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Breeding Better Watchdogs: Multidisciplinary Partnerships in Corporate Legal Practice

Peter C. Kostant†

INTRODUCTION

Large accounting firms, which now call themselves multidisciplinary partnerships (MDPs), are competing with law firms to provide legal services. While the heated debate surrounding this development rages, MDPs are enjoying considerable success in their competition with law firms. Legal ethics rules prohibit lawyers from practicing in professional associations controlled by nonlawyers, but the rules are

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1. For a discussion of these recent developments, see generally Peter C. Kostant, Paradigm Regained: How Competition from Accounting Firms May Help Corporate Attorneys To Recapture the Ethical High Ground, 20 PACE L. REV. (forthcoming 1999). For purposes of this Article, the term “MDP” is intended to encompass all multidisciplinary practice, including those in which nonlawyers may share ultimate control. The canard that lawyers somehow lose their professional objectivity when they share profits with nonlawyers has effectively been disposed of by leading commentators in professional responsibility. See, e.g., 2 GEOFFREY C. HAZARD, JR. & W. WILLIAM HODES, THE LAW OF LAWYERING: A HANDBOOK ON THE MODEL RULES OF PROFESSIONAL CONDUCT § 5.4:102 (2d ed. 1998) (suggesting that the decisive rationale underlying Model Rule 5.4’s flat prohibition on sharing fees is “economic protectionism”); Bruce A. Green, The Disciplinary Restrictions on Multidisciplinary Practice: Their Derivation, Their Development, and Some Implications for the Core Values Debate, 84 MINN. L. REV. 1115, 1144-49 (2000).

2. See Kostant, supra note 1 (manuscript at 709-13, on file with author).

3. See id. (manuscript at 706-09, on file with author).

largely being ignored or legalistically circumvented, and perhaps are about to change. This Article, drawing on both the positive and the normative, offers a partial explanation for what is occurring, and argues that a form of MDP legal practice could be a very good thing for corporate law, corporate clients and the ethical rules governing transactional corporate legal practice. Using insights of law and economics to explain how some changes may be occurring, this Article will suggest ways of encouraging beneficial change. This will require examining the demand for legal services, the moral hazard problem that all public corporations face due to their agents' actions, the ways in which both lawyers and accountants can be reputational intermediaries in third-party enforcement "gate-keeper" regimes, the expressive function of law in generating norms of corporate behavior and lawyer behavior, and how


6. MDPs stress that they are not practicing law but instead offering legal consulting services. See Hearings Before the Commission on Multidisciplinary Practice (Feb. 4, 1999) (written remarks of Kathryn A. Oberly, Vice Chair and General Counsel, Ernst & Young, LLP), available at <http://www.abanet.org/cpr/oberly1.html>.


8. The form herein proposed is emphatically not in accordance with the model proposed by the ABA Commission on Multidisciplinary Practice. See generally COMMISSION ON MULTIDISCIPLINARY PRACTICE, AMERICAN BAR ASS'N, REPORT (1999), available at <http://www.abanet.org/cpr/mdpreport.html> [hereinafter REPORT]. Perhaps the biggest problem with the Report is that it fails to address problems of confidentiality. See infra Part III.A.

9. The need for contextual practice has been eloquently argued by leading scholars such as David Wilkins, William H. Simon, David Luban and Fred Zacharias. To date, the organized bar has rejected these proposals. Rule 1.13 has been inadequate in moving to a more contextual ethic for corporate clients. See infra Part III.A.

