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William H. Simon

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After Confidentiality: Rethinking the Professional Responsibilities of the Business Lawyer

Cover Page Footnote

Arthur Levitt Professor of Law, Columbia University. This essay benefited from helpful comments at Fordham University School of Law at the conference The Internal Point of View in Law and Ethics in February 2006 and at Duke, where I gave an earlier version as the Rabbi Seymour Siegel Lecture in March 2005.

AFTER CONFIDENTIALITY: RETHINKING THE PROFESSIONAL RESPONSIBILITIES OF THE BUSINESS LAWYER

William H. Simon*

INTRODUCTION

Recent business scandals and the regulatory responses to them raise basic questions about the role of the business lawyer. Lawyers were major participants in Enron and in similar controversies over corporate disclosure. Lawyers have also been key players in the corporate tax shelter industry. In both instances, their conduct has prompted federal regulations that repudiate to an unprecedented degree the bar's traditional understanding of its structure and obligations.

The provision of the Sarbanes-Oxley Act of 2002 mandating "up-the-ladder" reporting by public corporation counsel was the first federal statute in American history to regulate lawyers directly and broadly.¹ The second came only two years later—the "Jobs Act" provision imposing requirements on lawyers engaged in shelter-like tax planning.² Both initiatives significantly abrogated the principle of professional "self-regulation"—the name that both the bar and social science give to the alliance of trade associations and compliant state judiciaries that have traditionally asserted regulatory authority over lawyers. And both statutes unsettle long-rooted conceptions of client loyalty.

The most frequent and vocal response of the organized profession to these developments has been emphatic reassertion of long-standing positions. In particular, the bar has been circling the wagons around confidentiality. Virtually every major corporate firm protested the SEC's "noisy withdrawal" proposal to require public companies to report their lawyers' withdrawal "for professional reasons" to the SEC (as companies

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1. 15 U.S.C. § 7245 (Supp. III 2003).

2. 26 U.S.C.A. §§ 6111(a), 6707A(c) (West 2006) (requiring tax advisors to disclose certain transactions having a potential for tax avoidance or evasion and to "describ[e] any potential tax benefits expected to result from the transaction").

have done for years with respect to accountants).³ An American Bar Association Task Force on Confidentiality is campaigning vigorously against the Department of Justice's practice of requiring companies facing criminal charges to waive attorney-client privilege with respect to internal investigations as a condition of deferred prosecution.⁴

Such responses are unfortunate. The bar's claims about corporate confidentiality are at best unsubstantiated and at worst fraudulent. Regardless of whether the bar succeeds in beating back the SEC's "noisy withdrawal" proposal and the Department of Justice waiver demands, lawyer-client confidentiality cannot play an important role in contemporary business regulation. Corporate confidentiality is dead, and the bar's attempt to suggest that things could be otherwise is an exercise in myth making.

A deeper objection to the bar's current preoccupations is that the bar largely ignores basic issues posed by recent scandals and regulatory responses. Two issues are critical. The first is formalism—the doctrine that only the letter of the law and not its spirit is binding. The bar has long had trouble defending formalism, but it has never been able to renounce it either.

The second problem concerns the meaning of client loyalty when the client is an organization. Although a major fraction of the bar has represented corporations more or less exclusively for more than a century, the bar's norms of practice have tended to speak of clients as if they were individuals. They have thus tended to ignore the internal conflicts of interest that differentiate organizational from individual clients. Lawyers have a strong tendency to identify their corporate clients with management. They know that in principle the corporation is not the same thing as its management. But they have no clear conception of what else it could be. Thus, in spite of themselves, lawyers instinctively fall back on views that conflate the organization and its personnel.

The confusion around these issues undermines the most fundamental claim of modern professionalism—that professionals can simultaneously serve their client's interests and the public's interest. Loyalty to clients is consistent with the public interest because client trust enables professionals to induce socially desirable behavior. In the case of lawyers, the social payoff is compliance with law. Thus, the bar's rationale for corporate confidentiality is that it induces more consultation with lawyers, which in turn enhances both the client's ability to pursue its own interests and compliance with law.⁵ But even if we concede that corporate confidentiality induces legal consultation—a concession to be mostly

3. See, e.g., Letter from 79 Law Firms to Jonathan G. Katz, Sec'y, U.S. Sec. & Exch. Comm'n (Apr. 7, 2003), available at <http://www.sec.gov/rules/proposed/s74502/79lawfirms1.htm>.

4. See ABA Presidential Task Force on Attorney-Client Privilege, Report to ABA House of Delegates (June 7, 2005), available at www.abanet.org/buslaw/attorneyclient/materials/hod/report.pdf.

5. See, e.g., Model Rules of Prof'l Conduct R. 1.6 cmt. 2 (2005).

retracted below—the claim is implausible without clarification of the ideas of “compliance” and client interests in the corporate context. If the “compliance” that lawyers induce means no more than conformity to the law’s literal terms, we have little reason to consider it of social value. And before we can conclude that confidentiality serves the interests of corporate clients, we need an explanation that clearly distinguishes between corporate and managerial interests.

There may be a promising emerging conception of compliance, and the business lawyer’s role in it, implicit in a range of recent regulatory developments and some relatively low-visibility activities of some business lawyers. I am thinking of some aspects of securities regulation, such as the “internal controls” requirements of Sarbanes-Oxley,⁶ as well as a broad range of “management-based” regulatory regimes that include the hazardous substance regulations of the Occupational Safety and Health Administration (OSHA),⁷ Project XL of the Environmental Protection Agency,⁸ and the Hazard Analysis and Critical Control Point food safety regime of the Department of Agriculture.⁹ Suggestive lawyer activities include the work of the tax section of the New York State Bar Association.¹⁰ These activities have implications for the problems of client interest and compliance, and imply responses to the issues of formalism and client identity.

