Notre Dame Law Review

Volume 56 | Issue 5 Article 5

6-1-1981

Changing Role of Outside Counsel: A Proposal for a Legal Audit

Myron P. Curzan

Mark L. Pelesh

III. Attorneys

The Changing Role of Outside Counsel: A Proposal for a Legal "Audit"

Myron P. Curzan and Mark L. Pelesh***

During the past several decades, the corporate governance debate has surfaced in many forms. Proposals for reform have addressed virtually every aspect of the way corporations are governed and operated.[1] The roles of officers, directors, and accountants have been examined and, in some respects, materially changed.[2] Codes of business conduct have been adopted.[3] Most corporate boards are now comprised of a majority of independent directors who have increased authority to monitor management and participate in long-range corporate planning.[4] Committees of the board have proliferated and deal with auditing, compensation, nominating, and social responsibility questions.[5] In particular, most major corporations now have audit committees composed of independent directors.[6] These committees work with the corporation's independent accountants to assure the accuracy of financial reporting and the adequacy of internal controls.

Demands for corporate accountability have also had ramifications for the role of shareholders. The courts and the Securities and Exchange Commission (SEC) have expanded access to the annual proxy process for the presentation of

* B.A., Columbia, 1961; M.A., Yale, 1962; LL.B., Columbia, 1965; Partner, Arnold & Porter, Washington, D.C.

** B.A., Stanford, 1975; J.D., Yale, 1978; Associate, Arnold & Porter, Washington, D.C.

1 *See generally* ALI-ABA COMMITTEE ON CONTINUING PROFESSIONAL EDUCATION, COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE (1979); Vagts, *The Governance of the Corporation: The Options Available and the Power to Prescribe*, 31 BUS. LAW. 929 (1976).

2 *See generally* Gillerman, *The Corporate Fiduciary Under State Law*, 3 CORP. L. REV. 299 (1980); Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 BUS. LAW. 883 (1976); Soderquist, *Toward a More Effective Corporate Board: Reexamining Roles of Outside Directors*, 52 N.Y.U. L. REV. 1341 (1977).

3 FOUNDATION OF THE SOUTHWESTERN GRADUATE SCHOOL OF BANKING, A STUDY OF CORPORATE ETHICAL POLICY STATEMENTS 6-9 (1980). Most large corporations have adopted such codes and policy statements on conflicits of interest largely in response to the SEC's program for the voluntary disclosure of questionable payments. Fedders, *Corporations on the Way to Cleaning Up Their Act*, Wash. Star, Feb. 3, 1980, § E, at 1, col. 2.

4 CONFERENCE BOARD, THE BOARD OF DIRECTORS: PERSPECTIVES AND PRACTICES IN NINE COUNTRIES (1977). Considering former or retired employees as nonmanagement directors, the Conference Board survey found that 84% of all American companies have a majority of outside directors. Considering such employees as management directors, the survey found that 66% of all American companies have a majority of outside directors. In contrast, a 1973 survey found these figures to be 77% and 62% respectively. CONFERENCE BOARD & AMERICAN SOCIETY OF CORPORATE SECRETARIES, INC. (ASCS), CORPORATE DIRECTORSHIP PRACTICES: MEMBERSHIP AND COMMITTEES OF THE BOARD (1973).

5 CONFERENCE BOARD, *supra* note 4. *See* Green & Falk, *Audit Committee—A Measured Contribution to Corporate Governance: A Realistic Appraisal of Its Objectives and Functions*, 34 BUS. LAW. 1229 (1979); Mautz & Newman, *The Effective Corporate Audit Committee*, 48 HARV. BUS. REV. 57 (1970); McMullen, *Committees of the Board of Directors*, 29 BUS. LAW. 755 (1974).

6 The 1977 Conference Board survey found that 93% of all American companies have audit committees. The 1973 survey set this figure at only 45%. CONFERENCE BOARD & ASCS, *supra* note 4.

shareholder proposals that have political, social, and economic significance.[7] These developments, together with other demands for corporate accountability, may well be part of a general revitalization of the concept of corporate democracy.[8]

Counsel has a crucial role to play in improving corporate governance. The presentation of independent and objective legal views to the board of directors is essential to improving the quality of the board's performance.[9] Counsel may also have a special ability to raise the level of ethical behavior in the corporation irrespective of whether the corporation is in technical compliance with the law.[10] In any event, the SEC and those demanding corporate accountability have begun to focus on the lawyer's role in the governance of corporations. The much-discussed case of *SEC v. National Student Marketing Corp.* [11] was only a harbinger of reform proposals aimed at requiring counsel to take actions designed to improve corporate governance and, in some cases, to disclose publicly corporate misconduct.[12]

The fundamental issue presented by these reform proposals is how counsel's role in improving corporate governance should be structured. An attorney's relationship to a corporation can take many forms. The most important and obvious distinction is that between inside and outside counsel. All corporate counsel, however, vary in their ability to influence the corporation they represent and in the degree to which they are subject to the control of management.