10. See Ronald J. Gilson, The Devolution of the Legal Profession: A Demand Side Perspective, 49 MD. L. REV. 869, 882-89 (1990) (arguing that the market for legal services makes it more difficult for lawyers to act as gatekeepers). Gilson's article, which focused on the problem of reducing strategic litigation reached rather pessimistic conclusions about what the market would allow attorneys to do. See id. My Article uses the changed market conditions brought about by MDP competition to reach a more optimistic conclusion. I do not focus on litigation, but suggest that there will be a more beneficial role for attorneys as gatekeepers in transactional practice for large corporations.

transition rules affecting new winners and new losers may help explain the dynamics of change.¹²

During the past fifteen years there have been substantial changes in American corporate governance, both with respect to the laws that regulate public corporations and the norms and belief systems of corporate constituents.¹³ These changes have made large public corporations more amenable to using MDPs for transactional legal services. At the same time, the accounting profession has occupied an increasingly important role in monitoring the performance of powerful inside managers.¹⁴

MDPs have been very successful in attracting clients for their legal services.¹⁵ One explanation for this success is a "de maximus rule:" when enough money is at stake, more powerful organizations will find a way to prevail over less powerful rivals. MDPs are currently far more powerful than law firms. Although power dynamics may explain why changes occur, it is important to channel the changes in beneficial ways. Even if some of the potential benefits from MDP transactional legal practice are unintended consequences of the MDP's desire to grow, these benefits also result from traditional accounting practice constraints that do not apply to law firms.

Courts, regulators and scholars recognize that a complex, multi-party gatekeeper regime¹⁶ is necessary for the internal control and accurate financial disclosure of public corporations.¹⁷ In gatekeeper enforcement regimes liability is "imposed on private parties who are able to disrupt misconduct by

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¹² See generally Saul Levmore, Changes, Anticipations, and Reparations, 99 COLUM. L. REV. 1657 (1999) (exploring how the law can influence its own development, using interest group analysis, with reference to "new winners" and "new losers").

¹³ Professor Levmore has suggested that the process of legal transition is affected by tensions between the incentives and disincentives among those who benefit and lose under new legal rules. See id.; see also Melvin A. Eisenberg, Corporate Law and Social Norms, 99 COLUM. L. REV. 1253, 1261 (1999).

¹⁴ See infra Part III.A (discussing these developments in corporate governance).

¹⁵ See Fox, supra note 5, at 21 (pointing to the success of the MDPs, and arguing that Model Rule 5.4 is being violated).

¹⁶ Reinier Kraakman analyzed this enforcement regime in an important article in 1986. See Kraakman, supra note 11, at 55-61.

¹⁷ See Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, 54 BUS. LAW. 1067, 1071 (1999) [hereinafter Blue Ribbon Committee Report]; infra Part II.C.1 (discussing the report).
withholding their cooperation from wrongdoers.”18 Corporate directors, and especially independent audit committee members and independent accountants, can act as essential gatekeepers. Corporate lawyers, by contrast, have remained on the sidelines or have been impediments to progress rather than becoming indispensable parties in improving financial disclosure.

Reliance on a flawed model for legal ethics has caused a failure to employ lawyers effectively. This unitary model insists on treating all lawyers as advocates in an adversarial system. In the process, it often mischaracterizes the duties of loyalty and confidentiality for corporate clients and rejects the need for ethics that are contextual and that can protect third parties.19 This widely accepted model, with its emphasis on advocacy rather than counseling, has badly served corporate clients20 and perhaps the bar itself.21 Furthermore, it fits well with the needs and aspirations of the powerful inside senior corporate managers that corporate lawyers have traditionally served.22 Now that inside managers have lost some of their power to new kinds of corporate boards with activist, independent audit committees,23 newly empowered directors can require assistance from their corporate lawyers. One way for directors to assure that corporate lawyers act in the interests of the corporation and not just inside management may be to employ transactional attorneys who work for MDPs.24


19. See William H. Simon, The Practice of Justice: A Theory of Lawyers’ Ethics 7-9 (1998) (arguing that the so-called “Dominant View” requires or at least permits lawyers to pursue any goal of the client through any arguably legal course of action, and that contextual ethics better protect third parties).

20. In connection with the savings and loan fiasco, civil actions were brought against 90 law firms between 1989 and 1993. See Harris Weinstein, Attorney Liability in the Savings and Loan Crisis, 1993 Ill. L. Rev. 53, 53.