I. FORMALISM AND THE PUBLIC INTEREST

Enron “special purpose entities” and tax shelters share a strong resemblance. Both are complex transactions structured and executed by multidisciplinary professional teams for very large fees for the sole purpose of circumventing legal constraints. They have no “business purpose,” and they manifestly frustrate the public purposes underlying the relevant laws.

The Enron “Raptor” transactions were structured so that illiquid investments that managers expected to decline in value could be removed from the company’s financial statements. Notes from the board meeting approving one set of these deals described them as a “hedge” but then noted, “[d]oes not transfer economic risk but transfers P[rofit] & L[oss]

6. See 15 U.S.C. § 7262 (Supp. III 2003).

7. See 29 C.F.R. § 1910.1200 (2006).

8. See Regulatory Reinvention (XL) Pilot Projects, 60 Fed. Reg. 27,282 (May 23, 1995); see also U.S. Env’tl. Protection Agency, What is Project XL?, <http://www.epa.gov/projectxl/file2.htm> (last visited Sept. 24, 2006).

9. See Pathogen Reduction; Hazard Analysis and Critical Control Point (HACCP) Systems, 61 Fed. Reg. 38,806 (July 25, 1996) (codified in scattered sections of 9 C.F.R.); see also William H. Simon, *Toyota Jurisprudence: Legal Theory and Rolling Rule Regimes*, in *Law and New Governance in the EU and the US* 37, 55-63 (Gráinne de Búrca & Joanne Scott eds., 2006).

10. Tanina Rostain, *Sheltering Lawyers: The Organized Tax Bar and the Tax Shelter Industry*, 23 Yale J. on Reg. 77, 97-109 (2006).

volatility.”¹¹ The Currency Options Bring Reward Alternatives (COBRA) tax shelters were currency option transactions, the sole purpose of which was to create economically fictitious losses that would offset economically real capital gains. Henry Camferdam, an entrepreneur who sold his technology company in 1999 for about \$70 million, was introduced to the idea when an Ernst & Young (E&Y) accountant called to say, as reported by the *American Lawyer*, that E&Y “had a plan that would make that capital gain disappear.”¹² Legal opinions from Jenkins & Gilchrist and Sidley Austin LLP would provide “insurance.”¹³

The professionals defended these transactions, and they still do. The defense depends on formalism. The defenders do not dispute that the transactions frustrate the purposes of the relevant laws. Rather, defenders argue, first, that the deals complied with the literal terms of the law, and second, that compliance with its literal terms was all that the law required. Both propositions are controversial. Arguably, many of the Enron transactions and tax shelters did not comply even with the literal terms of the law. Moreover, it is a matter of dispute whether the securities and tax laws should be interpreted to require only literal compliance. The securities laws have very broad definitions of fraud and other prohibited practices that seem to call for purposive interpretation, but at least some lawyers suggest that literal compliance with accounting rules should sometimes be sufficient, even for otherwise misleading practices.¹⁴ In the tax area, judicial authority seems more or less evenly divided between literalist and purposive approaches to compliance.¹⁵

But I am less interested in the specific mandates of the tax and securities laws than in the professionals’ general understanding of their obligations to law and the public interest and how that understanding shapes their conception of their role. All lawyers are formalists some of the time. No corporate lawyer would refuse to assist in a freeze-out merger with a shell corporation solely because the transaction is not really a business combination but a forced buy-out. Nor would any corporate lawyer refuse to execute a “poison pill” takeover defense on the ground that the “pill” is not really the dividend it purports to be but rather a device for expanding board power without a shareholder vote. Although each maneuver depends on a formalistic interpretation of the relevant statute, the courts have

11. Special Investigative Comm. of the Bd. of Dirs. of Enron Corp., Report of Investigation 157 (Feb. 1, 2002), available at <http://f11.findlaw.com/news.findlaw.com/hdocs/docs/enron/sicreport/sicreport020102.pdf>.

12. Paul Braverman, *Helter Shelter*, Am. Law., Dec. 2003, at 65, 69.

13. *Id.*

14. Compare *United States v. Simon*, 425 F.2d 796, 805-07 (2d Cir. 1969) (rejecting literalism), with Patti Waldmeir, *Inside Track: Don't Blame the Lawyers for Enron*, Fin. Times, Feb. 21, 2002, at 14 (reporting pro-literalism views of lawyers).

15. Joseph Bankman, *The Tax Shelter Battle*, in *The Crisis in Tax Administration* 9, 21-22 (Henry Aaron & Joel Slemrod eds., 2003).

approved each, and there are substantial reasons to think they can be consistent with public policy.¹⁶

Some lawyers, however, are formalists all the time, or at least, they are always ready to be formalists when doing so would serve client interests. They will invoke the public interest when that helps the client, but they do not feel constrained by any public interest that is not fully articulated in positive rules. They thus stand ready to exploit “loopholes” and “technicalities”—formal interpretations of rules that thwart their underlying purposes.

For a substantial segment of the bar, such formalism is a key feature of the professional ideal. In the debate about Vinson & Elkins’s (V&E) work for Enron, Lawrence Fox of the ABA Ethics 2000 Commission insisted, “Clients are entitled to know there are loopholes If you want to stop that, you have to rewrite the law.”¹⁷ Stephen Gillers of New York University Law School said, “The job of a lawyer is to figure out how to accomplish the client’s objectives within the law and if that can be done only through a technicality, that is not the lawyer’s fault.”¹⁸

There is, of course, another view. It was concisely expressed by the Enron accountant Sherron Watkins in her famous memo to Ken Lay. She made no mention of any of the accounting rules Arthur Andersen and V&E relied on. Instead, she noted that “[t]he overriding basic principle of accounting is that if you explain the ‘accounting treatment’ to a man on the street, would you influence his investing decisions? Would he sell or buy the stock based on a thorough understanding of the facts? If so, you best present [such facts] correctly. . . .”¹⁹

This appeal to an “overriding basic principle” contrasts markedly with the preoccupation of the Andersen accountants and the V&E lawyers with the technical requirements of Financial Accounting Standards Board standards. There is no indication that these professionals ever asked the question, “Is this misleading?” Or, if they did ask the question—as in a section of V&E’s response to the Watkins letter headed “Bad Cosmetics”²⁰—that these professionals considered the answer relevant to the permissibility of the transaction.