There are two requisites to fashioning an effective role for counsel in improving corporate governance. The first of these is "capacity": Counsel must have a grasp of the ongoing affairs of the corporation so that he will be in a position to influence its governance. The second requisite is "independence": Counsel must be sufficiently independent of management that he can confidently bring difficult legal and ethical problems before the board of directors.

The emergence of the corporate general counsel, largely over the last thirty years, poses a dilemma as one seeks to satisfy these two requisites. The general counsel of most major corporations is both a professional lawyer and an officer of the corporation. Typically, he employs a number of outside law firms to work on

7 Medical Committee for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir. 1970), *vacated as moot*, 404 U.S. 403 (1972); Securities Exchange Act of 1934 Release No. 12,999, 41 Fed. Reg. 52,994, 52,997 (1976).

8 *See, e.g.*, Curzan & Pelesh, *Revitalizing Corporate Democracy: Control of Investment Managers' Voting on Social Responsibility Proxy Issues*, 93 HARV. L. REV. 670 (1979).

9 *See* Palmieri, *The Lawyer's Role: An Argument for Change*, 56 HARV. BUS. REV. 30 (1978).

10 Williams, *Corporate Accountability and the Lawyer's Role*, 34 BUS. LAW. 7 (1978); Address by Harold M. Williams to the Eighteenth Annual Corporate Counsel Institute, Chicago, Illinois, The Role of Inside Counsel in Corporate Accountability (Oct. 4, 1978).

11 457 F. Supp. 682 (D.D.C. 1978) (since attorneys' failure to take steps to prevent merger based on materially misleading financial information violated securities laws, unnecessary to determine if attorneys had duty to disclose).

12 The most notable examples are the Petition for Rulemaking submitted by the Institute for Public Representation [hereinafter referred to as Georgetown Proposal], Securities Exchange Act of 1934 Release No. 16,045, 44 Fed. Reg. 44,881 (1979); the Corporate Democracy Act of 1980 proposed by a coalition surrounding Ralph Nader, M. GREEN, A. MARLIN, V. KAMBER & J. BERNSTEIN, THE CASE FOR A CORPORATE DEMOCRACY ACT OF 1980 (1970) [hereinafter referred to as GREEN & MARLIN]; and the Discussion Draft of the American Bar Association Model Rules of Professional Conduct proposed by the Commission on Evaluation of Professional Standards, ABA MODEL RULES OF PROFESSIONAL CONDUCT (Discussion Draft, Jan. 30, 1980) [hereinafter referred to as MODEL RULES]. For a discussion of these proposals, see the text accompanying notes 14-46 *infra*. *See In re* Carter & Johnson, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,175 (Mar. 7, 1979), *rev'd*, [Current] FED. SEC. L. REP. (CCH) ¶ 82,847 (Feb. 28, 1981); *In re* Keating, Muething & Klekamp, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124 (rule 2(e) disciplinary proceedings).

specific aspects of the corporation's legal problems while he and his staff address the corporation's ongoing legal affairs. Thus, the lawyer who has the greatest capacity for understanding the operations of the corporation—the general counsel—has the least independence because of his status as a member of management. The lawyer who has the greatest independence—the outside counsel—has a reduced capacity for comprehending the full range of the corporation's legal business because of his specialized role. This dilemma may be compounded by an apparent trend toward expansion of the staff and duties of the corporate general counsel and even more specialized use of outside counsel.[13]

This article will examine three proposals for structuring a role for counsel in corporate governance—the Georgetown Proposal, the Corporate Democracy Act of 1980, and the American Bar Association (ABA) Model Rules of Professional Conduct. In our judgment, these proposals are all deficient in that they fail to resolve the dilemma described above. As a result, the reforms they suggest have the effect of attacking the underpinnings of the attorney-client relationship. As an alternative to these reform efforts, the article proposes a regular legal review or "audit" to be conducted by independent outside counsel. We believe that this approach may offer a practical solution to the problem of defining the role of attorneys vis-a-vis the corporations they represent.

I. Proposals for Reform

On May 25, 1978, the Institute for Public Representation, a public interest law firm affiliated with the Georgetown University Law Center, submitted its first petition to the SEC for rulemaking on the responsibilities of attorneys to help enforce compliance with the securities laws. That petition sought to amend rule 2(e)[14] of the SEC's regulations to require attorneys, after first reporting to a corporation's management and then to its board of directors, to reveal matters involving securities frauds to the SEC.[15] On November 22, 1978, the Institute submitted a supplemental petition which modified and broadened the May 25 petition and requested the SEC to promulgate certain disclosure rules concerning the relationship between counsel and SEC registrants.[16] The SEC denied the

13 *See generally* Ferrara & Steinberg, *The Role of Inside Counsel in the Corporate Accountability Process*, 4 CORP. L. REV. 3 (1981); Taylor, *supra* note 2.

14 17 C.F.R. § 201.2(e) (1980).