21. See generally Anthony T. Kronman, The Lost Lawyer: Failing Ideals of the Legal Profession 7 (1993) (discussing the crisis in America’s legal profession and reaching the “gloomy conclusion” that the lawyer-statesman ideal is a thing of the past); Carl T. Bogus, The Death of an Honorable Profession, 71 Ind. L.J. 911 (1996) (discussing the poor image of lawyers and arguing that any improvement must derive from the concerted efforts of law schools and the bar); Geoffrey C. Hazard, Jr., The Future of Legal Ethics, 100 Yale L.J. 1239 (1991).

22. See REPORT, supra note 8; infra Part III.A.

23. See Blue Ribbon Committee Report, supra note 17, at 1070-71; infra Part II.C.1.

24. The expanding multi-party gatekeeper regime model of corporate gov-
By involving lawyers in the gatekeeping function, MDPs could improve the current system in which many transactional lawyers inadequately assure the effectiveness of the monitoring system for financial compliance and may be systematically contributing to audit failures. Because corporate lawyers are hired, fired and evaluated by inside senior managers and deal almost exclusively with them, it seems a fair surmise that corporate lawyers sometimes help inside senior managers hide material information from the board. At any rate, the temptation must be great, and the consequences are sufficiently deleterious to recommend preventive action. Lawyers can use the narrow attorney-client privilege and the broad ethical rule of confidentiality to shield themselves and the managers from detection of misconduct. As Dean Daniel Fischel has written, lawyers as agents face personal liability if they knowingly participate in a client's illegal scheme. But . . . the key determinant of liability is what the attorney "knew" about the scheme. Confidentiality rules create powerful obstacles to the discovery of attorney participation in an unlawful scheme . . . . Secrecy better enables the legal profession to define its role on its own terms and thus to avoid more public scrutiny of its activities.

The abuse of confidentiality is greatly exacerbated for corporate clients because counsel routinely treat inside senior managers as if they were the client. Detection of client wrongdoing becomes even less likely because counsel uses the shield of confidentiality to conceal wrongdoing both inside and outside the corporation. Inside managers rely on the lawyer's advocacy skills, selective disclosure, confidentiality, and reputation.

25. Recent changes in corporate law have clarified that an important role for the board of directors is to monitor the performance of inside managers. Attempts by directors, and especially independent directors to meet these higher duties is largely aspirational but there may also be some expanded exposure to liability. See infra Part III.A.


27. The savings and loan cases have become notorious examples of corpo-
Law has an expressive function in shaping belief systems and norms. The few cases involving lawyers who assisted or opposed senior inside managers of corporations involved in illegal activities give credence to the widely held belief that a "loyal" corporate lawyer is one who treats inside senior managers as the client. In *Balla v Gambro*, the court denied recovery to a corporate lawyer on his claim against a corporation that discharged him when he prevented its senior manager from selling lethally defective dialysis equipment.\(^{28}\) Nowhere in its opinion did the Illinois Supreme Court acknowledge that, in preventing this criminal and tortious activity, the attorney was loyally serving his corporate client and protecting it from a rogue agent.\(^{29}\) In a somewhat similar vein, the Rhode Island Supreme Court ordered a mild sanction against a lawyer who knowingly allowed his friend, the president of a mortgage company, to embezzle funds from the corporate client and from an out-of-state bank.\(^{30}\) The court reasoned that attorneys were easily confused by rules governing the identity and confidentiality duty for corporate clients.\(^{31}\)

rate managers that either engaged in serious misconduct, or were victims of inadequate protection. Internal documents revealed that some of the most prestigious law firms may have assisted management in avoiding detection of illegal schemes and not reporting to independent directors. *See* Peter C. Kostant, *When Zeal Boils Over: Disclosure Obligations and the Duty of Candor of Legal Counsel in Regulatory Proceedings After the Kaye, Scholer Settlement*, 25 ARIZ. ST. L.J. 487, 500 (1993). Despite a settlement of $41 million, one large firm continues to deny any misconduct as well as the factual basis of some of the government's allegations. Neither the ABA Task Force nor the New York Bar's disciplinary board found cause for discipline. Moreover, many prominent lawyers agreed with the firm's defense regardless of whether or not the government's allegations were true. *See* SIMON, *supra* note 19, at 7. More than 90 law firms were sued in connection with the savings and loan debacle. *See* Weinstein, *supra* note 20, at 53.