16. The formalism involved in the freeze-out merger and the poison pill resemble the type defended in Lon L. Fuller, *Legal Fictions* (1967). Language is stretched away from its original purposes in order to accommodate current social norms in a changed environment. A key feature of the more defensible forms of this practice is that they are sufficiently transparent to be reviewable by public officials. By contrast, a key feature of the Enron-style earnings games and tax shelters is that they presuppose or exacerbate inadequate public accountability. Enron tried to hide information from the public, and tax shelter strategies depend on the IRS’s inadequate enforcement resources.

17. Waldmeir, *supra* note 14, at 14.

18. *Id.*

19. Letter from Sherron Watkins to Kenneth L. Lay (Aug. 14, 2001), *available at* <http://news.findlaw.com/hdocs/docs/enron/empltr2lay82001.pdf>.

20. Letter from Max Hendrick III, Att’y, Vinson & Elkins L.L.P., to James V. Derrick, Jr., Executive Vice President and Gen. Counsel, Enron Corp. (Oct. 15, 2001), *available at* 2001 WL 1764266, at *7.

Among securities lawyers, the most articulate speakers are defenders of formalism. Those who have doubts tend to be silent or ambiguous. But the tax bar is openly divided, and a major contingent of practitioners, many in the big established firms, have taken a strong position against what they, along with the IRS, call "abusive" tax practice. They oppose the new shelter practice as socially "inefficient." While the securities lawyers have opposed SEC regulation of their practice with remarkable uniformity, the anti-shelter tax faction, led by the tax sections of the American Bar Association and, especially, the New York State Bar, have supported IRS initiatives and even called for their strengthening. The anti-shelter tax faction supports demanding "due diligence" requirements for shelter opinions, and even, in some cases, the requirement that practitioners make shelter client lists available to the IRS.²¹

Note the difference between the premises of the defenders of V&E and those of the New York Tax Section. The idea of a "loophole"—a course of action that fits the letter but violates the spirit of the law—is unintelligible to the former. To them, as Gillers put it, "[i]t's either legal or it's not."²² But the New York Tax Section accepts the IRS's premise that there is an important category of "abusive" practices that can be identified independently of the literal terms of the law.²³

The practitioners on both sides of the formalism debate are not just arguing about the characteristics of prevailing law. The formalists do not argue only that they should give their clients the benefit of formalistic manipulation because the law creates or accepts those benefits. The antiformalists do not argue only that literal compliance is insufficient because that's what the law says. Indeed, what we might call the legal positivist case—lawyers should be formalist because the law is formalist—is much stronger in the tax area, where the bar is divided, than in the securities area, where formalism is virtually unchallenged. In the tax area, there has long been an "economic substance" doctrine that condemns literal but counter-purposive positions, but it has never been uncontested. Yet, there has also been a minority position that formal compliance is enough (and it seems to have gained ground in recent years).²⁴ In the securities area, however, it is hard to square formalism with the open-ended nature of the securities acts' fraud norms and with the accountant's practice of opining with respect to financial statements, not only that they comply with Generally Accepted Accounting Principles (GAAP), but that they "fairly and accurately" portray the financial condition of the company. V&E's position implies that a financial statement can be knowingly misleading ("bad cosmetics") and yet, so long as it complies with GAAP, non-fraudulent. There is no authority for this position, and some against. Most

21. Rostain, *supra* note 10, at 96-109.

22. Waldmeir, *supra* note 14, at 14.

23. Rostain, *supra* note 10, at 97-109.

24. See Bankman, *supra* note 15, at 21-22.

importantly, securities laws prohibit statements that are “misleading” *tout court*. It is hard to find loopholes in such terms. Yet, formalism flourishes in the securities area even more than in the tax area.

Clearly, then, lawyers are not simply taking the law as they find it. Lawyers are arguing for and against formalism because they see stakes for society and for themselves in these issues. The stakes for the profession involve lawyers’ own sense of self-respect and dignity, the image of themselves they present to their clients, and the profession’s image before the public.

The lawyer image that best justifies formalist practice is libertarian. It sees government action as presumptively suspect and the lawyer as performing a valuable role in forcing greater clarity in the norms that authorize and regulate such action. Lawyers market themselves to their clients as champions committed to minimizing the interference of government with their pursuit of their private goals. They justify themselves to the public as an essential institution of government restraint. Formalist evasion pushes the rule maker to articulate its goals more precisely. The cycle of evasion and re-articulation moves upward to greater completeness and clarity. Completeness and clarity is good because it increases people’s ability to plan their affairs. It is further valued as an engine of democracy. Informal interpretation, John Manning complains, “relieves the legislature of both the responsibility and accountability for doing” its job.²⁵

Many lawyers will not be comfortable with the libertarian premise that we should be categorically more wary of government activity than of business activity. But whatever one thinks of this starting point, formalism does not follow. Both the certainty and the accountability arguments for formalism are unconvincing.

The certainty argument ignores that increased certainty for some people may imply reduced certainty for others. The argument is also wrong to assert any strong correlation between formalistic legality and the social experience of predictability or control of one’s life. For most people in many realms of life, predictability is best furthered by laws that track ordinary social expectations, and that will often be an informal legality.²⁶ Enron illustrates both points. Whatever certainty formalistic interpretation gave to Andrew Fastow and his cronies, it produced disruptive surprise for most other stakeholders in the company. And an interpretation of the rules that limited off-balance sheet finance to a disinterested informal judgment

25. John F. Manning, *The Absurdity Doctrine*, 116 Harv. L. Rev. 2387, 2437 (2003).

26. See 1 Friedrich A. Hayek, *Law, Legislation, and Liberty: Rules and Order* 118 (1973) (“What has been promulgated or announced beforehand will often be only a very imperfect formulation of principles which people can better honour in action than express in words. Only if one believes that all law is an expression of the will of a legislator and has been invented by him, rather than an expression of the principles required by the exigencies of a going order, does it seem that previous announcement is an indispensable condition of knowledge of the law.”).

about whether it made sense would have produced disclosures that would have been more accurately interpreted than the formalistic manipulations that were used.

