsibility to propose law firms, monitor their work, and report to the audit committee.

On the other hand, the audit committee should itself be directly involved in the selection and monitoring of lawyers representing the company in major transactions and in securities matters. In these transactions, senior managers may have interests that do not necessarily track the interests of shareholders. Examples of such transactions would include SEC periodic reporting and proxy solicitation under the 1934 Act, significant financing transactions, corporate reorganizations, freezeout transactions, and defending against unsolicited takeover bids. It is in transactions

We suggest that audit committees be delegated the responsibility of selecting the company's lawyer as a means to reduce the conflict that corporate lawyers face when they are hired, evaluated and, at times, fired by corporate managers.<sup>126</sup> We recognize, however, that this change would not entirely erase the structural conflict, just as auditors' conflicts are not erased by audit committee selection. It would be naive to think that such a change would overcome such persistent pressures.

Ultimately, we must hope, as we do with lawyers generally, that corporate lawyers are able to resist the substantial personal interests that can affect their independent professional judgment in representing clients. We believe, however, that the analogy to auditors and thus the argument in favor of moving control of the corporation's lawyers to the audit committee are compelling, especially if we are seeking more independence of lawyers for

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such as these that managers may, contrary to the best interests of shareholders, have an interest in restricted information flows or constructing outcomes that transfer wealth to themselves or other favored constituencies.

While one should be wary of a one-size-fits-all approach to procedures to be used in selection of the company's lawyers, audit committees under our proposal could select the company's law firms annually and could handle the task similarly to the way it selects the company's auditors. Thus, late in the year, the committee could meet to select the firms that will, for example, handle the company's transactional work for the next year, and, in the case of our insurance company example in the prior paragraph, the committee could select firms that will handle litigation matters for the year. We, certainly, would propose no requirement that the committee bid out the work each year. Instead, the selection procedure would be a matter of the business judgment of the committee. Obviously, the committee would want to examine the quality and quantity of the firm's last year's work, if the choice were to continue with the same firm for the upcoming year. The committee would also want to keep its hands around fees and to monitor the amount and quality of the work undertaken during the upcoming year.

126. The Cheek Commission proposed what we consider an overly modest solution for the structural conflict faced by lawyers for corporations. Their prescription is for the company's general counsel to establish a "direct line of communication" with the company's lawyers "through which these lawyers are to inform the general counsel of . . . violations of law . . . and breaches of fiduciary duty." The general counsel, in turn, is to meet "regularly . . . with a committee of independent directors to communicate concerns regarding legal compliance matters, including . . . violations of law . . . and breaches of fiduciary duty." *Cheek Commission Final Report, supra* note 9, Recommended Policies of Corporate Governance 7, at 32.

We consider this a decidedly inferior prescription for the structural conflict we identify. Lawyers for the company, under the Cheek Commission proposal, still depend on senior management for their financial rewards. We find little progress in merely assigning another member of senior management—the general counsel—responsibilities to monitor lawyers for the company and report potential misconduct to independent directors. Only by moving the control over the lawyers' rewards away from senior management can we remove the structural pressures that make it difficult for corporate lawyers to align themselves with the best interests of their corporate clients as reflected in the best interests of the shareholders.

corporations. If more is to be expected of corporate lawyers as gatekeepers in protecting the interests of shareholders and society, the structural conflict under which transactional lawyers for corporations labor must be recognized, confronted, and reduced.

### b. Intra-Shareholder Conflicts

The gloss that, we suggest, the law of corporations gives to the entity theory—that the best interests of the entity should be equated with the best interests of shareholders—is helpful in illuminating the lawyer's responsibilities when the corporate client proposes actions that affect the corporate constituencies differently. When the proposed corporate action creates conflicts within the shareholder constituency itself, however, this gloss does nothing to resolve the dilemma created for the corporation's lawyer. Two examples of common transactions fitting this pattern demonstrate the problem.

The first situation, already relied upon above,<sup>127</sup> involves a transaction in which Aggressor proposes to acquire all the common stock of Target at two times its market value in a highly leveraged transaction. If we now assume that Target also has outstanding preferred stock that will not be exchanged or purchased in the acquisition,<sup>128</sup> the preferred shareholders will likely face a decrease in the market value of their stock as a result of the additional leverage.<sup>129</sup> Under these assumptions, the transaction benefits common shareholders but harms preferred shareholders, thus placing the interests of the two groups of shareholders in conflict.<sup>130</sup>

A second problematic situation is presented when the majority shareholders of a corporation, with the help of the majority's

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127. See *supra* text accompanying note 93.

128. That is, the preferred shareholders will continue as investors in Target following the acquisition of all the common stock of Target by Aggressor.

129. See, e.g., *Dart v. Kohlberg, Kravis, Roberts & Co.*, 1985 WL 21145 (Del. Ch. 1985). KKR Associates was to acquire all the common stock of Amstar in a highly leveraged acquisition that left the preferred stockholders of Amstar outstanding but subject to the prior claims of the new debt generated by the transaction. *Id.* at \*2. Preferred shareholders sued, and the Chancery Court held that their complaint stated a cause of action. *Id.* at \*5. The court first observed that "the public preferred stockholders were left holding their shares in a corporation which, as a result of the transaction, has a much greater debt and therefore perhaps a lessened ability to pay preferred dividends." *Id.* The court concluded that "plaintiff has a cause of action . . . as to the allegations which attack the leveraged buy-out and its effect on the preferred stockholders." *Id.*

130. For an example of such a situation in which conflicts arise between the interests of preferred and common shareholders, see *Bowman v. Armour & Co.*, 160 N.E. 2d 753, 757-58 (Ill. 1959), in which an amendment to the articles of incorporation changed the redemption right of preferred shareholders. See *Bove v. Cmty. Hotel Corp. of Newport, R.I.*, 249 A.2d 89, 91-92 (R.I. 1969) (affiliated merger changing preferred shares into common shares).

nominees on the board of directors, propose a freezeout of the corporation's minority shareholders at an unfairly low price and ask the company's lawyer to lend assistance to the deal. In this case, the transaction benefits majority common shareholders and harms minority common shareholders.<sup>131</sup>

It is apparent that both of these situations involve conflicting interests within the company's shareholder constituency and that this conflict renders our suggested general principle, equating the best interests of the entity and the best interests of shareholders, unhelpful in guiding the lawyer's behavior. At the same time, the lawyer faced with these situations must keep in mind two additional concerns involving the professional responsibility of those representing corporations. First is the concern about lawyers' engaging in multiple representations.<sup>132</sup> Second is the restriction on a corporate lawyer's providing assistance to a manager's breach of fiduciary duty to the corporation.<sup>133</sup>

As to the first concern, the specter of the lawyer representing multiple parties with conflicting interests in these two situations underscores the functional value of the entity theory. Even though the interests of shareholders should normally be equated with the entity's interests, if the concept of corporate representation is to continue, the shareholders themselves cannot be treated as the lawyer's clients. In addition to disrupting the doctrinal resolution of several other issues pertinent to legal representations,<sup>134</sup> doing so would present frequent, insoluble instances of multiple representations in situations similar to the two under discussion.<sup>135</sup>

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131. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (discussing freezeout in which minority shareholders claimed they received unfair treatment).

132. MODEL RULES OF PROF'L CONDUCT R. 1.7, 1.9 (2003).

133. This restriction is provided in the original and the 2003 amended version of Model Rule 1.13(b). MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (2003); MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (1983).

134. For a discussion of other areas of law that are aided by the entity theory of conceptualizing the organizational client, see *supra* text accompanying notes 32-34.

135. It is not difficult to illustrate the complexities the lawyer would face in these two situations if we were to consider the corporate lawyer's clients to be the shareholders themselves. Since in both scenarios the interests of some shareholders are directly adverse to the interests of other shareholders, if the shareholders were viewed as the lawyer's clients, the dictates of Model Rule 1.7 would come into play. Under that rule, to continue representing the shareholders as clients under these circumstances, the lawyer would be required to believe reasonably that she could competently and diligently represent each group of shareholders (both the preferred and common shareholders in the first situation and the majority and minority common shareholders in the second). MODEL RULES OF PROF'L CONDUCT R. 1.7(b)(1) (2003). In addition, the lawyer would have to obtain and have confirmed in writing the consent of both groups of shareholders to continue the multiple representation. *Id.* R. 1.7(b)(4). Setting aside the question of how the lawyer would go about obtaining such consent



In situations involving intra-shareholder conflicts, the entity theory allows the lawyer to surmount concerns about multiple representation. Even if we generally equate the best interests of the entity with the best interests of the shareholders broadly, treating the entity as the client allows the lawyer to continue the representation despite the conflicting interests of the two groups of shareholders. At the same time, the entity theory also permits an application of the concepts of attorney-client privilege and confidentiality that allows the lawyer to use information relating to the representation even if it may harm the interests of some shareholders.<sup>136</sup> As a result of the entity theory, therefore, in following the directions of the managers lawfully authorized to speak for the corporation, the lawyer is free to continue the representation despite its negative effect on some shareholders. Thus, using the first of our two examples, the lawyer is not in a conflict situation when lending assistance to the highly leveraged acquisition, since the lawyer's client is the corporation, not the preferred shareholders. Similarly, in the second example, the lawyer is viewed as representing only the corporation and not majority or minority

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and how unlikely it would be for the shareholders to grant that consent if it could be sought practically, it is difficult to see how the lawyer could make the determination that her relationship with one group would not adversely affect the competence and diligence in her representation of the other. *Id.* R. 1.7(b)(1); 1.7(b)(4). This would mean that the lawyer could not ethically represent both groups of shareholders in these two situations. The comment to Model Rule 1.7 also deals with the situation in which a conflict arises mid-stream, and it states that in that case "the lawyer ordinarily must withdraw from the representation, unless the lawyer has obtained the informed consent of the client." *Id.* R. 1.7 cmt. 4.