In amending the statutory duty of accountants, Congress found it significant that 28 of 30 failed savings and loans in California had received clean audits despite the fact that serious financial improprieties were subsequently revealed. *See* Quinton F. Seamons, *Audit Standards and Detection of Fraud Under the Private Securities Litigation Reform Act of 1995*, 24 SEC. REG. L.J. 259, 266 n.20 (1996) (noting that this fact was cited as an important argument in favor of the fraud detection requirement for auditors in the 1995 amendments to the federal securities laws). One wonders how many of the attorneys for these 28 savings and loans hid their suspicions from the auditors.

31. *See id.*
This Article will present a market-oriented explanation for why MDPs may be able to provide better transactional legal services to large public corporations, and reject the facile explanation that corporations are simply attracted to the convenience of “one-stop shopping.” Competition from MDPs may force virtually all transactional lawyers, even those that do not work for MDPs, toward a new professional ethic that better assists corporate clients with legal compliance.

The MDP model proposed here would permit MDPs to provide transactional legal services to clients for whom they perform audits only if the corporate clients agree, ex ante, that lawyers in the MDP firm must share any potentially material information with the audit engagement partner. This Article suggests reasons that this model would benefit corporate clients and shows why large public corporations should prefer it.

The strong resistance of the Securities and Exchange Commission (SEC) to multidisciplinary auditing firms may be misplaced because potential advantages for accurate reporting exist. Indeed, the SEC should welcome the augmented disclosure that this model would provide, instead of focusing on compromised auditor independence. At the very least, transactional attorneys could improve the quality of audits and ensure that more of the information necessary for good corporate governance and compliance with the law would reach corporate audit committees. Transactional lawyers working for MDPs may be better equipped than lawyers in traditional law firms to further the SEC’s goals of full disclosure of material information, effective monitoring by corporate audit committees and auditors, and the avoidance both of fraud and the chicanery of


33. See infra Part III.A.

34. One recent development in the governance of large public corporations is that audit committees are composed entirely of independent directors. For a discussion of changes in the roles of auditors and audit committees, see infra Part II.C.1.
“earnings management.” Those goals benefit not only the investing public, but also the long-term shareholders and other constituents of public corporations.

As a practical matter, after serious accounting scandals, corporations routinely bring in law firms to work closely with new accounting firms to help solve these problems. Getting this cooperation as part of the normal audit process should be a logical part of preventive law and accounting practice. Law-

35. The need to include corporate attorneys in the audit is underscored by what the SEC Chairman recently called the “noticeable erosion” in the quality of corporate financial disclosure, caused by the propensity for corporate managers to manipulate financial statements to meet analysts’ forecasts with a “gimmick known as earnings management.” See Anna Snider, Levitt Challenges Lawyers to Fight Accounting Fraud, N.Y. L.J., Feb. 16, 1999, at 1. Under my proposal, corporate attorneys would assist in preventing this misconduct. By contrast, under current rules and norms of corporate legal practice, some corporate lawyers may actually assist in this misconduct, or at least defer to the judgment of the senior inside managers engaged in “earnings management.” By treating these managers as though they were the corporate client, attorneys help to keep relevant information “confidential” from the board of directors or its audit committee. See infra Part II.C.3. Thus even in such an egregious case of “earnings management” as the massive fraud of Charles Keating and the managers of Lincoln Savings and Loan, the ABA Task Force in 1993 concluded that counsel had no duty to advise the independent directors of their client. See REPORT, supra note 8; infra Part III.A (discussing other cases of alleged attorney assistance in corporate misconduct).