15 The proposed rule stated:

> A lawyer who receives information clearly establishing that: (1) his client has, during the course of representation, perpetrated a fraud upon any person or upon the SEC with respect to any law administered or enforced by the SEC, shall promptly call upon his client to rectify the same, and if his client refuses or is unable to do so, he shall reveal the fraud to the affected person or to the SEC, except when the information is protected as a privileged communication (as distinguished from a confidential communication); (2) a person other than his client has perpetuated a fraud upon any person or the SEC with respect to any law administered or enforced by the SEC, shall promptly reveal the fraud to the SEC. "Fraud" includes a material misrepresentation or omission of material fact.
>
> In calling upon the client to rectify the fraud, the lawyer shall bring the facts and legal implications of the fraudulent conduct to the attention of management, including if necessary the chief executive officer. If management does not take action considered by counsel to be necessary to rectify the fraud, the lawyer shall bring the facts and legal implications of the fraudulent conduct to the attention of the Board of Directors.

Supplemental Petition of the Institute for Public Representation for Rulemaking on the Responsibilities of Corporate Counsel 5 (Nov. 22, 1978) (SEC File No. 4-210).

16 *Id.*

May 25 petition, but published the November 22 petition for comment without taking any position with respect to it.[17] Extensive critical comments on the Georgetown Proposal were submitted, and the SEC denied the petition on April 30, 1980.[18]

The Georgetown Proposal[19]—as modified and broadened—would have imposed three requirements. First, it would have required corporations filing reports with the SEC to include in their annual reports on Form 10-K a certificate stating that the board of directors had instructed every attorney employed or retained by the corporation to report to the board certain corporate activities discovered by the attorney which, in the attorney's opinion, violated or probably violated the law.[20] The required certificate would also state that all attorneys for the corporation had indicated their compliance by reporting the existence or absence of such violations, that the board had considered the attorneys' reports and taken appropriate action, and that information on material violations of law had been communicated to the corporation's independent auditors.[21]

Second, the Georgetown Proposal would have required reporting corpora-

17 Securities Exchange Act of 1934 Release No. 16,045, 44 Fed. Reg. 44,881 (1979).

18 Securities Exchange Act of 1934 Release No. 16,769, 45 Fed. Reg. 30,454 (1980).

19 The proposed rules stated:

> 1. Every corporation required to file reports with the Securities and Exchange Commission ("reporting corporation") shall include in its Form 10-K and in its annual report to shareholders a certificate stating that:
>
> (A) Its board of directors has instructed each attorney employed or retained by the corporation to report promptly to the board, either directly or through the audit committee or some other committee of the board with a similar ratio of independent directors, any corporate activities discovered by the attorney through reasonable diligence during the course of representation which, in the attorney's opinion, violate or probably violate any law administered or enforced by the SEC or any other law, where such violations or probable violations:
>
> (i) Could result in material financial liability for the corporation;
>
> (ii) Call into question the quality and integrity of management in connection with corporate activity; or
>
> (iii) Are part of a pattern or practice of recurring activity;
>
> (B) All attorneys have indicated their compliance with the board's instructions either by reporting such violations or probable violations, or by reporting, at least annually, that no such violations or probable violations have come to their attention;
>
> (C) The full board of directors has considered each attorney's report and has taken all actions determined to be appropriate;
>
> (D) Information regarding such violations or probable violations has been conveyed to the independent auditors if, in the opinion of the board, the violations or probable violations are material.
>
> 2. Every reporting corporation shall file with the Commission copies of written agreements delineating the relationship between the corporation and its outside attorneys. Such agreements may cover any aspect of the relationship which, in the opinion of the corporation might be of concern to stockholders and other investors, and, in any case, shall include:
>
> (A) The frequency and nature of counsel's contacts with the corporation's board of directors, general counsel, independent auditor, and chief executive officer; and
>
> (B) Obligations of counsel with regard to corporate conduct which counsel considers illegal or probably illegal.
>
> 3. When a reporting corporation's general counsel or any attorney retained in connection with matters pertaining to the laws administered or enforced by the Commission resigns or is dismissed, the corporation shall file with the Commission Form 8-K, describing the circumstances of the resignation or dismissal. Prior to submission of the Form 8-K to the Commission the corporation shall provide the resigning or dismissed attorney with an opportunity to comment on the accuracy and completeness of the description. The attorney's comments shall become part of the corporation's submission to the Commission.

Securities Exchange Act of 1934 Release No. 16,045, 44 Fed. Reg. 44,881 (1979).

20 *Id.* § 1(A).