Further, if the lawyer were to make this determination properly and decide to withdraw from the representation of one of the groups of shareholders in these situations (say, the preferred shareholders in the first situation and the minority common shareholders in the second), the lawyer would also need to follow the requirements of Model Rule 1.9(a) in continuing the representation of the other group of shareholders. Since the lawyer would be continuing the representation against her now former clients (the abandoned preferred shareholders or minority common shareholders), the lawyer would be required to obtain the consent of those former clients. *Id.* R. 1.9(a). The Comment, in conjunction with Rule 1.9(a), goes on to permit the lawyer who withdraws because of the occurrence of a mid-stream conflict, to continue to represent one of the parties only if "the former client gives informed consent, confirmed in writing. *Id.* R. 1.9(a). Again, the practical barriers to and the unlikely success in obtaining this consent make the continued representation by the lawyer inappropriate. Thus, if we were to treat the shareholders themselves as the lawyer's clients, she would have to resign from the representation entirely once the conflict between shareholders developed. Furthermore, any other lawyer hired to represent the corporation would face the same difficulty.

136. For a brief discussion of the concepts of privilege and confidentiality in corporate representation, see *supra* note 33.

common shareholders.<sup>137</sup> Defining the lawyer's duty by reference to the corporate entity as a whole, therefore, leads to a workable and an appealing outcome because it permits the representation of the corporation in the transaction despite the conflicting interests of groups of shareholders resulting from its representation.

This brings us, however, to the second professional concern the corporate lawyer must address in these conflict situations. While the lawyer may surmount the professional problems associated with multiple representation, he still must be concerned about the potential for the managers' breach of their fiduciary duty to the corporation. For the lawyer, this is a matter of professional ethics under Model Rule 1.13(b)<sup>138</sup> and of potential civil liability as well.<sup>139</sup> The lawyer may be free to advise and assist the managers proposing the recapitalization or the freezeout, but in order to avoid these twin difficulties he must be sure that he is mindful of the managers' duties of care and loyalty to the shareholders who are negatively affected.

The legal duty owed by the managers to the shareholders thus becomes important in determining the professional duty of the lawyer. The freeze-out of minority shareholders, described above,<sup>140</sup>

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137. This conclusion is supported variously. Perhaps most directly and importantly, both the original and amended versions of Model Rule 1.13 state that a lawyer for a corporation "represents the organization acting through its duly authorized constituents." MODEL RULES OF PROF'L CONDUCT R. 1.13(a) (2003); MODEL RULES OF PROF'L CONDUCT R. 1.13(a) (1983). The Comment to both versions of that rule deals with the situation in which the

organization's interest . . . become[s] adverse to those of one or more of its constituents. In such circumstances, the lawyer should advise any constituent, whose interest the lawyer finds adverse to that of the organization of the conflict . . . that the lawyer cannot represent such constituent, and that such person may wish to obtain independent representation.

MODEL RULES OF PROF'L CONDUCT R. 1.13 cmt. 10 (2003); MODEL RULES OF PROF'L CONDUCT R. 1.13 cmt. 7 (1983). The Restatement also states that a lawyer "represents the interests of the organization" and that this "entity' theory of organizational representation . . . is now universally recognized in American law." RESTATEMENT, *supra* note 30, § 96 cmt. b. The Restatement also speaks of the obligation of the lawyer to "proceed in what the lawyer reasonably believes to be the best interests of the organization." *Id.* cmt. f. Further, the Restatement pointedly notes that "[a] lawyer representing only the organization has no duty to protect one constituent from another, including from a breach by one constituent of such fiduciary duties, unless the interests of the lawyer's client organization are at risk." *Id.* cmt. g.

138. As discussed above, under that rule a lawyer for a corporation is required to take remedial action when a manager's proposed action will violate a duty to the corporation. See *supra* text accompanying notes 47-57.

139. By assisting managers' breach of fiduciary duties, the lawyer could become liable as well. See *Lawyers' Manual, supra* note 12, at 91:2005.

140. See *supra* text accompanying note 131.

illustrates this point. Were they to be challenged, the actions of managers in proposing and facilitating this transaction would likely be judged under the fiduciary standard of "intrinsic fairness", which includes not only the component of fair price but also that of fair dealing.<sup>141</sup> Managers meet their fair dealing obligations by establishing procedures that ensure fair treatment of minority shareholders. In applying this standard, courts typically are interested in whether minority shareholders are protected by independent negotiating committees and receive free flow of all material information and appropriate professional assistance, such as that from investment bankers. Failure by the managers to establish such procedures of fair dealing may cause a court to find a breach of the managers' duty of loyalty, a component of their fiduciary duties to the corporation. A lawyer who fails to recognize this and assists with the transaction faces possible professional discipline and potential civil liability as well.<sup>142</sup>

Under an application of our suggested gloss to the entity theory, in which the entity's interests are equated with the best interests of the shareholders, the corporate lawyer must remain alert to conflicts within the shareholder constituency. In the face of such conflicts, the entity theory permits the lawyer to continue to represent the corporation and to further transactions that favor the interests of some shareholders over the interests of others. The lawyer must be vigilant in protecting the fiduciary rights of all the shareholders, however, and must be cautious about transactions that would violate the legal obligations of managers to those shareholders. This again takes us to proposed transactions that appear to go too far.

### *B. Protecting the Client and Society from Managers' Misconduct*

As discussed above,<sup>143</sup> the Model Rules recognize that a lawyer representing a corporation may face situations involving inappropriate conduct by corporate managers.<sup>144</sup> While lawyers are generally expected to comply with directions from managers as the duly authorized agents of the corporation,<sup>145</sup> both the 1983 and 2003 versions of Model Rule 1.13(b) direct the lawyer to take remedial

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141. See *Weinberger*, 457 A.2d at 703 (holding that the merger did not satisfy the intrinsic fairness test).

142. See *supra* notes 138-39.

143. See discussion *supra* Part II.A.2.

144. Corporate managers include officers and other managerial employees and thus are included among the persons about whose actions lawyers must be concerned under that rule. MODEL RULES OF PROF'L CONDUCT R. 1.13 cmt. 1 (2003); MODEL RULES OF PROF'L CONDUCT R. 1.13 cmt. 1 (1983).

145. See *supra* notes 39-42 and accompanying text.

action when misconduct by the managers or agents is sufficiently severe.<sup>146</sup>

If the corporate lawyer is to serve as a gatekeeper for his client's conduct, however, the duty encompassed in Model Rule 1.13(b) is inadequate. It demands too high a level of certainty before the lawyer has a duty to act to protect the best interests of the corporate entity, which the law of corporations equates with the interests of the shareholders. It also narrows the duty to act in other ways that undermine the role of lawyers as effective gatekeepers of corporate conduct.

### 1. The Lawyer's Knowledge of Wrongdoing

Under the 1983 version of Model Rule 1.13(b) a lawyer is required to act to protect the interests of the corporation when she "knows" that the actions of a corporate manager violate a legal obligation to the corporation.<sup>147</sup> Under the "terminology" portion of the Model Rules, the term "knows" refers to "actual knowledge of the fact in question," although "knowledge may be inferred from circumstances."<sup>148</sup> Thus the Model Rules eschew an objective standard in such cases,<sup>149</sup> opting instead to judge the propriety of the lawyer's conduct under a subjective, actual knowledge standard.<sup>150</sup>

146. See *supra* notes 47-57 and accompanying text.

147. MODEL RULES OF PROF'L CONDUCT R. 1.13(b) (1983). Nothing in the Model Rules prohibits or discourages a corporate lawyer from taking the same sort of remedial action even when she is not certain about the constituent misconduct she fears. Indeed, the comments to the 2003 amendment to Model Rule 1.13 expressly note:

Even in circumstances where a lawyer is not obligated by Rule 1.13 to proceed, a lawyer may bring to the attention of an organizational client, including its highest authority, matters that the lawyer reasonably believes to be of sufficient importance to warrant doing so in the best interest of the organization.

MODEL RULES OF PROF'L CONDUCT R. 1.13 cmt.4 (2003). While permissible under the Rules, we might expect that practical realities of the representation of corporate clients probably render such voluntary action unlikely. For purposes of this article, our focus is on the lawyer's *duty* to act as a gatekeeper, not the lawyer's freedom to do so.