36. Of course, failing to disclose material information or allowing managers to control earnings via accounting subterfuges might harm corporate miscreants or short-term investors who happen to sell at an erroneously inflated price. It is hard to imagine that these are the corporate constituents that the corporate entity is legally constructed to serve, however. See generally Steven M.H. Wallman, The Proper Interpretation of Corporation Constituency Statutes and Formulation of Directors Duties, 21 STETSON L. REV. 163 (1991) (discussing why shareholders cannot be treated as a uniform class within an identical set of interests, and why directors must serve the long-term wealth appreciation interests of the corporate entity). If we believe in the rule of law, we should be able to postulate that complying with federal securities laws is in the long-term interests of public corporations. Cf. John A. Humbach, The National Association of Honest Lawyers: An Essay on Honesty, “Lawyer Honesty” and Public Trust in the Legal System, 20 PACE L. REV. (forthcoming 1999) (manuscript at 94-96, on file with author) (arguing that in current practice lawyers often effectively seek to circumvent the rule of law).

37. This occurred, for example, after serious problems were discovered at Cendant Corp., W.R. Grace & Co., Sunbeam Corp. and Livent Inc. The law firm of Willkie, Farr and Gallagher has become a specialist at working with accounting firms. See Snider, supra note 35, at 7. In addition, after the serious financial scandals at Salomon Brothers, a former general counsel of the SEC was brought in as chief of internal audits. See Simon M. Lorne, Corporate Governance and the Audit Committee, in ADVANCED SECURITIES LAW WORKSHOP 1999, at 519-24 (PLI Corp. Law & Practice Course Handbook Series No. B-1134, 1999).
yers, accountants and independent corporate directors would function better in the increasingly rigorous multi-party gatekeeper regimes that are evolving to protect large public corporations. Requiring lawyers within MDPs to play a role in the audit function should move all transactional corporate practice in the direction of helping corporations achieve transparency and disclosure.

Part I of this Article criticizes the current position of the SEC for failing to recognize that MDP-transactional legal practice can provide a richer and more context-sensitive model for corporate lawyers to exercise meaningful independence and loyalty on behalf of their corporate clients. Part II describes how recent changes both in our understanding of the nature of large public corporations and in the rules and practices of corporate governance now require a different role for corporate lawyers. Congress, the SEC and even the accounting profession recognize that accountants and corporate audit committees must be the activist lynchpin for corporate compliance monitoring. If lawyers do not play a functionally related role, these regimes will not work. Part III compares the ethical features that could evolve in MDPs' legal practice with the currently accepted paradigm of corporate legal practice. This Article concludes that reasons for optimism exist as MDPs increasingly provide legal services to corporations. The new competitive market for legal services can be a lever to shift the behavior of corporate lawyers. Market pressures from MDPs and corporate clients are helping to end the bar's self-regulation and may result in new and better contextual practice rules. Corporate lawyers may even regain some of the independence and moral force that the bar has enjoyed in the past.

I. THE SECURITIES AND EXCHANGE COMMISSION AND MDP LEGAL PRACTICE

On June 8, 1999, the American Bar Association's (ABA) Commission on Multidisciplinary Practice issued a report with unanimous recommendations that would allow MDPs to deliver legal services. The Report did not address what is perhaps

38. See infra Part II.C.1.
39. The 1995 amendments to the federal securities laws make clear that the detection of fraud is part of the audit function. See infra Part II.C.2.
40. See REPORT, supra note 8. The Report recommends that Rule 5.4 be
the most important problem faced by audit firms that provide legal services to the same client: whether the lawyers would disclose confidential information to the audit engagement partner who in turn might have a duty of disclosure to the outside world. Instead, the Report merely assumed that lawyers in MDPs must provide the same confidentiality to their clients that law firms do. By ignoring this issue, the Commission missed the opportunity to establish contextual rules for the transactional lawyers in MDPs, including a different standard for confidentiality.