21 *Id.* § 1(B)-(D).

tions to file with the SEC copies of written agreements describing the relationship between the corporation and its outside counsel and the obligations of counsel with regard to discovery of illegal conduct.[22]

Third, the Georgetown Proposal would have required reporting corporations to file with the SEC a report on Form 8-K whenever the corporation dismissed its general counsel or one of its securities lawyers.[23] The report would have followed the SEC's practice with respect to dismissal of a reporting corporation's independent auditors.[24] The Institute defended the Georgetown Proposal on grounds that it would improve the flow of information to the board, especially to independent directors; clarify the relationship of attorneys to the corporation; and protect investors, shareholders, and the public by minimizing the likelihood of unlawful corporate conduct.[25]

The Georgetown Proposal inspired a section of the Corporate Democracy Act of 1980 proposed by a coalition of members of Public Citizen's Congress Watch, the Council on Economic Priorities, and the Building and Construction Trades Department of the AFL-CIO.[26] The proposed act comprehensively addresses the structure and operation of large corporations.[27] Section 107 of the proposed act follows the first section of the Georgetown Proposal in prescribing that a corporation's counsel should report corporate activities that violate the law to a special committee of the board.[28]

A number of commentators raised a variety of objections to these proposals.[29] It was argued that existing internal corporate reporting systems are adequate[30] and that rulemaking would be inopportune when the legal profession is considering internal reform through revision of the Code of Professional Responsibility.[31] It was also argued that the proposals would strain the attorney-client relationship and stifle the exchange of information between corporations and

22 *Id.* § 2.

23 *Id.* § 3.

24 This requirement is contained in Item 4 of Form 8-K, adopted pursuant to § 13 of the Securities Exchange Act of 1934. 17 C.F.R. § 249.308 (1980).

25 Comments of the Institute for Public Representation in Response to Securities Exchange Act Release No. 16,045 at 2-3 (Nov. 30, 1979) (SEC File No. 4-210).

26 GREEN & MARLIN, *supra* note 12, at 44-45. The activities of the coalition culminated in a "Big Business Day" on April 17, 1980.

27 For example, it would require greater shareholders' rights and an independent constituency board of directors representing not only shareholders but also consumers, employees, environmentalists, and other groups. *Id.* at 9-14. It would also mandate increased corporate disclosure, 24-month notification prior to the closing of a plant, and restitution to victims of hazardous corporate conduct. *Id.* at 14-19, 24.

28 Section 107 states:

> The Board shall certify that it has instructed all lawyers and auditors on salary or retained by the firm to report to the Law Compliance Committee any conduct by the firm that they consider to be illegal or probably illegal if the illegality a) would result in material financial liability to the company, b) call into question the quality and integrity of management, c) are part of a recurring practice, or d) involve significant harm to consumers.

Id. at 12.

29 The objections to the Georgetown Proposal are summarized in Securities Exchange Act of 1934 Release No. 16,769, 45 Fed. Reg. 30,454 (1980). *See also* Blomquist, *Corporate Disclosures of Relationships With Counsel: A Comment on Recent SEC Proposals*, 61 CHI. B. REC. 230 (1980); Burke, *The Duty of Confidentiality and Disclosing Corporate Misconduct*, 36 BUS. LAW. 239, 273-75 (1981); Gross, *Attorneys and Their Corporate Clients: SEC Rule 2(e) and the Georgetown "Whistle Blowing" Proposal*, 3 CORP. L. REV. 197 (1980); *SEC Corporate Counsel Proposals Draw Fire*, 66 A.B.A.J. 31 (1980).

30 *See* Securities Exchange Act of 1934 Release No. 16,769, 45 Fed. Reg. 30,454 (1980); Gross, *supra* note 29.

31 Securities Exchange Act of 1934 Release No. 16,769, 45 Fed. Reg. 30,454 (1980).

their counsel.[32] Inhibiting the flow of information would in turn increase the possibility of corporate wrongdoing. Finally, the Georgetown Proposal was criticized as ambiguous, impractical, and too costly.[33]

These objections to the proposals are well taken. An additional criticism is that the proposals fail to distinguish between inside and outside counsel. In imposing reporting obligations on all of a corporation's counsel irrespective of the nature of their relationship to the corporation, the proposals fail to recognize that inside and outside counsel have different capacities for influencing corporate governance and different degrees of independence from management.

In response to criticisms that the proposals would undermine the attorney-client relationship, the proponents of both proposals denied that they would create "whistleblower" obligations or breach the attorney-client privilege.[34] It is difficult to see how reporting to the board would not be regarded as "whistleblowing," at least by the member of management whose activities are reported. In any event, the proposals could have a more significant, albeit indirect, "whistleblower" effect, since such reporting might be held not responsive to a request for legal advice and hence not protected by the attorney-client privilege in ensuing litigation.[35] Moreover, communicating the report to the corporation's independent accountant would most likely prevent assertion of the privilege.[36]

Neither the Georgetown Proposal nor the Corporate Democracy Act of 1980 shows proper sensitivity for the "confessor" role that counsel should and must play in relation to his clients.[37] Imposing an ongoing obligation upon counsel to report "probable" violations of law would strip the lawyer of this role, chill com-

32 Blomquist, *supra* note 29; Gross, *supra* note 29; Securities Exchange Act of 1934 Release No. 16,769, 45 Fed. Reg. 30,454 (1980).

33 Gross, *supra* note 29; Securities Exchange Act of 1934 Release No. 16,769, 45 Fed. Reg. 30,454 (1980).

34 Comments of the Institute for Public Representation in Response to Securities Exchange Act Release No. 16,045 at 3 (Nov. 30, 1979) (SEC File No. 4-210); GREEN & MARLIN, *supra* note 12, at 44-45.