148. MODEL RULES OF PROF'L CONDUCT R. 1.0(f) (2003) (defining "knowingly," "known," or "knows."). This definition was also used in the original version of the Model Rules. MODEL RULES OF PROF'L CONDUCT, Terminology (1983).

149. Section 96(2) of the Restatement also contains a "knows" standard for when the lawyer must take remedial steps in the face of a breach of a fiduciary duty by a corporate manager, but Comment e to that Section suggests a negligence standard. RESTATEMENT, *supra* note 30, § 96 cmt. e ("The lawyer . . . must not knowingly or negligently assist any constituent to breach a legal duty to the organization.") (emphasis added).

150. A "knows" or "actual knowledge" standard is generally considered a subjective standard and is not measured by reference to an objective criterion. For example, Section 102(a) of the Revised Uniform Partnership Act states that one "knows a fact if

This subjective standard in Model Rule 1.13(b) was recently the subject of scrutiny by the American Bar Association. That organization's Task Force on Corporate Responsibility, the so-called Cheek Commission, recommended a change from the subjective standard in the 1983 version of Model Rule 1.13 to an objective standard.<sup>151</sup> Unfortunately, the ABA in its August 2003 revision of Model Rule 1.13 rejected the objective standard proposed by the Cheek Commission.<sup>152</sup> As a result, Model Rule 1.13(b) continues to obligate the lawyer for a corporation to take remedial steps only if the lawyer "knows" that the actions of a manager violate his legal obligations to the corporation.

In January 2003, the Securities and Exchange Commission, acting under the Sarbanes-Oxley Act,<sup>153</sup> adopted an objective standard in its new rules applicable to lawyers who practice before the Commission.<sup>154</sup> The SEC's rules require those lawyers to take remedial action in instances where "it would be unreasonable" for the lawyer "not to conclude that it is reasonably likely" that a violation of

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the person has actual knowledge of it." UNIF. P'SHIP ACT § 102(a) (1997). A Comment adds the following: "[k]nowledge is cognitive awareness." *Id.* In an article that became the foundation for some of the early works discussing the "scienter" requirement under Rule 10b-5, Professor Page Keeton discussed the culpability predicate for misrepresentation: "it has been said that knowledge on the part of the misrepresenter of the falsity of his statement is a prerequisite to recovery. This is often taken to mean that he must at least believe that the fact asserted to exist does not." Page Keeton, *Fraud: The Necessity for an Intent to Deceive*, 5 UCLA L. REV. 583, 589 (1958).

151. The Cheek Commission's Preliminary Report recommended that Model Rule 1.13(b) be amended to require remedial actions by a lawyer when she "knows or reasonably should know" of misconduct. *Cheek Commission Preliminary Report*, *supra* note 9, at 204. The Commission's recommendation of such an objective standard received opposition. *See, e.g., ACCA Submission*, *supra* note 10, at 5. The American Corporate Counsel Association, for example, objected to the Cheek Commission's proposal, contending that the change will "shift the lawyer's attention away from healthy participation and inquiry into the client's day-to-day actions by mandating a new role for corporate counsel as a full-time in-house investigator." *Id.* The ACCA also predicted such an objective standard will cause corporate clients to be less welcoming of lawyer "participation on the management team." *Id.* at 6. The Cheek Commission's Final Report revised but continued to propose an objective standard by recommending that a lawyer be required to act under Model Rule 1.13(b) when she "knows facts from which a reasonable lawyer, under the circumstances, would conclude" that misconduct was occurring. *Cheek Commission Final Report*, *supra* note 9, at 42-44, 82.

152. For a description of the ABA House of Delegates' consideration of the proposed amendments to Model Rule 1.13, see Lawyers' Manual, *supra* note 12, 19 Current Reports 467-69 (Aug. 13, 2003).

153. § 307, 115 Stat. at 375.

154. Final Rule: Implementation of Standards of Prof'l Conduct for Attorneys, Securities Act Release No. 33-8185, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,823, at 87,069 (Jan. 29, 2003), available at <http://www.sec.gov/rules/final/33-8185.htm>.

securities laws or fiduciary duties has or is about to occur.<sup>155</sup> Thus, the Commission will hold securities lawyers to an objective standard, while the American Bar Association has refused to do so.

In light of Enron and other corporate debacles, the actual knowledge standard of Model Rule 1.13(b) is an overly lax, inappropriate measure of a lawyer's obligation to protect the interests of his client.<sup>156</sup> While we support a move to a more rigorous, objective standard, the standard we articulate differs somewhat from that used in the Commission's Sarbanes-Oxley rules or proposed by the Cheek Commission.

To illuminate our criticisms of the actual knowledge criterion as the proper measure of a lawyer's conduct, consider the impact of the standard in the context of an illustration from the Restatement in which the lawyer for the corporation is requested by the corporation's president to lend assistance to an unwarranted corporate gift to a friend of the president.<sup>157</sup> Assume that the lawyer incorrectly concludes that the gift does not amount to a violation of the president's fiduciary duties to the corporation, takes no remedial action, and lends assistance to the transaction. In such circumstances, the lawyer's conduct does not violate the actual knowledge standard of Model Rule 1.13(b), even if the lawyer's incorrect conclusion is inconsistent with ordinary care or, indeed, even if the lawyer's incorrect conclusion is so unreasonable as to amount to an extreme deviation from ordinary care, a common

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155. *Id.* A lawyer subject to the Commission's rule is obligated to take remedial action when he "becomes aware of evidence of a material violation." 17 C.F.R. § 205.3(b) (2003). A "material violation" includes violations of "federal or state securities law," a "breach of fiduciary duty" or a "similar material violation". 17 C.F.R. § 205.2(i). "Evidence of a material violation" is defined as "credible evidence, based upon which it would be unreasonable . . . for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur." 17 C.F.R. § 205.2(e).

156. Conditioning the lawyer's duty to act on the highest level of certainty, the "knowing" standard, can be viewed as "pro-lawyer" in its orientation, insulating the profession to a maximum extent from any responsibility for inaction in a given matter. It can also be regarded as "pro-client", since the lawyer will likely be inclined to cause disruption within the corporation only in the most glaring instances of constituent impropriety. In the post-Enron world, however, neither characterization is appealing.

Certainly the public is now less likely to be accepting of ethical measures intended to be protective of lawyers in the corporate setting. Furthermore, the rule's knowing standard can be viewed as "pro-client" only if the best interests of the corporation are equated with the interests of the managers of the corporation rather than those of its shareholders. Properly equating the corporate client's best interests with the best interests of shareholders, however, renders the "knowing" standard of Model Rule 1.13(b) distinctly "anti-client" in its orientation.

157. RESTATEMENT, *supra* note 30, §96, illus. 1.

formulation for recklessness.<sup>158</sup> This example thus shows that the subjective standard of the 1983 and 2003 versions of Model Rule 1.13(b) provides inadequate incentive for the corporate lawyer to act in the best interests of her client.

Even more troubling, the “knowing” standard also tends to promote a course of willful blindness on the part of the corporate lawyer, even when managerial misconduct might be suspected.<sup>159</sup> Such an approach is risky for the lawyer, since the Model Rules’ definition of “knows” notes that “knowledge may be inferred from the circumstances,”<sup>160</sup> and courts in many contexts are not receptive to such studied ignorance as a defense.<sup>161</sup> Still, the “knowing” standard invites the lawyer to inflate, perhaps generate, sophisticated justifications for the gift in order to avoid the duty to react to managerial misconduct.<sup>162</sup> Corporate lawyers’ natural desire to please managers and their expected deference to managers’ business decisions provide ample motivation for this reluctance to conclude that Model Rule 1.13(b)’s duty to take remedial action applies.<sup>163</sup>

158. See, e.g., *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033, 1044-45 (7th Cir. 1977) (a Rule 10b-5 case in which the court defined recklessness as “not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care.”). As Professor Cramton notes, under Model Rule 1.13(b) lawyers are held to “a less demanding scienter standard in professional discipline cases . . . than the standard that lay persons must meet to avoid criminal and civil liability.” Cramton, *supra* note 15, at 148.

159. The Cheek Commission’s Preliminary Report observed that corporate lawyers have been criticized “for turning a blind eye to the natural consequences of what they observe and claiming that they did not ‘know’ that the corporate officers they were advising were engaged in misconduct.” *Cheek Commission Preliminary Report*, *supra* note 9, at 208.

160. MODEL RULES OF PROF’L CONDUCT R. 1.0(f) (2003).

161. See WOLFRAM, *supra* note 33, at 696; Cramton, *supra* note 15, at 149.

162. In response to the assertion that lawyers cannot ever “know” what a client intends, Professor Hazard notes:

Of course, speaking in terms of radical epistemology, it is true that a lawyer cannot “know” what a client - or anyone else - intends. In these terms it is impossible for a lawyer to “know” anything. Yet the practice of law is based on practical knowledge, that is, practical assessments leading to empirical conclusions which form the basis for irrevocable action. Lawyers certainly possess such practical knowledge. If a lawyer can have practical knowledge of how the purposes of others may affect his client, he can have the same knowledge of how his client’s purposes may affect others. It is in that sense that the lawyer can “know” when a client’s purpose is illegal.