The SEC responded to the ABA's proposal by stating that the "SEC will continue vigorous enforcement of its rules on auditor independence, and that... those rules prohibit an auditor from certifying the financial statements of a client with which his firm also has an attorney-client relationship." In

totally revised and includes proposals to assure that only qualified lawyers would provide legal services, that they would continue to be bound by ethical rules, be able to exercise independent judgement and continue to be subject to the bar's vague and unenforceable requirement to provide pro bono legal services. See id. The Report only acknowledges that the SEC believes "auditor independence regulations specifically state that the roles of auditors and attorneys under the federal securities laws are incompatible," and has asked the Independence Standards Board for guidance about auditor independence in connection with legal services. Id. at n.3.

41. Perhaps the issue was ignored so that auditors would be rendered unable to provide legal services. In any event, the ABA Multidisciplinary Practice Commission's proposal received such harsh criticism from lawyers that it has been withdrawn. A major criticism of the official rules of legal ethics is that they are categorical and do not reflect the importance of adapting to varied contexts. For a criticism of the unitary and non-contextual ethics of the organized bar, see SIMON, supra note 19, at 7-13; David B. Wilkins, Making Context Court: Regulating Layers After Kaye, Scholer, 66 S. CAL. L. REV. 1145, 1167-82 (1993). The problem is perhaps greatest in corporate representation because these categorical rules were designed primarily for adversarial proceedings and are particularly ill-suited to transactional corporate representation. Even Model Rule 1.13, the specific rule adopted for representing organizations like the corporate client, has been criticized as overly vague and providing less protection to corporate clients than individuals. See Stephen Gillers, Model Rule 1.13(c) Gives the Wrong Answer to the Question of Corporate Counsel Disclosure, 1 GEO. J. LEGAL ETHICS 289 (1987); infra Part IIIA (discussing and criticizing Model Rule 1.13); see also Fred C. Zacharias, Fact and Fiction in the Restatement of the Law Governing Lawyers: Should the Confidentiality Provisions Restate the Law?, 6 GEO. J. LEGAL ETHICS 903, 930 (1993) ("[T]he term 'lawyering' is a euphemism for a variety of professions. The codes fail to acknowledge differences between a law firm, corporate counsel and sole practitioner. They equate litigators, advisors and even lawyers acting for regulated industries....").

42. Letter from Harvey J. Goldschmid, SEC General Counsel, Lynn E. Turner, SEC Chief Accountant, and Richard H. Walker, SEC Director of En-
one recent case, *In re Falk*, an attorney/CPA provided legal services to a corporation that was an audit client of the firm in which he was a principal. Although he did not participate as engagement partner or concurring partner on any of the client’s audits, he declined to answer questions about the legal representation, relying on attorney-client privilege. The SEC found that Falk had violated the standards of auditor independence because of the “fundamental conflict between the roles of independent auditor and attorney.” The SEC, citing *United States v. Arthur Young & Co.*, explained that auditors must be “skeptical,” a posture which requires “total independence,” while lawyers have “a duty to serve as the client’s confidential advisor and loyal advocate.” The SEC also pointed to enforcement to Philip S. Anderson, President, American Bar Association (July 12, 1999), available at <http://www.abanet.org/cpr/goldschmidt.html>. The SEC’s auditor independence regulations specifically state that the roles of auditors and attorneys under the federal securities laws are incompatible. Rule 2-01(c) of Regulation S-X, 17 C.F.R. 210.2-01(c) states that in determining whether an accountant is independent of a particular person, the SEC “will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission.” Qualifications and Reports of Accountants, 17 C.F.R. § 210.2-01 (1999). The Commission further stated in an interpretive release, which as been incorporated into its Codification of Financial Reporting Policies, that one of the relationships that must be considered in making independence determinations is the relationship created by rendering legal services. The SEC stated:

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Certain concurrent occupations of accountants engaged in the practice of public accounting involve relationships with clients which may jeopardize the accountant's objectivity and, therefore, his independence. In general, this situation arises because the relationships and activities customarily associated with this occupation are not compatible with the auditor's appearance of complete objectivity or because the primary objectives of such occupations are fundamentally different from those of a public accountant . . . .