As for accountability, note to begin with that formalists do not confine their efforts to settings in which there are well-functioning processes of policy monitoring and revision. On the contrary, one of the disturbing features of Enron-style securities practice and tax shelter practice is that they depend on or exacerbate weaknesses in processes of public enforcement and oversight. Thus, Enron used literalistic interpretation of disclosure norms to justify the concealment of information necessary for public appraisal of its practices. Tax shelter practice is designed to exploit the IRS's limited audit and litigation resources. The low probabilities that public authorities will detect their practices have influenced lawyers' advice in favor of aggressive tax positions, and practitioners have gone to elaborate lengths to make it hard for the IRS to identify its products. Legislative revision to take account of practices that never come to light is unlikely.

More generally, the demand of formalism that government specify fully the obligations of citizens before enforcement increasingly seems both too strong and too weak a condition of accountability. It is too strong a condition because the government lacks the ability to anticipate and specify in advance the full range of situations to which public norms apply. The increase in recent decades in the pace of innovation in financial markets has exacerbated this problem. Even if public enforcement resources were more balanced with private evasion resources, the government could not keep up with the capacities of professionals advising the private sector for evasive innovation. Joseph Bankman suggests that the ultimate practical result of a consistently formalist tax regime would be that no tax would be collected from anyone with access to good professional advice.²⁷ One might also predict that the result of a consistently formalist securities disclosure regime would be that all corporate wealth would be expropriated by insiders.

But in other respects formalism is a weak condition of accountability. Formalism demands only that norms be specified, not that they serve their purposes. A formalist regime breeds not only counter-purposivist evasion but also counter-purposivist compliance—costly activity dictated by the literal terms of rules that make little contribution to their underlying purposes. Formalism imposes no constraints on the substance of norms. Thus, the Enron-era crisis of under-compliance has been followed by a crisis of *over-compliance* in the implementation of the “internal controls” provisions of Sarbanes-Oxley. The statute requires management to certify the adequacy of the company's financial controls,²⁸ and managers necessarily depend on accountants for this function. The statute and regulations are not specific on what adequacy means. The accountants, encouraged by their regulator (the Public Company Accounting Oversight

27. See Bankman, *supra* note 15, at 19-20.

28. See 15 U.S.C. § 7241(a) (Supp. III 2003).

Board) and empowered by their oligopolistic industry structure, chose to interpret the statute in a way that served no purposes but their own. They overreacted to minor deficiencies and demanded costly safeguards out of proportion to the magnitudes of the risks involved. They minimized liability risk to themselves and generated enormous fees, but they imposed unjustified costs on the companies and the public.²⁹

Donald Nicolaisen, former Chief Accountant at the SEC, recently complained about the “compliance mindset,” by which he meant both evasive and defensive formalism. In rhetoric strikingly reminiscent of Sherron Watkins’s forlorn exhortation, he suggested that those who prepare financial statements should ask themselves what kind of information they rely on in making their own investment decisions and then use the answer as a guide to deciding how to report on their clients.³⁰ In the current climate, the idea that the information lawyers and accountants produce under securities law should be useful to anyone comes easily only to mavericks or government officials.

The libertarian/formalist model of lawyering has become a liability for lawyers. The wedge that formalism drives between legal norm and public purpose undermines the profession’s claim that its services have public value. This is increasingly true as the image of formalist evasion—the price of a cycle of progressive clarification of law—seems less plausible than the image of a downward spiral of reciprocally exacerbating legal rigidity and opportunistic evasion.

There is another dimension to the problem. The libertarian/formalist vision disables the professions from responding to the demands and opportunities of a style of regulation that has become increasingly prominent in recent decades. Sarbanes-Oxley is a recent example of this critical trend. The trend extends to education (the No Child Left Behind Act³¹), environmental law (e.g., Project XL³² or Habitat Conservations Plans³³), product safety (e.g., Hazard Analysis and Critical Control Points regime in food safety³⁴), occupational health and safety (e.g., OSHA’s hazardous substance program³⁵), and many other areas.

29. See Donald C. Langevoort, *Internal Controls After Sarbanes-Oxley: Revisiting Corporate Law’s “Duty of Care as Responsibility for Systems”*, 31 J. Corp. L. 949 (2006), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=808084.

30. Jack T. Ciesielski, *What Keeps the SEC Busy—2005*, Analyst’s Acct. Observer, Jan. 18, 2005, at 1, 2.

31. See No Child Left Behind (NCLB) Act, Pub. L. No. 107-110, 115 Stat. 1425 (codified in scattered sections of 20 U.S.C.).

32. See Regulatory Reinvention (XL) Pilot Projects, 60 Fed. Reg. 27,282 (May 23, 1995).

33. Such plans are developed and approved pursuant to § 10 of the Endangered Species Act. See 16 U.S.C. § 1539(a)(1)(B) (2000).

34. See Pathogen Reduction; Hazard Analysis and Critical Control Point (HACCP) Systems, 61 Fed. Reg. 38,806 (July 25, 1996) (codified in scattered sections of 9 C.F.R.).