Hazard, *supra* note 34, at 672.

163. Professor Cramton observes that the problem originates in corporate lawyers mistakenly equating the roles of advisors in transactions with advocates in litigation. See Cramton, *supra* note 15, at 173. He notes:

These lawyers take the position that they must do everything for the client that the client’s managers want them to do, providing the conduct is permitted by law. The problem is that by constantly going to the edge of the

As a professional standard, the “knowing” threshold in Model Rule 1.13(b) is too forgiving of careless and inappropriate conduct by lawyers. Such a lax standard is impossible to reconcile with any claim that the legal profession requires sensible, fair, and demanding conduct from its members or that members of the profession function as gatekeepers. Indeed, this actual knowledge standard in Model Rule 1.13(b) seems generally inconsistent with the broader duty of providing competent representation to the client under Model Rule 1.1.<sup>164</sup>

What is needed is a standard that reaches both incompetent and evasive lawyers, and this requires an objective criterion rooted firmly in a reasonableness or negligence standard.<sup>165</sup> In order to protect

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law and taking a very permissive view of what the law permits, these lawyers gradually adopt a mindset that ignores and may eventually assist the client’s managers in illegality that harms third persons and the client entity.

*Id.* This mindset is furthered by various rationalizations and psychological tendencies for persons facing a choice among only unappealing alternatives, such as that between the options of aiding managerial fraud or taking remedial action. *See id.* at 174.

164. Model Rule 1.1 states: “A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation reasonably necessary for representation.” MODEL RULES OF PROF’L CONDUCT R. 1.1 (2003). One might speculate that most cautious lawyers seeking to provide competent representation to their corporate clients would employ a more demanding standard than “actual knowledge” when confronting potentially inappropriate managerial conduct. Professor Cramton notes that lawyers should be inclined to do so in order to avoid the later application of the “hindsight bias”, making “defendants appear more culpable than they may be” in reviewing any later allegations of civil fraud. *See Cramton, supra* note 15, at 147. Indeed, “the courts may impose liability on a corporate lawyer for failing to take reasonable protective action to safeguard the corporate client against the wrongful acts of its officers.” Hazard, *Lawyers and Client Fraud, supra* note 107, at 708. Therefore, it would seem that lawyers should be inclined to be more vigilant than the “knowledge” standard warrants.

165. Our effort to find both an objective standard and a measure that significantly expands the corporate lawyer’s duty to take remedial action under Model Rule 1.13(b) is justified on two grounds. The first is that the duty to take remedial action is limited to taking such action within the corporation itself. This is clear under the original version of Model Rule 1.13. *See* MODEL RULES OF PROF’L CONDUCT R. 1.13(b) (1983). Even under the 2003 amendments to Model Rule 1.13(b), a lawyer is merely permitted to make disclosures beyond the corporate confines under certain circumstances, not required to do so. MODEL RULES OF PROF’L CONDUCT R. 1.13(c) (2003). Given that the duty in the original and amended Model Rule 1.13 does not mandate public disclosures, it is hard to imagine why the standard of knowledge should be set high. If corporate lawyers are to act to protect the best interests of the shareholders, as we assert they should, a low threshold for doing so serves that purpose more effectively than a high standard.

Our second ground for asserting that a more expansive duty is called for is the likely response of lawyers to whatever standard is inserted. Lawyers will predictably and naturally construe in a narrow fashion any standard for triggering the duty to take



sufficiently the interests of shareholders and to define an appropriate professional standard for lawyers, we contend that a “reasonably should believe” standard is the most promising.<sup>166</sup> Under this approach, a lawyer for a corporation would be obligated to take remedial action when a lawyer of reasonable prudence and competence would suppose that the action proposed by the manager amounts to a breach of that manager’s duty to the corporation or is unlawful.<sup>167</sup>

Our proposed objective standard for Model Rule 1.13(b) would enhance the gatekeeper role of lawyers and increase public confidence in sound corporate governance in the post-Enron environment.<sup>168</sup> In addition, the broader objective standard will bring

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remedial action. This tendency is already evident in lawyers’ reluctance to conclude that they “know” that a constituent is engaged in misconduct warranting such action on their part. If an expanded gatekeeper role for lawyers is to be implemented, it is likely to be necessary to draw the duty sufficiently broadly to counteract lawyers’ predictable tendency to whittle it down in application.

166. The Terminology section of the Model Rules offers several possible alternatives for consideration. See MODEL RULES OF PROF’L CONDUCT R. 1.0 (2003). One is that the lawyer “believe” that a constituent is about to engage in misconduct relative to the corporate client. *Id.* 1.0(a). Under the definition offered for this standard, the lawyer would be expected to act when she “supposed the fact in question to be true.” *Id.* This term, though offering a standard less demanding than actual knowledge, suffers from the same shortcomings of the current standard. See *id.* R. 1.0(f). Like the “knowing” standard, it hinges the duty to take remedial action on the lawyer’s subjective state of mind, leaving the careless lawyer and the lawyer intentionally seeking to avoid taking remedial action beyond the reach of the duty.

The Model Rules also offer the standard of “reasonably should know,” which “denotes that a lawyer of reasonable prudence and competence would ascertain the matter in question.” *Id.* R. 1.0(j). This standard interjects an objective element into the standard, compelling the lawyer to consider not only his own state of knowledge regarding the pending constituent misconduct but that state of knowledge which a reasonable lawyer would have under the circumstances. Because it incorporates the “knowing” standard, it still is diminished by the degree of certainty that it demands. A lawyer under the “reasonably should know” standard may well find it as easy to find doubt for the “lawyer of reasonable prudence and competence” as it was for himself under the present subjective standard. *Id.* R. 1.0(j).

167. The threshold for remedial action could be set even lower. In their 1996 article, Professor Painter and Ms. Duggan urged the passage of federal securities legislation that would give further guidance to securities lawyers confronting client fraud. See Painter & Duggan, *supra* note 61, at 226-29. In that article, the authors suggested that a lawyer who “becomes aware of information that an illegal act has occurred” should be expected to report to a higher authority in the corporation. See *id.* at 261 (quoting Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 301(a)(1), 109 Stat. 737). In interpreting their own standard, the authors noted that “[a] lawyer need not be absolutely certain of an illegal act in order to be aware of information *indicating* that such an act has occurred.” *Id.* at 262. This standard appears to set a level of certainty less demanding than “reasonably should believe.”

168. In its Preliminary Report, the Cheek Commission recommended a “reasonably should know” standard, *Cheek Commission Preliminary Report, supra* note 9, at 208,

lawyers' obligations to their corporate clients more in line with standards that are worthy of a self-regulated profession.<sup>169</sup>

Economic analysis also supports our proposal. Economists might suggest that an appropriate standard for measuring the propriety of the lawyer's conduct is the standard that the parties themselves would adopt if they were able to negotiate with each other.<sup>170</sup> The parties in interest in the example we use above are the company's lawyers and its shareholders. We are hard pressed to muster a convincing argument that shareholders in those circumstances would agree to purchase such low quality legal work as is implicit in the actual knowledge standard set by the Model Rules. Instead, we believe it is likely that shareholders would demand and be willing to pay the corporate lawyers to provide a quality of legal services that at least is consistent with services offered by reasonably competent attorneys in the marketplace.

In summary, we support an enhanced standard for lawyers under Model Rule 1.13(b). A lawyer should be expected to take remedial action within the corporation when she "reasonably should believe" that managers are involved in misconduct rather than only when she "knows" that this is occurring. We consider this a proper expansion of a gatekeeping role for corporate lawyers in the post-Enron world.

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214, although it stated at another point in its Preliminary Report that "certainly the lawyer is not expected to go over the head of the individual with whom the lawyer is dealing unless he or she has *reason to believe* that the officer or employee is acting illegally or fraudulently, or in breach of a duty to the corporation." *Id.*, at 204 (emphasis added). In its Final Report, the Cheek Commission proposed an amendment to Model Rule 1.13(b) obligating the lawyer for a corporation to take remedial steps if he "knows facts from which a reasonable lawyer, under the circumstances, would conclude" that a corporate manager is violating a legal obligation to the corporation. *Cheek Commission Final Report*, *supra* note 9, at 44. The proposal of the Cheek Commission, however, was rejected by the American Bar Association. *See supra* notes 151-52 and accompanying text.

169. The present subjective "knowing" standard can be seen by critics as an example of the profession protecting its own members at the expense of their clients. *See discussion supra* note 156. In economic terms, one might describe this in terms of the profession assisting in the creation of a market failure in which the purchaser of legal services is led to believe that lawyers are utilizing reasonable care on his or her behalf, while the actual ethical standard requires much less of the lawyer.

170. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1445 (1989) (discussing the economic argument in favor of corporate law that "fills in the blanks and oversights with the terms that people would have bargained for had they anticipated the problems and been able to transact costlessly in advance"); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1264 (1982) ("Optimal fiduciary duties should approximate the bargain that investors and managers would reach if transaction costs were zero.").