35 *See* United States v. United Shoe Mach. Corp., 89 F. Supp. 357, 358 (D. Mass. 1950) (privilege applies if communication "relates to a fact of which the attorney was informed (a) by his client (b) without the presence of strangers (c) for the purpose of securing primarily either (i) an opinion on law or (ii) legal services or (iii) assistance in some legal proceeding . . . ."). Ensuing litigation would be likely if the corporate misconduct were serious.

The Supreme Court of the United States recently broadened the application of the attorney-client privilege in the corporate setting in Upjohn Co. v. United States, 101 S. Ct. 677 (1981). The Court rejected the narrow "control group test," which extended the privilege only to communications between counsel and those in the control group of the corporation, but refused to sanction a different test for the application of the privilege. The Court emphasized that the Upjohn employees communicated with corporate counsel for the purpose of securing legal advice. *Id.* at 685. Even though *Upjohn* dealt with communications between lower echelon employees and counsel, the Court's analysis will likely govern whether the attorney-client privilege applies to an attorney's "whistleblowing" communications to the board of directors. To qualify for that protection under *Upjohn*, it appears clear that the communication must be responsive to a request for legal advice. *See* Note, *The Implications of Upjohn*, 56 NOTRE DAME LAW, 887 (1981).

36 *See* FTC v. TRW, Inc., 479 F. Supp. 160, 163 n.7 (D.D.C. 1979), *aff'd*, 628 F.2d 207 (D.C. Cir. 1980); Attorney Gen. of the United States v. Covington & Burling, 430 F. Supp. 1117, 1121 (D.D.C. 1977).

37 *See* Hazard, *An Historical Perspective on the Attorney-Client Privilege*, 66 CALIF. L. REV. 1061 (1978). Judge George Sharswood, generally accepted as the progenitor of the Canons of Ethics, *see* Lorne, *The Corporate and Securities Adviser, the Public Interest, and Professional Ethics*, 76 MICH. L. REV. 425, 430 (1978), compared the legal profession to the "sacred ministry" and stated that "the great duty which the counsel owes to his client is an immovable fidelity." G. SHARSWOOD, PROFESSIONAL ETHICS 50 (1854). *See also* Note, *The Attorney-Client Privilege—Identifying the Corporate Client*, 48 FORDHAM L. REV. 1281 (1980); Note, *Applicability of the Attorney-Client Privilege to Corporate Communications*, 48 U. CIN. L. REV. 819 (1979); Note, *Conflicting Standards for Applying the Corporate Attorney-Client Privilege*, 33 VAND. L. REV. 999 (1980).

munication between attorney and client, and thus undermine the goal of achieving greater corporate compliance with the law.

The SEC denied the Georgetown Proposal in part because the proposed revision of the ABA Code of Professional Responsibility "may provide further guidance concerning the professional responsibilities of corporate counsel."[38] The Model Rules therefore take on added significance to the structuring of a role for counsel in corporate governance.[39]

The Model Rules take an approach similar to, although less categorical than, the Georgetown Proposal and the Corporate Democracy Act. The two rules of principal relevance to the problem presented are rules 1.7 and 1.13.[40] Rule 1.7 governs treatment of a client's confidences in general.[41] Subsection (a) prohibits disclosure of information about the client where the information is confidential, except as provided by subsections (b) and (c). Subsection (b) *compels* disclosure of information where it is necessary to prevent the client from committing an act resulting in death or serious bodily harm to another or where disclosure is compelled by law or the rules of professional conduct. Subsection (c) *permits* disclosure in order to prevent or rectify a "deliberately wrongful act" by the client, except where the lawyer has been employed after the act has been committed to represent the client concerning the act.[42]

---

38 Securities Exchange Act of 1934 Release No. 16769, 45 Fed. Reg. 30,454 (1980).

39 Debate in the ABA House of Delegates on the Model Rules was scheduled for February 1981 but, in light of extensive criticism of the Rules, debate was put off. *See* Subin, *War over Client Confidentiality: In Defense of the Kutak Approach*, Nat'l L.J., Jan. 19, 1981, at 22; Burke, *supra* note 29, at 282-94; Ferrara & Steinberg, *supra* note 13, at 15-19.

40 Rule 3.1, MODEL RULES, *supra* note 12, at 59, which deals with attorney candor toward a tribunal, and rule 4.2, *id.* at 88, which addresses attorney behavior in negotiations, also have some relevance to the problem of disclosure of corporate misconduct.

41 Rule 1.7 provides:

> (a) In giving testimony or providing evidence concerning a client's affairs, a lawyer shall not disclose information concerning the client except as authorized by the applicable law of evidentiary privilege. In other circumstances, a lawyer shall not disclose information about a client which relates to the client-lawyer relationship, which would embarass the client, which is likely to be detrimental to the client, or which the client has requested not be disclosed, except as stated in paragraphs (b) and (c).
>
> (b) A lawyer shall disclose information about a client to the extent it appears necessary to prevent the client from committing an act that would result in death or serious bodily harm to another person, and to the extent required by law or the Rules of Professional Conduct.
>
> (c) A lawyer may disclose information about a client only:
>
> (1) For the purpose of serving the client's interest unless it is information the client has specifically requested not be disclosed;
>
> (2) To the extent it appears necessary to prevent or rectify the consequences of a deliberately wrongful act by the client, except when the lawyer has been employed after the commission of such an act to represent the client concerning the act or its consequences. . . .