35. See 29 C.F.R. 1910.1200 (2006).

These regimes are a response to the problems that defeat formalism—that the regulator never knows as much about the problems she regulates as the regulated, that even if she were omniscient she could never express her understanding in sufficient detail to preclude ambiguity, and that the problem and potential solutions change more rapidly than the regulations can be revised.³⁶

In the emerging approach to regulation, the regulator looks to the regulated to identify problems and solutions and to continuously revise her understanding of both. The regulator promises leniency, flexible accommodation, and technical assistance in exchange for transparency and collaborative information sharing on the part of the regulated. Among the characteristic features of these legal regimes are substantive norms that are deliberately under-specified coupled with duties on the part of the regulated party to themselves identify and clarify the ambiguities in the norms. The “management discussion and analysis” requirement of the Securities Exchange Act of 1934 is an early example, and the Sarbanes-Oxley requirement that management assess the strengths and weaknesses of its “internal controls” is a newer one.³⁷ In such measures, the regulator elaborates goals and, rather than telling the regulated exactly what she should do in order to attain them, orders the regulated to herself identify the most effective responses and to both report and implement them. Moreover, explicitly or effectively, these regimes charge the regulated with a duty to disclose to the regulator deficiencies in the regulator’s formulation of the rules. An example is the provision proposed for (but ultimately left out of) the *Restatement (Third) of Torts* on the preemptive effect of administrative regulation in products liability cases. Compliance with administrative requirements immunizes the manufacturer from tort liability if she has disclosed to the regulator any information that suggests the requirements are inadequate.³⁸ The Federal Sentencing Guidelines provision that treats as a significant mitigating factor for corporate liability the adoption of reasonable compliance procedures is in the same spirit.³⁹

In an important sense, these new regimes vindicate the legitimate goal of the libertarian/formalist vision: the progressive clarification of law. Like the libertarians, the new reformers aspire to produce a progressively clarifying cycle of revision, but one that moves much faster. Although the core governing norms are typically expressed in general terms, both regulators and practitioners are expected to describe their practices as explicitly as possible. Yet, in the new regimes, normative specification is genuinely a means to clarification and understanding, not a shield from the pressures of public accountability. Where form diverges from purpose, practitioners should at least signal that fact to the public in a way that

36. See Simon, *supra* note 9, at 55-63.

37. 15 U.S.C. § 7241(a)(4)-(5) (Supp. III 2003).

38. Restatement (Third) of Torts § 4 (Proposed Final Draft, 1997).

39. 18 U.S.C.S. App. § 8C2.5(f) (LexisNexis 2006).

facilitates convergence. Practitioners must report deficiencies in the regulations to the regulators. And where the demands of such norms are ambiguous, those subject to the norms have a duty at least to make their conduct transparent to regulators, so that regulators can assess whether the norms require re-articulation.

These regimes try to co-opt the more technologically dynamic, socially responsible, and image-conscious members of the relevant industries. These firms are not averse to standards that enhance public confidence in the industry and its products, especially if the standards are generally enforced so that their competitors are precluded from offering lower prices by ignoring them. This means that in any given field of practice, the client community is likely to divide in its attitudes toward regulation. High-road clients will support regulation and want to participate in a way that makes the new regimes work. Low-road clients will want to minimize regulatory burdens any way they can. The high-road constituency means that lawyers who have a professional stake in associating their work with the vindication of the public purposes underlying the regime will have political allies when they work collectively for both regulatory and professional reforms that undercut opportunities for formalistic evasion. These clients will also demand lawyering services that require both skills and attitudes different from those associated with formalistic evasion (or defensive formalism). These new skills involve the ability to assess and revise norms and institutional structures in the light of their evolving purposes. This is not a radical idea. It is quite similar to the vision of lawyering Henry Hart and Albert Sacks expounded in the 1950s.⁴⁰ Recent developments in the economy and regulation have enlarged the opportunities for this type of lawyering. However, at the same time, we have seen a revival of the libertarian/formalist rival of this vision.

A potential role for bar organizations in the new regime is to facilitate aggregation of information and collective deliberation among practitioners about emerging perceptions of problems in the existing regulatory apparatus and ways for improving them. Lawyers should be among the first to perceive the problems, and if they shared information and ideas, they would be in a good position to formulate advice and proposals for the regulators. Such a role is well within the traditional commitments of bar associations to public service and law reform. It would be a difficult role for an inclusive or integrated bar representing all the lawyers in a jurisdiction. Lawyers with ideologies of their own or clients that committed them to low-road strategies of resistance or evasion would not support such activities. But voluntary bar associations with high-road members might be attracted to them. The efforts of the New York State Bar Association tax section, mentioned above, suggest possibilities.

40. Henry M. Hart, Jr. & Albert M. Sacks, *The Legal Process: Basic Problems in the Making and Application of Law* 209-40 (William N. Eskridge, Jr. & Philip P. Frickey eds., Found. Press 1994) (1958).

It seems doubtful that the libertarian/formalist view and the emerging "new-governance" view reflected in the new regulatory developments can be accommodated within a single professional vision. If the bar is to have a common vision of its role and responsibilities, it must choose. The choice is not dictated by either tradition or self-interest. But the newer approach has the best promise of vindicating the bar's claim that its service to private clients furthers public interests, and it seems to present the best opportunities to enhance the bar's social influence and status.

II. ORGANIZATIONS AND CLIENT LOYALTY

In its defense of its work for Enron, V&E said, "When clients ask us [if they can do something] our job is to . . . figure out if there is a legally appropriate way to do it. That's what we do. And so does every other law firm in America."⁴¹ I've been focusing on how we understand the idea of "lawful," and especially the relative roles of letter and spirit. Now I want to turn to the idea of "client" presupposed by this rhetoric.

To suggest that a corporate lawyer's duty to her client requires her to do her best to effectuate a manager's request to find a lawful way to withhold information from the shareholders is to suggest that the manager is the client. Every corporate lawyer knows that the manager is not the client. Yet, most corporate lawyers think and talk much of the time as if the manager were the client. Moreover, few corporate lawyers have a coherent idea of what a corporate client could be other than the manager.