## 2. The Reach of the Duty to Act

Even if the “knowing” standard of Model Rule 1.13(b) were to be changed as we recommend, the rule presents some troubling restrictions on the lawyer’s duty to respond to constituent misconduct. These restrictions diminish what is expected of lawyers in protecting the best interests of shareholders.

Under both the 1983 and 2003 versions of Model Rule 1.13(b), a lawyer is to respond when he determines that a constituent “is engaged in action, intends to act or refuses to act” inappropriately in regard to the corporation.<sup>171</sup> The duty of the lawyer to act remedially is thus limited to instances of on-going or prospective constituent misconduct.<sup>172</sup> Given the preventive nature of the remedial actions suggested by Model Rule 1.13(b), this limitation makes some sense.

It is quite possible, however, that a lawyer for a corporation might discover past misconduct by managers that constituted a breach of their duty to the corporation or that was unlawful and likely to result in substantial injury to the corporation. Furthermore, this discovery could be made at a time when the impact of the misconduct on the corporation could still be ameliorated. In such situations, the entity’s interests would be served by the lawyer taking the sort of remedial actions called for in Model Rule 1.13(b). To expect lawyers to do so when the effects of that past misconduct could still be avoided or mitigated<sup>173</sup> would be a valuable expansion of the lawyer’s duty under that rule.<sup>174</sup>

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171. MODEL RULES OF PROF’L CONDUCT R. 1.13(b) (2003); MODEL RULES OF PROF’L CONDUCT R. 1.13(b) (1983).

172. *See id.*

173. In its August 2003 amendment of Model Rule 1.6, the ABA included exceptions to the lawyer’s duty of confidentiality in similar circumstances. The amended rule now provides that a lawyer may reveal confidential information when the lawyer reasonably believes it is necessary 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. MODEL RULES OF PROF’L CONDUCT R. 1.6(b)(3) (2003). While this rule would also be applicable in the case of a lawyer representing a corporate client, it pertains only to disclosures of confidential information outside of the confines of the client. It does not affect the lawyer’s duty take action within the corporation to try to address the past misconduct. A similar provision is found in Model Rule 5.3(c), which prescribes when supervising lawyers should be professionally responsible for a subordinate lawyer’s ethical violation. MODEL RULES OF PROF’L CONDUCT R. 5.3(c). That rule provides that it is a violation for a supervising lawyer to know of a subordinate lawyer’s unethical conduct “at a time when its consequences can be avoided or mitigated” and to fail “to take reasonable remedial action.” *Id.* R. 5.3(c)(2).

Conceivably, Model Rule 1.13(b) could be amended to require lawyers to report all serious past failings of managers to their superiors, regardless of the potential for mitigation of that conduct. Such a requirement, however, would not be remedial in

Another restriction on the duty to take remedial action under the original and amended versions of Model Rule 1.13(b) is the vagueness of the phrase “violation of law.”<sup>175</sup> This language raises the question whether it should be read narrowly to include only statutory and regulatory provisions of law or broadly to include common law doctrine as well.<sup>176</sup> Given the natural pressures on lawyers to align themselves with managers’ interests,<sup>177</sup> it might be anticipated that lawyers would tend to read the obligation narrowly. If lawyers are to be expected to act in the best interests of shareholders, however, response to “violations” of common law duties might be at least as important as violations of statutory and regulatory provisions.<sup>178</sup> The lawyer’s intervention by the remedial steps stated in Model Rule 1.13(b) could prevent serious consequences to the interests of the shareholders in these situations as well. Clearer guidance to lawyers on the meaning of “violation of law,” even in the comments to the rule, would help assure that this is done.

One final concern with the 2003 version of Model Rule 1.13(b) is the indeterminate nature of the lawyer’s duty when her remedial actions fail to arrest the manager’s misconduct. In this situation, the

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character and would have little to do with the protection of the interests of the corporation or its shareholders that is sought by Model Rule 1.13(b).

174. Professor Gillers has made a similar recommendation. Gillers, *supra* note 54, at 306.

175. MODEL RULES OF PROF’L CONDUCT R. 1.13(b) (1983); MODEL RULES OF PROF’L CONDUCT R. 1.13(b) (2003).

176. The Cheek Commission appropriately reads the term broadly to include common law in its Preliminary Report. *Cheek Commission Preliminary Report*, *supra* note 9, at 197. Professor Wolfram seems to read “violation of law” broadly as well in noting that “[a] law violation, such as the illegal manufacture of a defective product, that threatens injury to nonclient third parties could still result in injury to the organization because of the threat of suits.” WOLFRAM, *supra* note 33, at 744. There is a similar issue as to the meaning of “illegal” in a proposal to amend Model Rule 1.2(d). See *infra* text accompanying notes 218-24.

177. For a discussion of this phenomenon, the structural conflict, see *supra* Part III.A.2.a.

178. Even the threat of expenses of litigation and the costs of adverse publicity could render civil wrongs more damaging to a corporation than many statutory or regulatory breaches. Lawyers’ Manual, *supra* note 12, at 91:2406. A hypothetical fact pattern presented in a popular professional responsibility casebook may offer some insight. A transactional lawyer might, in the course of her representation of a corporation, learn of a manager’s determination that a dangerous product should be produced and marketed despite the risk it presents to the corporation’s financial condition. THOMAS D. MORGAN & RONALD D. ROTUNDA, PROFESSIONAL RESPONSIBILITY: PROBLEMS AND MATERIALS 288 (7th ed. 2000). This decision, however, might not constitute a violation of the manager’s duty to the corporation or a violation of a statutory or regulatory provision. Nevertheless, the decision might present a “violation” of the law of products liability and expose the corporation to substantial liability. Professor Wolfram makes the point with a similar example. See *supra* text accompanying note 176.

newly amended Model Rule 1.13(c) permits the lawyer to reveal confidential information when the misconduct “is clearly a violation of law, and . . . reasonably certain to result in substantial injury to the organization.”<sup>179</sup> A lawyer could also choose to withdraw from the representation of the corporate client under these circumstances.<sup>180</sup> Given this discretion, the lawyer may choose not to make any disclosure outside of the client’s confines and to continue to represent the corporation for a range of practical<sup>181</sup> and even professional reasons,<sup>182</sup> and this may present no further difficulty for the lawyer in many situations. What is the lawyer to do, however, if she is asked to further the very transaction that caused her to take the unsuccessful remedial action under Model Rule 1.13(b)? The guidance offered to the lawyer by the Model Rules in this situation is diffuse<sup>183</sup> and, therefore, unclear. The rule should be amended to declare that the lawyer choosing to continue in the representation under these circumstances must avoid assisting in any transaction that embodies or furthers the manager’s troubling action.

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179. MODEL RULES OF PROF’L CONDUCT R. 1.13(c) (2003).

180. *Id.* R. 1.16(b)(2); 1.16(b)(4).

181. Most obviously, the lawyer may not wish to suffer the personal financial loss that withdrawal would likely impose. This would be true in the case of outside counsel and in-house counsel as well.

182. The lawyer may correctly conclude that the best interests of the client would not be served by withdrawal. The change of legal counsel could impose significant costs on the client.

183. Certainly the lawyer would have to refuse to assist the transaction if the lawyer knows it to be criminal or fraudulent under Model Rule 1.2(d), which directs lawyers not to “counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent.” MODEL RULES OF PROF’L CONDUCT R. 1.2(d) (2003). For further discussion of this prohibition, see *supra* text accompanying notes 73-80, and *infra* text accompanying notes 185-201. Furthermore, if the lawyer knows that the transaction would otherwise be a violation of law, Model Rule 1.16(a)(1) requires her to withdraw if the client insists on her participation after consulting with the client regarding the illegality. See MODEL RULES OF PROF’L CONDUCT R. 1.16(a)(1) (2003). What may be less clear, however, is what the lawyer should do when she has complained about a manager’s action that she perceives to be a breach of his duty to the corporation, her remedial action has failed to have that action overturned, she has chosen not to blow the whistle by revealing confidential information under Model Rule 1.6(b)(3), and she is then asked to lend assistance to the troubling transaction.

Only the amalgam of rules that constitute the lawyer’s duty to serve the best interests of her client provide guidance here. See *supra* note 81 and accompanying text which discuss these rules. In addition, the lawyer must fear civil liability for aiding the constituent in his violation of his fiduciary duties to the corporation. For further discussion of this limit on lawyers, see *supra* note 34. Under a complete analysis of the restrictions presented by these limitations, therefore, the careful lawyer will refuse to participate in the transaction. Still, the lawyer is not offered guidance by the 2003 amendment’s version of Model Rule 1.13(b) and (c) on this important issue. See MODEL RULES OF PROF’L CONDUCT R. 1.13(b), 1.13(c) (2003).

Lawyers for corporations who confront the troubling circumstances of constituent misconduct would be aided by clarification of these issues pertaining to the reach of their duties under Model Rule 1.13(b).<sup>184</sup> The gatekeeper role of lawyers would be strengthened by addressing these shortcomings as well.