Id. at 21-22.

42 The lawyer's duty not to reveal past wrongs becomes unclear where the wrong is continuing. This problem is especially acute in the securities area where failure to disclose material past wrongs in registration statements, proxy statements, and the like may be a new or future wrong. *See generally* Hoffman, *On Learning of a Corporate Client's Crime or Fraud—the Lawyer's Dilemma*, 33 BUS. LAW. 1389, 1402-03 (1978).

The comments to rule 2.3 suggest a resolution to an ambiguity surrounding the exception to rule 1.7(c)(2). The comments state:

> When the client's course of action has already begun and is continuing, the lawyer's responsibility is especially delicate. The lawyer is not required to reveal the client's wrongdoing, except where necessary to avoid additional serious consequences. See Rule 1.7. However, the lawyer is required to avoid furthering the purpose by suggesting, for example, how it might be concealed.

MODEL RULES, *supra* note 12, at 56-57. The comments thus suggest that a continuing wrong may be

Rule 1.13 deals specifically with disclosure of the confidence of a corporate client.[43] Subsection (a) reiterates that the lawyer represents the entity rather than any of the corporation's constituent elements. Subsection (b) suggests certain measures counsel might take upon discovering a legal violation. These measures are asking reconsideration of the matter, seeking a separate legal opinion, and referring the matter to higher authority including, if necessary, the board. In determining the appropriate measure, counsel is adjured to consider a number of factors, including the seriousness of the legal violation, its consequences, and the scope of his representation. Counsel is also supposed to minimize "disruption" and the disclosure of client confidences. In the event the board does nothing about the violation of law, subsection (c) authorizes counsel to take remedial action, including disclosure.

A technical problem posed by the Model Rules is that the relationship between rules 1.7 and 1.13 is unclear. Does rule 1.13 qualify rule 1.7 so that disclosure of corporate client confidences is restricted to violations of law as specified by rule 1.13? Or does rule 1.13 supplement rule 1.7 in the sense that it is one of the rules referred to in rule 1.7 which permits lawyers to disclose information as permitted by law or the rules of professional conduct?[44]

A more fundamental problem is that the Model Rules do little more than restate the problem of how counsel can improve corporate governance and, more specifically, of when he should report or disclose corporate wrongdoing. The Model Rules list factors and lay down permissive guidelines, but considerations such as the seriousness of the violation and the likelihood of harm to the corporation are well known, especially to counsel confronted with the problem of potential corporate misconduct. The different levels of authority to which counsel may appeal are also all too well known. To the extent they lay down a general rule requiring reports and disclosures for all corporate counsel, the Model Rules are

---

revealed pursuant to rule 1.7. The practical consequence of this view is that corporations may be unable to obtain counsel in securities matters where they most need legal advice.

43 Rule 1.13 provides:

> (a) A lawyer employed or retained by an organization represents the organization as distinct from its directors, officers, employees, members, shareholders, or other constituents.
>
> (b) If a lawyer for an organization knows that an officer, employee, or other person associated with the organization is engaged in or intends action, or a refusal to act, that is a violation of law and is likely to result in significant harm to the organization, the lawyer shall use reasonable efforts to prevent the harm. In determining the appropriate measures, the lawyer shall give due consideration to the seriousness of the legal violation and its consequences, the scope and nature of the lawyer's representation, the responsibility in the organization of the person involved, and the policies of the organization concerning such matters. The measures taken shall be designed to minimize disruption and the risk of disclosing confidences. Such measures may include:
>
> (1) Asking reconsideration of the matter;
>
> (2) Seeking a separate legal opinion on the matter for presentation to appropriate authority in the organization;
>
> (3) Referring the matter to higher authority in the organization, including, if necessary, referral to the highest authority that can act in behalf of the organization as determined by applicable law.
>
> (c) If, despite the lawyer's efforts in accordance with paragraph (b), the highest authority that can act on behalf of the organization insists upon action, or a refusal to act, that is clearly a violation of law and is likely to result in substantial injury to the organization, the lawyer may take further remedial action, including disclosure of client confidences to the extent necessary, if the lawyer reasonably believes such action to be in the best interest of the organization.

MODEL RULES, *supra* note 12, at 40-41.

44 *See* Burke, *supra* note 29, at 289-90.

subject to the same infirmities as the Georgetown Proposal and the Corporate Democracy Act: Different capacities for influencing corporate governance and different degrees of independence are not recognized. Although the Model Rules are appropriately deferential to the attorney-client relationship, they still would require abandonment of the attorney's role as "confessor."