The bar's rhetoric shows a strong tendency on the one hand to imply that the manager is the client or on the other to beg the question of whom (or what), if not the manager, the client is. In its vigorous opposition to the SEC's "noisy withdrawal" proposal, the bar repeatedly invoked Justice Warren Burger's distinction between the lawyer, a "loyal representative whose duty it is to present the client's case in the most favorable possible light," and the accountant, a "watchdog" whose "ultimate allegiance [is] to the corporation's creditors and stockholders, as well as to the investing public."⁴² The distinction raises the question of who, once we exclude creditors, shareholders, and the investing public, remains for the corporate lawyer to be loyal to. Managers are the first group to come to mind, but they are not necessarily a more deserving one.

Until 1982, about a century after the emergence of modern corporate law practice, professional responsibility doctrine spoke of clients only as solitary individuals. Finally, the ABA produced Model Rule 1.13, which acknowledged that organizations were distinctive. The basic idea of Model Rule 1.13 was that agents (i.e., managers) should be treated as speaking for the client when they had authority to do so.⁴³ This was plausible but ambiguous. The rule provided more specific guidance for one troubling

41. Waldmeir, *supra* note 14, at 14.

42. *United States v. Arthur Young & Co.*, 465 U.S. 805, 817-18 (1984).

43. Model Rules of Prof'l Conduct R. 1.13(a) (2005).

category of situations: In essence, it said that when managers are acting illegally in ways likely to harm the corporation, the lawyer should think about going to the board. Although the disciplinary rules did not address it specifically, there was another category of situations where corporate and civil procedure doctrine suggested that lawyers should stand back from managers: where the managers had a clear and explicit conflict of interest, notably, with respect to compensation arrangements and derivative suits against them. Here, the doctrine prescribed that managers get their own lawyers, and corporate counsel again take instruction from the board.⁴⁴

Key ambiguities remained. Two are especially important. First, what was the lawyer to do when the board encouraged or acquiesced in managerial lawlessness? If we take seriously the principle that only authorized conduct can be attributed to the organization, then the board can no longer be regarded as speaking for the client. In this situation, the inference would be natural that the best way to protect the corporation's interests would be for the lawyer to consult the shareholders, the corporate constituency that would usually have the greatest stake and to whom the law gives authority to remove the directors. In addition, or in the alternative, it might seem necessary to go to government agencies with supervisory authority over the corporation. Yet, when the SEC suggested in *SEC v. National Student Marketing Corp.*⁴⁵ that lawyers might go to the shareholders, or in its Sarbanes-Oxley "noisy withdrawal" proposal that lawyers should send a weak signal to the SEC itself, the bar rebelled. Most strikingly, the bar opposed such responsibilities on the ground that they undermined loyalty to the *client*.⁴⁶ Again, lawyers seemed to be forgetting that the managers were not the client.

Second, how is the lawyer to understand managerial lawlessness? In particular, should any managerial breach of fiduciary duty be deemed lawless, hence triggering duties to go to the board (and perhaps beyond)? In practice, lawyers interpreted lawlessness to mean either breach of criminal or regulatory law on the one hand or explicit conflict of interest situations on the other. But that left a range of decisions that were potentially breaches of fiduciary duty but not violations of specific legal commands or explicit conflicts. Consider takeover defense, for example. To require that lawyers routinely pass judgment on whether managerial decisions on such matters are in shareholders' interests seems implausible, but routine deference to such decisions ignores patent, if indirect, conflicts of interest.

It happens that an interesting subcategory of such judgments includes financial reporting issues of the Enron variety. Enron's managers were not

44. Geoffrey C. Hazard, Jr., et al., *The Law and Ethics of Lawyering* 534-39 (4th ed. 2005).

45. 457 F. Supp. 682 (D.D.C. 1978).

46. See Hazard, *supra* note 44, at 184-90; Lawrence J. Fox, *The Fallout from Enron: Media Frenzy and Misguided Notions of Public Relations Are No Reason to Abandon Our Commitment to Our Clients*, 2003 U. Ill. L. Rev. 1243.

unusual in devoting major time and effort to conduct that was intended to create a favorable effect on their company's financial statements. Public corporation managers are constantly proposing and executing transactions intended to improve their accounting numbers or structuring ordinary transactions to induce a desired appearance on financial statements. "Earnings management" is one name for it, and although it is controversial, it is more or less shamelessly indulged, if not promoted, by business professionals of all stripes. Long after the negative publicity about its Enron activities began, V&E continued to advertise on its website its expertise in the use of offshore entities to help businesses achieve "off balance sheet treatment" for debt.

Of course, many types of earnings management violate securities laws. It is even arguable that earnings management activities should be deemed presumptive violations of the securities laws. But the question to consider at this point is whether even otherwise lawful earnings management can ever be consistent with managers' fiduciary duties to their corporations. When the manager asks the lawyer, accountant, or banker to assist in earnings management, he is proposing to withhold or obscure information that shareholders would consider relevant to their investment decisions. Why is such a proposal not a presumptive breach of fiduciary duty? It is no answer that the manager's duties are to the corporation, not the shareholders. The corporation's interests embrace the shareholders' interest in unbiased financial reporting.⁴⁷ What if the manager asserts that the accounting treatment she is trying to achieve would be more reflective of the true financial condition of the company? This position has little credibility when the manager is seeking to withhold information entirely, rather than just influence its presentation. Even where the manager's plan affects only presentation, it is questionable whether she should be heard on such subjects. Financial accounting is the most important mechanism of