### *C. Limits on Lawyers Furthering Clients' Wrongdoing*

The ethical obligation of a lawyer to pursue the best interests of a corporate client, as reflected in the best interests of its shareholders, remains constrained by the outer limit imposed by Model Rule 1.2(d).<sup>185</sup> Under that rule a transactional lawyer representing a corporation cannot assist a client in conduct that the lawyer "knows" is "criminal or fraudulent"<sup>186</sup> even if it produces results beneficial to the corporation's shareholders.<sup>187</sup> When the rule is considered as a component of the lawyer's role as gatekeeper, however, both the "knowing" standard of Model Rule 1.2(d) and its reach only to a limited range of unlawful conduct are problematic.

In clear situations of managerial wrongdoing that a corporate lawyer may confront the rule's standard presents no difficulties. Consider an example in which a manager seeks the lawyer's help in filing a tax return that materially understates the company's income. To make the point, we can assume further that the resulting savings will be of certain benefit to the company's shareholders and that there is no chance that the corporation's violation will be discovered.

184. The Preliminary Report of the Cheek Commission points to other characteristics of the widely-adopted 1983 version of Model Rule 1.13(b) that tend to discourage lawyers from taking remedial action to protect the interests of corporate clients. *Cheek Commission Preliminary Report, supra* note 9, at 203-04. These include the provision's requirement that an agent's misconduct be "related to the representation" in order for the duty to arise. *Id.* at 203. Also, the emphasis on the duty to minimize disruption to the corporation is seen as misplaced. *Id.* at 203-04. The Cheek Commission also sees the Comment's preference for "clear justification" before going over the head of a manager as discouraging the lawyer's remedial action. *Id.* at 204. Finally, that group believes that the rule should make clear that the lawyer does not have to follow the remedial measures sequentially. *Id.* at 204.

185. For a discussion of this obligation of lawyers, see *supra* text accompanying notes 73-80.

186. MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2003) (forbidding a lawyer to "counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent").

187. This limitation is particularly salient for the corporate lawyer who chooses not to withdraw after exhausting the remedial measures called for in Model Rule 1.13(b). What is she to do when corporate managers expect her to assist in the very transaction that caused her concern? She is permitted by Model Rule 1.13 to continue in the representation, but that rule does not instruct the lawyer on what course to take in furthering the client's inappropriate conduct. *Id.* R. 1.13. Model Rule 1.2(d) offers the only, but not definitive, help. For a discussion of this anomaly, see *supra* note 183.

Even so, if the company's lawyer is aware of the material understatement, Model Rule 1.2(d) prohibits the lawyer from lending assistance to this fraudulent and criminal action by the client despite its economic benefit to the shareholders.<sup>188</sup> No competent and ethical lawyer would think otherwise.

Most applications of Model Rule 1.2(d), however, present more troubling issues of application and greater temptation for the lawyer. Usually, the potentially criminal conduct proposed by the corporate client is less blatant and morally repugnant than tax fraud,<sup>189</sup> rendering the boundaries of the rule's prohibition more subtle.<sup>190</sup> For example, managers of a corporate client may propose selling securities without registration, relying on the intrastate exemption provided by Rule 147.<sup>191</sup> While a competent lawyer would be aware that a misapplication of that exemption could constitute a crime,<sup>192</sup> the proposed action is likely to cause her less immediate consternation than would a client's proposed tax fraud. Additionally, the application of Model Rule 1.2(d) to the sale of the unregistered securities raises yet again the elusive issue of what the lawyer "knows"<sup>193</sup> about her client's conduct, and the structural alliance with managers<sup>194</sup> provides incentive for the lawyer to resist concluding that she has such certainty.

Because Model Rule 1.2(d) purports to restrict lawyers in furthering the worst kinds of their clients' conduct, the "knowing" standard is too permissive in any sort of legal representation.<sup>195</sup> The

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188. Advising clients on questionable tax issues presents a range of difficult issues. WOLFRAM, *supra* note 33, at 700-01, 709-10. The client's known fraud in understating the corporation's income, however, is not among them. *See id.* at 700-01, 709-10.

189. Not all matters of tax advice, however, involve the clear illegality assumed in the hypothetical intentional understatement of income. *Id.* at 700.

190. Professor Wolfram notes the difficulty the lawyer faces when the law is not clear and the client would like to be aggressive in approaching the issue. He states that "[i]t would be improbable that a lawyer could perform the lawyerly function of advice-giving in such a situation in the same way in which a lawyer advises on legally and morally unquestionable transactions." *Id.* at 692.

191. 17 C.F.R. § 147 (2003) (exempting from the registration requirements of the Securities Act of 1933 offers and sales of securities to persons who are residents of the same state in which the issuer is incorporated and doing business).

192. A "wilful" violation of the provisions of the Securities Act of 1933 carries a penalty of a fine of up to \$10,000 or a jail term of up to "five years, or both." 15 U.S.C. § 77x (2000).

193. The standard of the lawyer's "knowledge" was discussed above in reference to the lawyer's duty to take remedial action under Model Rule 1.13(b). *See supra* text accompanying notes 147-74. For a discussion on Professor Hazard's view of what a lawyer "knows" in reference to the term's use in Model Rule 1.13(b), see *supra* note 162.

194. *See* discussion *supra* Part III.A.2.a.

195. MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2003).

standard tends to encourage all lawyers to discount their suspicions and concerns regarding the criminality or fraudulent character of their clients' conduct, largely freeing them to assist that conduct through their provision of professional services except in the face of glaring impropriety. The only possible justification for such broad leeway is as a means of furthering the interests of clients even in the most questionable of circumstances.<sup>196</sup>

In many instances involving corporate representations, however, the "knowing" standard of Model Rule 1.2(d) cannot even be characterized as being "pro-client," at least if we keep clearly in mind that the interests of the corporate client are generally to be equated with those of the shareholders. When a corporate lawyer is asked by a manager to assist in a transaction the lawyer believes constitutes a crime or fraud, resolving doubts in favor of furthering the manager's proposed conduct may well serve the manager's interests, but it provides insufficient protection to the best interests of those shareholders and, therefore, to the corporate client itself. When coupled with the structural pressures to favor managers' interests, the "knowing" standard of Model Rule 1.2(d) tends to dissuade lawyers from resisting managerial misconduct, the very sort of professional concern that arises from the Enron experience. For the corporate lawyer, proper concern for the interests of shareholders often demands refusal to assist transactions even when the lawyer's level of certainty does not reach a state of "knowing" that the conduct is criminal or fraudulent.

Given the broad application of Model Rule 1.2(d) to all types of legal representation, we must be mindful that, unlike Model Rule 1.13(b), the limitation on lawyers that it presents does more than serve the interests of shareholders in the corporate context; it also serves as a significant limitation on the loyalty of all lawyers to their clients and on their clients' ability to establish their own objectives for legal representations. Still, while all might agree that a lawyer should be encouraged to be loyal to her clients and deferential to their objectives, when a reasonable lawyer would decide that a client's proposed course of conduct is unlawful, she should be expected to withhold her professional assistance. If not, it is hard to imagine in what sense lawyers are truly to be viewed as "officer[s] of the legal system."<sup>197</sup>

We maintain that lawyers should be prohibited from assisting their clients' conduct when they "reasonably should believe"<sup>198</sup> that

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196. *Cheek Commission Preliminary Report*, *supra* note 9, at 208.

197. MODEL RULES OF PROF'L CONDUCT pmb1. para. 1 (2003).

198. This is the same scienter standard we propose for the duty of corporate lawyers to take remedial action under Model Rule 1.13(b). For a discussion of this standard,



the conduct is illegal.<sup>199</sup> This objective standard would allow lawyers and their clients the necessary discretion to pursue objectives when reasonable lawyers would disagree as to the law's application or the client's purpose, thus preserving clients' ability to take legitimate risks as to the application of the law. Furthermore, it is imperative that Model Rule 1.2(d) continue to exempt good faith efforts to test the validity of the law,<sup>200</sup> something that may require conduct that is known to be clearly illegal. In other situations, however, when reasonable lawyers would suppose the client's conduct to be illegal, a lawyer should not assist the client's conduct.<sup>201</sup> With our proposed standard in place, lawyers would be expected to be more cautious in providing legal assistance to their clients' unlawful objectives,

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see *supra* text accompanying notes 165-69. As to the limitation in Model Rule 1.2(d), the Preliminary Report of the Cheek Commission recommends a "reasonably should know" standard. *Cheek Commission Preliminary Report*, *supra* note 9, at 214. This is similar to its proposal to amend the "knowing" standard of Model Rule 1.13(b). *Id.* at 207-08; see also discussion *supra* note 168. The Cheek Commission's Final Report, however, made no recommendation to amend Model Rule 1.2(d), choosing to focus on "facilitating the flow of information and analysis concerning legal compliance issues within the organizations" and "the limitations on the ability of the lawyer to disclose to third parties information concerning criminal or fraudulent conduct by the client." *Cheek Commission Final Report*, *supra* note 9, at 34. Thus, its recommendations on amendments to the Model Rules are limited to Model Rule 1.13 on the representation of organizations and Model Rule 1.6 on confidentiality. *Id.* at 34-35. Professor Cramton also urges adoption of the "reasonably should know" standard for Model Rule 1.2(d). Cramton, *supra* note 15, at 185. We contend, however, that this standard still demands too high a level of certainty before the lawyer faces the limit of the rule. The question we would ask is whether a lawyer should be justified in counseling or assisting a client in conduct that a reasonable lawyer would suppose is unlawful. That is, in deciding between our proposed standard and that of the Preliminary Report of the Cheek Commission and Professor Cramton, should an officer of the legal system be able to avoid professional sanction by asserting that, while a reasonable lawyer would have supposed the client's conduct to be unlawful, a reasonable lawyer would not have been certain?