The Georgetown Proposal, the Corporate Democracy Act and the Model Rules all seek to impose upon counsel obligations akin to those of an independent financial auditor.[45] Although the model of lawyer as auditor is not irrational, it is a significant departure from the model of lawyer as confidant.[46] Most of the criticisms of these proposals stem from this departure. Although the model of lawyer as auditor can be useful in establishing a role for counsel in improving corporate governance, this result can only be fashioned if the model is formulated in a more limited and structured fashion.

II. A Proposal for a Legal "Audit"

One of the most significant changes in corporate governance in recent years has been the increase in the number and responsibilities of audit committees of the board.[47] The SEC has long urged the formation of such committees.[48] In 1967, the American Institute of Certified Public Accountants recommended the appointment of committees composed of ouside directors to nominate the corporation's independent auditor and to review the auditor's work.[49] Such committees would discuss with the auditor the scope of his examination, review the auditor's report, direct supplemental audits if necessary, determine that the auditor had received all information requested, and invite the auditor's recommendations.[50] The auditor would bring to the audit committee's attention any significant questions concerning the company's financial statements that had not been satisfactorily resolved at the management level.[51] The audit committee would then take the matter to the board of directors with a recommendation for action. In the absence of satisfactory action by the board, the auditor would decide whether to take an exception in his opinion or resign.[52]

Subsequently, the SEC again endorsed the concept[53] as did the New York Stock Exchange[54] and the ABA Committee on Corporate Laws.[55] The SEC has

45 *See generally* Sommers, *The Emerging Responsibilities of the Securities Lawyer*, [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,631 at 83,689-90.

46 *See* Lorne, *The Corporate and Securities Adviser, the Public Interest, and Professional Ethics*, 76 MICH. L. REV. 425, 466-75 (1978).

47 *See* note 6 *supra*; Green & Falk, *supra* note 5; Mautz & Neuman, *supra* note 5.

48 SEC Accounting Series Release No. 19, 5 FED. SEC. L. REP. (CCH) ¶ 72,020 at 62,107-108 (Dec. 5, 1940); SEC Accounting Series Release No. 123, 5 FED. SEC. L. REP. (CCH) ¶ 72,145 (Mar. 23, 1972); SEC Accounting Series Release No. 126, 5 FED. SEC. L. REP. (CCH) ¶ 72,148 (July 5, 1972).

49 AICPA, *AICPA Executive Committee Statement on Audit Committees of Boards of Directors*, 124 J. ACCOUNTANCY 10 (Sept. 1967).

50 *Id.*

51 *Id.*

52 *Id.*

53 Securities Exchange Act of 1934 Release No. 9,548, [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,670 (Mar. 23, 1972).

54 *See* [1973] SEC. REG. & L. REP. (BNA) No. 232 at A-21.

55 ABA COMMITTEE ON CORPORATE LAWS, SECTION OF CORPORATION, BANKING & BUSINESS LAW, CORPORATE DIRECTOR'S GUIDEBOOK 29-30, 32-33 (rev. ed. 1978).

now approved a New York Stock Exchange rule[56] that requires, as a condition for listing, all domestic companies to establish independent audit committees.[57]

Using these precedents on the role of auditors and audit committees as a guide, the American Bar Association and the corporate sector should consider adopting a comparable approach for dealing with the problem of the relationship of counsel to the corporation he represents. Each corporation should consider appointing a special committee of the board of directors with responsibility to oversee that corporation's compliance with governing legal requirements. This committee would engage outside counsel on a periodic, perhaps annual, basis to review the significant legal affairs of the corporation.[58] This "auditor" counsel should not have had a prior "non-auditor" relationship to the corporation. The "auditor" counsel would meet with the corporation's general counsel and his staff and other outside counsel retained by the corporation for specific matters. These attorneys to the corporation would be obligated to make relevant materials available to the "auditor" counsel. "Auditor" counsel would also review various corporate transactions and meet with a range of corporate officials and employees. The "auditor" counsel would then report to the special committee of the board. In the event that signficant legal problems were uncovered, the special committee would be obligated to report to the board with a recommendation for action.[59]

This type of legal review process would have a number of salutary effects. It would increase the likelihood that significant legal problems would come to the attention of both management and the directors of corporations. This "highlighting effect" would occur for two reasons. On the one hand, management and inside counsel would know that if they attempted to avoid presenting significant issues to the board, they would face the embarrassing predicament of having "auditor" counsel discover the problem. Thus, their inclination would be to bring these issues to the board's attention. On the other hand, in the press of day-to-day corporate affairs management and inside counsel may not fully perceive the significance of potential legal issues. An "auditor" counsel review process would provide a significant check on questionable management decisions and establish a secondary review on what matters are brought to the board's attention.

This proposal would also increase the flow of information to corporate directors. By incorporating an independent legal review as well as an independent financial audit into the corporate governance process, directors would have

56 *See* Securities Exchange Act of 1934 Release No. 15,570, [1979 Transfer Binder] FED. SEC. L. REP. ¶ 81,959 at 81,393 & n.6 (Feb. 15, 1979).