47. Some managers apparently believe that earnings management that is not otherwise prohibited is consistent with their fiduciary duty to the corporation because the shareholders have an interest in keeping the share price up. See Steven L. Schwarcz, *Temporal Perspectives: Reconciling the Conflict Between Current and Future Investors*, 89 Minn. L. Rev. 1044, 1049 (2005) (approving this view). While unclear as a matter of doctrine, the view seems wrong as a matter of principle. Earnings management is likely to prop up share price only in the short term. In the long run, it is apt to undermine share price by impairing the corporation's reputation for financial integrity. Moreover, financial disclosure is a key mechanism of managerial accountability to shareholders. Earnings management hurts shareholders by impairing accountability. Of course, if one looked at shareholders individually, one would find divergent interests. Short-term traders might be grateful for manipulation, while diversified buy-and-hold types would not be. But the public corporation manager's duty cannot be defined in terms of the interests of whomever happens to hold her company's shares at the moment. Duty should be elaborated in terms of a hypothetical shareholder with interests that are generally regarded as important and legitimate. This was the approach the Supreme Court took in defining materiality under the securities laws in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (defining materiality with reference to the interests of a "reasonable shareholder"). If taken in the fiduciary duty context, it would lead to the conclusion that manipulations designed solely to produce favorable accounting effects are not the shareholders' interests.

managerial accountability. To give managers influence over it is like allowing students to grade their own exams.⁴⁸

I do not mean to suggest that the amount of deference lawyers should give to managerial assertions about the interests of their corporate clients is an easy question. On the contrary, my point is precisely that it is a hard question. The bar, however, has not treated it as such. That V&E could see its participation in the Enron deceptions as a matter of loyalty to its client bespeaks deep confusion that seems to arise from a failure to treat seriously the meaning of organizational representation.

We see the same confusion in the bar's anxiety about the pressures on corporate attorney-client confidentiality. I argued above that the formalism problem undermines the claim that legal advice promotes some socially desirable form of compliance. It is time to observe another implausible feature of the argument for corporate confidentiality—the contention that confidentiality plays an important role in inducing managers to confer with the corporation's lawyers. The bar's arguments often seem to assume that the privilege belongs to the managers. Of course, the confidentiality proponents must know that this is not the case; the privilege belongs to the organization. But if the proponents really understand this, it is difficult to see how they can think that confidentiality is important in inducing disclosure to counsel.

Consider: Because the privilege belongs to the organization, the organization can waive it no matter how costly disclosure is to the manager. In fact, we know that corporations often cooperate in prosecutions against errant former managers in order to gain leniency for themselves.⁴⁹ And they sometimes sue former managers for damages for wrongdoing. Boards have a fiduciary duty to sacrifice managers when it is in the interest of the organization to do so. And the decision to waive privilege is made by the board sitting at the time of the waiver decision, not the one sitting at the time of the communication.⁵⁰ Thus, a current board cannot be sure that a future board will not waive privilege with respect to the current board's communications. A derivative plaintiff can often discover a manager's communications with corporate counsel even over the objection of the board.⁵¹ Moreover, the privilege puts no constraint on disclosure within the organization. A corporate lawyer who learns about wrongdoing from a

48. See William H. Simon, *Earnings Management as a Professional Responsibility Problem*, 84 Tex. L. Rev. 83 (2005); see generally William H. Simon, *Whom (or What) Does the Organization's Lawyer Represent?: An Anatomy of Intraclient Conflict*, 91 Cal. L. Rev. 57 (2003).

49. For the most recent of many examples, see Lynnley Browning, *A Single Trial for 18 Named in Tax Shelters*, N.Y. Times, Apr. 5, 2006, at C3 (discussing KPMG's agreement to avoid prosecution by cooperating in a case against former partners).

50. *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343 (1985).

51. See *Garner v. Wolfenbarger*, 430 F.2d 1093, 1100-01 (5th Cir. 1970) (setting out a multifactor balancing test for deciding when management can assert privilege in a derivative suit).

manager will often have a duty to report the facts to the manager's superiors.

Recall also that the privilege protects only the communication and not the information it contains. This means that when a corporate lawyer learns something that he must disclose under the civil discovery or securities laws, the privilege does not affect his duty to see that the information is disclosed, whether or not the communicating manager wishes the information disclosed.

Given these long-standing limits on the privilege, it has always been irrational for a manager to make disclosures to the corporation's counsel that she would not have been willing to make in the absence of any confidentiality safeguards. If managers are more wary now, it is probably because recent scandals have made them more alert to the long-standing limits, not because of prosecutors' new practices. Fortunately, managers have strong incentives to make disclosures without confidentiality. Aside from any sense of responsibility to the organization, managers risk liability by not disclosing. For example, they may lose the "business judgment" and "advice of counsel" defenses to civil claims.

The rationale for confidentiality in the corporate context has always been out of place with the contours of the doctrine. If our only concern is to induce managerial communication to lawyers, we should give the privilege to the managers. We do not. The privilege belongs to the corporation with the consequence that a board can waive at the expense of errant officers, and a successor board can waive at the expense of an errant past board. This means that corporate counsel can never assure managers of strong confidentiality.

Clearly, there is a competing consideration that holds us back from following out the logic of the confidentiality rationale. I am unaware of any articulation of this consideration, but I think it is clear enough: client loyalty. If the bar's argument were right, giving the privilege to the manager might actually induce more compliance. But it would not be tolerable because it would too often require the lawyer to remain silent in the face of conduct that was both unlawful and harmful to her organizational client. To preclude the lawyer from intervening to prevent lawless harm to the client would affront all the values that give dignity to the professional role.

There is thus a strong tension between the goal of managerial trust and that of corporate client loyalty. If managerial trust in lawyers is based on confidentiality, rather than a shared sense of loyalty to the organization's goals and norms, it will have to come at the expense of client loyalty.

Confronting this tension more squarely might lead the bar to take a less hostile attitude toward the new regulatory initiatives that are compromising confidentiality. The demands to cut back confidentiality do not occur in isolation. More often than not, these demands are part of the approach to regulation I mentioned earlier that aspires to combine transparency with leniency and flexibility in order to induce collaborative and continuously

revised public-private ordering. At least some corporate clients have an interest in embracing these new approaches.