199. See *infra* text accompanying notes 218-23 for a discussion on the issue of what is meant by "illegal."

200. The present rule provides that a lawyer may "counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law." MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (2003).

201. This approach would bring the duty of lawyers under professional standards more in line with their duty to avoid assisting inappropriate conduct under the law of agency and criminal law. Professor Hazard notes that agency law's concept of "privilege" will protect a lawyer from liability only if the lawyer has a reasonable belief as to facts supporting the propriety of the client's action. Hazard, *supra* note 34, at 677, 678, 681. He further notes that "complicity" under criminal law turns on a similar standard. *Id.* at 682 ("As to the extent of knowledge that will result in complicity, the cases say not only that liability results from actual knowledge of the client's illegal purpose, but also that it results from knowledge of facts that reasonably should excite suspicion.").

thereby reducing the likelihood of the clients engaging in anticipated misconduct in a broader range of circumstances.

The present limitation of Model Rule 1.2(d) is also too restrained in its prohibition of lawyer assistance only to client conduct that is "criminal or fraudulent."<sup>202</sup> The issue is not new, having been debated in the course of the adoption of the Model Rules in 1983.<sup>203</sup> Under the counterpart to Model Rule 1.2(d) contained in the prior Code of Professional Responsibility,<sup>204</sup> a lawyer was not to assist a client's fraud or conduct the lawyer knew to be "illegal", a term reaching beyond the criminal law.<sup>205</sup> Even under that standard, some scholars questioned whether lawyers ought to be permitted to assist in transactions involving unconscionable terms that favored their clients.<sup>206</sup> Earlier proposed versions of the Model Rule provision also took a broader view of conduct that was unworthy of lawyer assistance. The original proposal from the Kutak Commission prohibited a lawyer from giving "advice which the lawyer can reasonably foresee will . . . be used by the client to further an illegal course of conduct."<sup>207</sup> A later proposal proscribed a lawyer's assistance in preparing written instruments with "legally prohibited terms."<sup>208</sup> Model Rule 1.2(d) as adopted by the ABA, however, constitutes a substantial retreat from the broad prohibition in the Code and from the Kutak Commission proposals in forbidding a lawyer's assistance only when the client's conduct is known to be a crime or fraud.<sup>209</sup>

To illustrate the limitation of the current rule, consider the Revised Model Business Corporation Act's provision that requires a corporation to provide a shareholders' list to any of its shareholders

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202. Professor Wolfram asserts that the Model Rules, including Model Rule 1.2(d), "do not limit a lawyer's advice, even encouragement, to a client about unlawful acts so long as the acts are not criminal or fraudulent." WOLFRAM, *supra* note 33, at 704.

203. *See id.* at 704-05.

204. MODEL CODE OF PROF'L RESPONSIBILITY DR 7-102(A)(7) (1981). *See generally* Hazard, *supra* note 34, for a helpful discussion of the reaches of the limitation on lawyers imposed by DR 7-102(A)(7).

205. *See* WOLFRAM, *supra* note 33, at 694.

206. *See* Alvin B. Rubin, *A Causerie on Lawyers' Ethics in Negotiation*, 35 LA. L. REV. 577, 591 (1975) (stating that a "lawyer cannot ethically accept an arrangement that is completely unfair to the other side"); Murray L. Schwartz, *The Professionalism and Accountability of Lawyers*, 66 CAL. L. REV. 669, 685-86 (1978) (proposing a "Professional Rule for the Nonadvocate").

207. Stephen L. Pepper, *Counseling at the Limits of the Law: An Exercise in the Jurisprudence and Ethics of Lawyering*, 104 YALE L.J. 1545, 1583 n.75 (1995) (quoting MODEL RULES OF PROF'L CONDUCT R. 2.3(a) (Discussion Draft 1980)).

208. WOLFRAM, *supra* note 33, at 705 (quoting MODEL RULES OF PROF'L CONDUCT R. 4.3 (Discussion Draft 1980)).

209. MODEL RULES OF PROF'L CONDUCT R. 1.2(d) (1983). Professor Wolfram concludes that this was the intended result of the ABA. WOLFRAM, *supra* note 33, at 704-05.

under certain conditions.<sup>210</sup> Failure on the part of the corporation to accede to such a clearly lawful request, however, carries no criminal penalty.<sup>211</sup> In fact, the only “penalty” imposed on a corporation improperly failing to turn over the list to the requesting shareholder is that the corporation may have to pay the expenses if the shareholder goes to court for an order requiring inspection.<sup>212</sup> Under Model Rule 1.2(d) presently, a lawyer for the corporation that, in the heat of a battle for corporate control, receives a legitimate request for a shareholders list from the insurgent can feel free to advise the corporate client to refuse to provide the list, even though it is clear that such conduct is in violation of the statute. This is because such a refusal is not “criminal or fraudulent.”<sup>213</sup>

Such an outcome is impossible to justify. By the action of its duly elected representatives, society has spoken through this statute to define a legal duty despite the lack of a criminal sanction. If the profession is serious about its members’ role as officers of the legal system, lawyers should not be permitted to facilitate the flouting of articulated legal standards. Instead, the restraint imposed by Model Rule 1.2(d) should be broadened beyond client crimes and fraud.

In response to the Enron outrages and other corporate scandals, some prominent authorities have urged greater responsibilities for lawyers to serve the public interest in the representation of their clients.<sup>214</sup> One way to implement such sentiments would be to expand the reach of Model Rule 1.2(d) to prohibit lawyer assistance to transactions that fail to serve the interests of the public.

Although the Enron experience suggests that expansion of the prohibition in Model Rule 1.2(d) is necessary, a standard defined by the “public interest” is unwise. Such a standard would be nearly impossible for lawyers and tribunals to apply given the variety of views on what constitutes the “public interest.”<sup>215</sup> While lawyers

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210. Model Bus. Corp. Act §§ 16.02(b)(3), (c) (2002).

211. *Id.* §§ 16.01-16.06.

212. *Id.* § 16.04(c).

213. The refusal could, however, be viewed as a breach of management’s legal obligation to the corporation requiring remedial action by the lawyer knowing of it. See MODEL RULES OF PROF’L CONDUCT R. 1.13(b) (2003); MODEL RULES OF PROF’L CONDUCT R. 1.13(b) (1983).

214. For example, Harvey Pitt, then Chairman of the Securities and Exchange Commission, declared in the wake of Enron that “it is inappropriate for corporate lawyers to . . . *disserve the public interest*, even if those results can be achieved in a manner arguably within the literal letter of the laws.” *This Week’s Highlights*, No. 2014, Fed. Sec. L. Rep. (CCH) 1 (Feb. 27, 2002) (emphasis added). Chairman Pitt further stated that “all upon whom the present system depends [should] adopt a bias in favor of the *needs of the investing public*.” *Id.* (emphasis added).

215. Consider, for example, a request by a client that a lawyer lend assistance to the acquisition and ultimate clear cutting of a stand of timber, which, we assume for our

ought to be, and are, free to refuse to assist in transactions because of their views of the public interest,<sup>216</sup> a duty to do so would be another matter. This is particularly true in the vast range of activities for which no societal affirmation of policy has been achieved by legislative, rule-making, or judicial bodies.<sup>217</sup> Indeed, given the structural pressures working on them, it would not be surprising to find that corporate lawyers' view of the public interest in these situations is aligned nicely with the interests of managers. While it could be argued that the adoption of a public interest standard in Model Rule 1.2(d) would serve as a strong pronouncement by the organized bar of lawyers' important public interest role, unless it affected the way lawyers act, it would likely be another source of public dissatisfaction with the profession and of cynicism within it.

While a public interest standard does not present a promising alternative for defining the reach of the restriction imposed on lawyers' actions by Model Rule 1.2(d), the reach of the rule's prohibition only to client conduct that is criminal or fraudulent demands reform. We believe that the prohibition should be expanded to include any client conduct that would be generally characterized as "illegal." This "reform" would merely constitute a return to the standard embraced by the profession prior to the adoption of the

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purposes here, is legal. Many in society may consider such an act to be contrary to the best interests of society, and, indeed, some may consider this entirely legal act to be immoral. Under a public interest standard, it would be difficult for the lawyer, and ultimately a tribunal, to determine whether the lawyer would violate an obligation to promote the "public interest" if the lawyer participated in this legal transaction.