57 Securities Exchange Act of 1934 Release No. 13,346 (Mar. 9, 1977). The SEC also amended its rules to require disclosure in proxy statements of the existence or absence of audit committees. 17 C.F.R. § 240.14a-101, Item 6(d)(1) (1980).

58 To establish a workable scope for the review, the committee's engagement of the "auditor" counsel should specify that counsel's role is to investigate the significant areas of legal exposure of the corporation and the significant potential legal problems it faces.

59 The concept of a legal "audit" has been suggested as a stop-gap to relieve SEC-generated pressure for disclosure of corporate wrongdoing and prosecution of corporations and their officers. Pickholz, *Confronting SEC Pressure: A Need for Legal Audits*, Legal Times of Wash., Oct. 29, 1979, at 14, col. 1. Although that proposal provides a useful starting point, it does not address the corporate governance issues that underlie demands for corporate accountability. For example, it does not resolve the "audit" counsel's role vis-a-vis the board of directors. *See also FTC's Model Antitrust Compliance Audit Program*, Legal Times of Wash., Aug. 27, 1979, at 18, col. 1.

greater assurance that they were obtaining the salient facts about the corporation. This type of audit process would obviate the need for proposals that corporate boards be provided with staffs to help them monitor corporate management.[60]

This approach offers the additional benefit of clarifying the role of both inside and outside counsel to a corporation. Corporate counsel represents the corporation as a whole, and therefore has a duty to bring serious legal issues to the attention of the board of directors.[61] The "auditor" counsel approach pragmatically addresses the realities of the ongoing management-counsel relationship. If counsel is to play a major role in guiding the corporation's day-to-day affairs and is to serve as a corporate "confessor," then he must be trusted by management. To foster management's trust, the natural inclination of almost all corporate counsel is to temporize and to down-play the significance of legal issues; to find answers at the operational level and not to direct these issues to the board of directors. In our experience, corporate counsel tends not to seek out problems that may require reference to the board and disclosure to the public.

The "auditor" counsel approach eases this problem for corporate attorneys. To the extent that counsel does not raise issues at the board of directors level, his actions are subject to another level of scrutiny. It is the "auditor" counsel who has final responsibility for ensuring that important matters are brought to the attention of the corporation's board. Such counsel will place a new check on the current balance between management and the board.

The "auditor" counsel approach directs the resolution of serious legal problems to the board of directors—where it should reside. The board should know the significant issues facing the corporation and should make the decisions resolving them. The proposed approach provides increased assurance to the corporate policy-makers that information will reach them. Of equal importance, it puts pressure on the board to deal with that information. Although any reports of "auditor" counsel would presumably be privileged—since they would constitute responses to a communication from the client for legal advice[62]—they would still require action by the board. If the board failed to act it would probably face the prospect of "auditor" counsel's resignation. This should have the same deterrent effect as does the resignation of a corporation's financial auditors.

In any event, the adoption of this proposal by the American Bar Association and the corporate community would help eliminate proposals for direct or indirect "whistleblowing" by corporate counsel to the public. Corporations cannot operate efficiently if their regular counsel cannot play the role of "confessor" and adviser. When corporate management and the board of directors fail to act in the face of illegal corporate behavior, then counsel should resign.[63] Any revela-

60 *See generally* Goldberg, *Debates on Outside Directors*, N.Y. Times, Oct. 29, 1972, § 3, at 1, col. 3; McMullen, *supra* note 5; Wilde & Vancil, *Performance Audits by Outside Directors*, 50 HARV. BUS. REV. 112 (1972).

61 At least two corporations, Connecticut General Insurance and Mead, have adopted policies that require the general counsel to report significant legal and ethical problems to the board or to the audit committee. Palmieri, *supra* note 9, at 44.

62 Upjohn Co. v. United States, 101 S. Ct. 677 (1981) (employee responses to counsel's investigation held privileged where communications were made at direction of corporate superiors in order to secure legal advice).

63 Kramer, *Clients' Frauds and Their Lawyers' Obligations: A Study in Professional Irresponsibility*, 67 GEO. L.J. 991 (1979).

tions or confessions to the public or to regulatory agencies should come from the corporation's board of directors or management.

III. Conclusion

Many proposals have been advanced relating to the role of counsel in the corporate setting. Unfortunately, these proposals do not address the two requisites to counsel playing an effective role in corporate governance. Instead, they deny the inherent tension between the "capacity" requirement—that information must become available to the general counsel if he is to be effective—and the "independence" requirement—that counsel's utility will be reduced if he is perceived as an investigator or watchdog to a corporation. The proposal for "auditor" counsel set forth in this article substantially reduces these problems by introducing to the process a new participant whose responsibilty would be to ferret out difficult legal and ethical issues. The proposal should permit regular counsel to perform a more customary counseling role.

If there is any significant disadvantage to this approach, it is that the proposal would increase current corporate auditing costs. We submit that any response to the growing demands for corporate accountability must involve some cost. Far more detrimental would be the absence of any response at all by the corporate community. In the long run such a refusal to deal with an existing problem might be the most costly approach of all, since it could lead to further losses of public confidence in the corporate sector and eventually to intrusive and inefficient government regulation.