The assistance that lawyers can best provide in these new regimes has less to do with keeping secrets and more to do with problem solving, devising more efficient and flexible responses that reconcile the client's legitimate interests with the public purposes of the regulatory regimes. The bar's current preoccupation with reassuring nervous managers is misplaced. The project is superfluous for most managers and futile for the rest. It would take a revolutionary expansion of current confidentiality doctrine to enable lawyers to promise a manager that she will not be worse off for having confided in the lawyer. Moreover, in these new regimes, the most important kind of trust lawyers must inculcate is not of managers in lawyers but trust of regulators and other regime participants in their clients. Such trust is the precondition of the autonomy and flexibility the new regimes contemplate. Lawyers' disclosure duties are entirely compatible with this latter kind of trust.

Of course, many areas of law have been unaffected by the new regulatory models, and in those that have been affected, the models have been imperfectly implemented. Transparency norms are often weak or weakly enforced. Prosecutorial discretion can be arbitrary and can impose large costs on relatively well-behaved companies. Prosecutors often respond to voluntary transparency, not by leniency, but by seizing on the opportunity for an easy and potentially highly publicized victory. Once they invest resources in an investigation, prosecutors are reluctant, even if they find little or nothing, to close it with nothing to show for their effort. And of course, transparency opens the company to private litigation, particularly class action suits, a process which corporate executives deeply (and to my mind, plausibly) distrust as rife with arbitrariness and opportunism.

The arguments that corporate counsel make in private for confidentiality, as opposed to the public ones I have criticized, usually emphasize these defects in the public and private enforcement processes. Corporate lawyers and their clients value confidentiality as a defense against opportunistic prosecutors or class action lawyers. A small quantum of evidence, perhaps taken out of context, is sometimes enough to permit these actors to impose, or threaten to impose, enormous procedural costs on businesses that may plausibly believe themselves largely blameless.

There are, of course, direct responses to these dangers. Some of the same mechanisms of transparency and accountability that the new regulatory regimes impose on businesses are readily adaptable to the conduct of agencies and prosecutors themselves. Prosecutors should articulate standards for the exercise of discretion, measure their own performance under the standards, provide transparent procedures for revising the standards in the light of experience, and provide remedies for targets that

believe they have been harmed by violations of the standards.⁵² Recent class action reform has not eliminated the extortionate potential of the procedure; more reform would be desirable.

Confidentiality is not a substitute for reforms that directly address defects in the judicial process. It may help some companies avoid meritless charges and wasteful proceedings, but from a social point of view, confidentiality makes things worse. Confidentiality can be asserted to block access to evidence for meritorious claims as easily as for meritless ones. It makes all claims more difficult and expensive to bring.

It is easy to imagine a role for lawyer organizations in addressing litigation abuses, but there are no outstanding examples. The ABA has no commission on class action abuses or regulatory enforcement discretion. Instead, it gives us a Task Force on Confidentiality. No doubt, conflicts among its vast membership over the first two topics make them difficult for the organization to address. Confidentiality is a lowest common denominator. But a more specialized voluntary bar might plausibly take on these issues.

Finally, let me briefly observe that the tax shelter practice addressed by IRS Circular 230⁵³ raises a further critical issue about the meaning of client loyalty. A central aspect of tax shelter practice is a legal opinion that the statutory interpretation on which the deal is based is valid, or perhaps "more likely than not" to be upheld if litigated. Whether given to clients or non-clients, these opinions are always "third party" opinions in an important sense. Although they are framed as advice to the client, this is not their purpose. The client seeks the opinion so that in the event of an IRS challenge she can bolster her argument that she believed in "good faith" that the transaction was valid, and hence should not be subject to penalties.

Here we have a situation where, under the guise of giving advice to their clients, lawyers confer on clients immunity from public sanctions. The selfish interests of lawyers and clients would best be served if confidentiality could also be claimed for such transactions. That way, clients could play the "audit lottery" and then pull out the letter only if they should be detected. But whatever the strength of the arguments for confidentiality in the usual context, they are hard to take at all seriously when the lawyer is not so much giving legal advice as exercising a power of public dispensation. Thus, the IRS's elaborate and ingenious tax shelter regulations are designed to make tax shelter practice more transparent and accountable.⁵⁴

Note that in this context lawyers have assumed an intermediating public-private role that has some resemblance to the one I suggested is called for

52. For suggestions as to how transparency and accountability methods might be applied to prosecutors in the context of capital cases, see James S. Liebman, *The Overproduction of Death*, 100 Colum. L. Rev. 2030 (2000).

53. 31 C.F.R. §§ 10.0-10.93 (2005).

54. See 31 C.F.R. pt. 10; Herbert N. Beller, *The New Penalty Regime Finally Arrives: Proceed with Caution!*, Tax Executive, Nov.-Dec. 2004, at 491.

by new regulatory trends more generally. In principle, the function of the opinion is both to inform the client and to reassure the IRS of the client's good faith. This development illustrates that the idea of a more public lawyering role is not as radical as it might sound. But of course, it also shows that such a role can be corrupted. The new regimes do not dispense with the need for adequate sanctions—especially with respect to disclosure norms—and monitoring. And they require new methods of accountability for lawyers. Although they are not adequate in the absence of effective penalties or auditing resources, the IRS rules move in precisely the right direction. In effect, the IRS is moving toward auditing lawyers and accountants, as a means of assessing the reliability of their vouching for their clients. This is the logic of the new regime.

CONCLUSION

In confronting the crisis, lawyers have two options that parallel the choices that the new regulatory environment presents their clients. The low road—the one that demands least effort and imagination but has the least promise of neutralizing the threats to public respect and independence—is the one lawyers seem to be taking. This involves clinging to the prerogatives of formalism and an interpretation of confidentiality that rationalizes treating managers as if they were clients. The high road—the most difficult in the short run but the one with the most promise for the profession and its role in society—requires the rejection of formalism and of the tacit managerialism of current confidentiality efforts. The high road requires lawyers to interpret their professed commitment to law in terms of spirit and purpose rather than literal terms, and requires them to confront explicitly the tensions of organizational client loyalty, especially the tension between client loyalty and managerial trust.

Notes & Observations