216. MODEL RULES OF PROF'L CONDUCT R. 1.16(b) (4) (2003) (permitting a lawyer to withdraw from the representation of a client if the client "insists upon taking action that the lawyer considers repugnant"). Furthermore, lawyers are required to provide their clients with "candid advice," which is not required to be limited to purely legal considerations but may also include "moral, economic, social and political factors, that may be relevant to the client's situation." MODEL RULES OF PROF'L CONDUCT R. 2.1(2003).

217. Measuring appropriate lawyer conduct by a "public interest" standard is further complicated by the different risk-reward structures faced by the transactional lawyer, on the one hand, and her client, on the other. Reconsider our clear cutting example, *supra* note 215. On the reward side, we assume that the client stands to make a lot of money from a successful clear cutting of the land, while the lawyer will receive a more modest reward of her hourly rate for her legal work. On the risk side, we are assuming that clear cutting is not a crime or illegal. Thus, the client's only risk is the business risk that is present in all business transactions and, perhaps, some personal reputational damage among persons who consider clear cutting bad. The lawyer, however, risks significant professional damage, including disbarment and professional reputation damage, if it is determined that clear cutting is not in the public interest. In such a case, lawyers may thus have an incentive to err on the side of a broad interpretation of the "public interest," while the client's interests would favor a narrow interpretation of that concept.

Model Rules.<sup>218</sup> As noted above,<sup>219</sup> the term was used in the Code of Professional Responsibility's counterpart to Model Rule 1.2(d)<sup>220</sup> and was generally regarded as reaching beyond the criminal law.<sup>221</sup>

Our proposed use of the term "unlawful" is intended to convey the same broad reach. Certainly we believe it is imperative that the prohibition contained in Model Rule 1.2(d) be expanded to reach all client conduct that would violate a statute or regulation, whether or not that conduct is considered criminal, given that these enactments are the clearest legal pronouncements of societal norms. We also believe that the rule's restriction on lawyer assistance should reach intentional client conduct that violates common law duties as well.<sup>222</sup> While the source of such duties is the judicial system, the legal and societal standards embodied in the common law are no less compelling than those that are legislative in nature. Exceptions for breach of contract and invasions of property interests would be necessary,<sup>223</sup> since such breaches of duty are often viewed as mere economic choices rather than failures to comply with legal norms.<sup>224</sup> Even under this proposal, clients may choose to act contrary to defined legal standards, but at least they will not be as likely to have the assistance of their lawyers in doing so.

218. See MODEL CODE OF PROF'L RESPONSIBILITY DR 7-102(A)(7) (1981).

219. See *supra* text accompanying notes 204-05.

220. MODEL CODE OF PROF'L RESPONSIBILITY DR 7-102(A)(7).

221. WOLFRAM, *supra* note 33, at 694.

222. Indeed, Professor Hazard reads "illegal" in the Code prohibition to include criminal violations, regulatory offenses, and intentional conduct resulting in civil liability other than contract breaches and invasions of property interests. Hazard, *supra* note 34, at 672-75. He concludes that a lawyer violates her duty under the Code's DR 7-102(A)(7) "to refrain from 'assisting' a client[s]" illegal conduct when:

- (1) The client is engaged in a course of conduct that violates the criminal law or is an intentional violation of a civil obligation, other than failure to perform a contract or failure to sustain a good faith claim to property;
- (2) The lawyer has knowledge of the facts sufficient to reasonably discern that the client's course of conduct is such a violation; and
- (3) The lawyer facilitates the client's course of conduct either by giving advice that encourages the client to pursue the conduct or indicates how to reduce the risks of detection, or by performing an act that substantially furthers the course of conduct.

*Id.* at 682-83.

223. *Id.* at 675 ("The term 'illegality' in ordinary legal parlance does not embrace breach of contract or invasion of a property interest.").

224. As Professor Hazard also notes, however, "there are breaches of contract and invasions of personal and property interests that are more flagrant and more harmful than many torts, and indeed more harmful than many regulatory offenses." *Id.* Still, we believe the exception for such conduct provides a reasonable balance for permitting generally accepted economic decision-making relevant to contract performance and property rights.

Our proposal to change the “knowing” standard and to broaden the reach of the illegality covered by Model Rule 1.2(d) would reduce the rule’s present lenience toward lawyers’ participation in their clients’ unlawful activities. In corporate representations, where clients act through transactions generally requiring the assistance of lawyers, the change should have particular importance in reducing the likelihood of client misconduct. More broadly, the change would bring the reality of the expectations of lawyers embodied in the Model Rules more in line with the bar’s self-professed role as officers of the legal system.

#### IV. CONCLUSION

The Enron debacle serves as a tragic reminder that corporate managers can engage in misconduct that has far-reaching, disastrous consequences for shareholders, employees, creditors, and others. Because that misconduct can be implemented through corporate transactions, lawyers who provide legal services in accomplishing those transactions often play the role of gatekeepers for their corporate clients’ conduct. Unfortunately, an analysis of the present gatekeeper role of lawyers as embodied in the prevailing rules of professional ethics reveals that it offers too little protection to the interests of the corporate client and, therefore, to other interests as well. We propose several reforms to invigorate lawyers’ gatekeeper role in representing corporations.

First, we believe that Model Rule 1.13(a)’s use of the entity theory can lead the lawyer to adopt a vague, intuitive sense of the identity of the corporate client. This approach offers little help in assessing the propriety of certain managerial decisions. To counter this deficiency, the rules of professional ethics should reflect directly that it is the substantive law of corporations that determines to which of the various constituencies the managers, and therefore the corporation’s lawyers, owe their primary duty. Thus, lawyers should be made aware that the conception of the entity must be informed by the law of corporations. This could be accomplished by a declaration to that effect in the comments to Model Rule 1.13. Although corporate lawyers are to give wide deference to the business decisions of managers, they must act when those decisions would violate the managers’ duty to the corporation. With additional guidance from the comments to the rules, lawyers would thus be guided by the interests of shareholders in determining whether a manager’s action violates a duty to the corporate entity.

Second, we believe that the scienter standard applicable to lawyers under Model Rule 1.13(b), even after the 2003 amendments, fails to protect the interests of corporate clients. Under that rule, a lawyer is required to take remedial actions only when she “knows”

that managers are engaged in misconduct.<sup>225</sup> We conclude that lawyers should be expected to take that action when they “reasonably should believe” that managers are doing so and that Model Rule 1.13(b) should be so amended.

Third, we believe that the obligation of lawyers to act to protect the best interests of corporate clients is too narrow in several other respects. Currently neither the 1983 nor the 2003 versions of Model Rule 1.13(b) requires lawyers to take any remedial action when past managerial misconduct is discovered. We propose that the rule be amended to require such action when the effects of the past misconduct can still be avoided or mitigated. Model Rule 1.13(b) would also be improved by a notation in the comments that “violation of law” is to be read broadly to include common law duties as well as other legal requirements. We also propose that if lawyers choose to continue in the representation of corporate clients after their remedial actions have failed to arrest managers’ misconduct, they should be aware that they must avoid assisting in any transaction that embodies or furthers the managers’ troubling action. This could be accomplished by amendment of Model Rule 1.13(c) to that effect or by clarification in the comments.

Fourth, as an important final limit on the lawyer’s duty to act on behalf of the best interests of a client, Model Rule 1.2(d) is inadequate. By prohibiting a lawyer’s assistance only when he “knows” of his client’s wrongdoing, Model Rule 1.2(d)’s effectiveness as a meaningful professional limit is hampered. We propose that this standard be replaced with a “reasonably should believe” standard by amendment of the rule. The limitation of Model Rule 1.2(d)’s prohibition only to a client’s “criminal or fraudulent” conduct is also too lenient. We propose that the rule be amended to prohibit a lawyer’s assistance to any “illegal” conduct and that the comments make clear that this includes common law duties as well. These changes will make Model Rule 1.2(d) a more meaningful part of the lawyer’s duty as an officer of the legal system in all sorts of representations. In corporate representations, the amended rule would also constitute an important component of the lawyer’s role as gatekeeper.

Finally, we believe that corporate lawyers’ natural allegiance to the managers who hire, compensate, and supervise them, constitutes a significant barrier to the professional independence required in the role of gatekeeper. These allegiances create a structural conflict for the corporate lawyer in serving the interests of the corporation as embodied in the interests of shareholders. To reduce this conflict, we propose that as a matter of corporate governance, lawyers for a

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225. MODEL RULES OF PROF’L CONDUCT R. 1.13(b) (2003).

corporation should be selected, compensated, and supervised by independent audit committees. Such committees constitute the best available alternative in terms of representing the interests of shareholders. This requirement could be accomplished by corporations' own actions, by statutory amendment, by regulatory action, or through stock exchange rules.

We believe that the changes we propose will inflate the role of corporate transactional lawyers as gatekeepers of their clients' conduct beyond its present state in the rules of professional conduct. Ultimately, however, this role will only be fulfilled by the commitment of lawyers to serve their corporate clients faithfully by providing the sort of independence in judgment and action those clients, the profession, and society should expect. Enron should have taught those of us in the profession that lawyers, among others, can do more to reduce the likelihood of similar future tragedies.