A legal counsel enters into a personal relationship with a client and is primarily concerned with the personal rights and interest of such client. An independent accountant is precluded from such a relationship under the Securities Acts because the role is inconsistent with the appearance of independence required of accountants in reporting to public investors.
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44. See id.
45. Id.
46. Id. (citing 465 U.S. 805, 817-18 (1984)).
the requirement in Model Rule 1.3 that a lawyer must act "with zeal in advocacy on the client's behalf."47

Although the SEC reached the correct result in *Falk*, it failed to recognize that the predominant and almost exclusive role of a transactional lawyer is one of advisor and not advocate. Indeed, as discussed more fully below, having transactional lawyers act as advocates can cause substantial harm. The analysis in *Falk* therefore perpetuates the false dichotomy established in *United States v. Arthur Young & Co.*48 The SEC should instead allow and even encourage corporations to employ MDPs that require their lawyer to communicate about a client with the audit partner. Of course, this should never be allowed in the context of litigation, for which stricter confidentiality is probably necessary,49 but the ethical rules should at least recognize that litigation is not the sole, nor even the dominant, model for legal services.

The SEC has become more aggressive in requiring directors to act as monitors in order to learn about financial improprieties.50 Boards must be diligent in preventing "earnings

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47. *Id.; see also* Samuel George Greenspan, Securities Act of 1933 Release No. 6097, 49 S.E.C. Docket 1086, 1099 (Aug. 26, 1991); Samuel George Greenspan, Litig. Release No. 12862, 48 S.E.C. Docket 1690, 1691 (May 23, 1991). The conduct that occurred in *Falk*, which the SEC is certainly correct in prohibiting, appears to be permitted under the misguided standards of the ABA Commission's Report. Such a result would have preserved confidentiality at the expense of an honest, independent audit.

48. In fact, in the context of transactional corporate practice, lawyers can be much more effective as advisors if they are not advocates. The current involvement of practitioners who act both as advisor and advocate in determining what information reaches auditors and audit committees actually increases the likelihood of audit failure. Non-advocates are better reputational intermediaries, and the lemons market problem is avoided. *See infra* note 169 (explaining the "lemons market" problem). Ironically, some opponents of the Multidisciplinary Practice Report argue that it diminishes the role of attorneys as advocates. *See Debate on Multidisciplinary Practice Report Continues as Vote by ABA Delegates Nears, 68 U.S.L.W. 2020-21 (July 13, 1999).*

49. *But see generally* Humbach, *supra* note 36 (arguing that confidentiality, among other things, provides an excuse for many lawyers to bend the truth in the course of client representation).

50. *See, e.g.,* Peter R. DeGeorge, Accounting and Auditing Enforcement Act Litig. Release No. 15,556 (Nov. 12, 1997), cited in *Lorne, supra* note 37, at 508 n.3 (criticizing the board for failing to detect improper transfer of corporate assets to a separate company co-owned by corporate insiders); The Cooper Cos., Inc., Exchange Act Litig. Release No. 14,351 (Dec. 12, 1992), cited in *Lorne, supra* note 37, at 509 n.4 (criticizing the board for failure to make timely inquiry after senior insiders exercised their privilege against self-incrimination); Caterpillar, Inc., Exchange Act Release No. 30,532 (Mar. 31, 1992), cited in *Lorne, supra* note 37, at 516 n.10 (criticizing the board for fail-
management. Because fiduciary duties of corporate directors are more rigorously observed under state law, the SEC is demanding a similarly high level of care under federal law both for directors and independent auditors. A multi-party gatekeeper regime is emerging, with liability under both state and federal law, to help ensure accurate financial reporting. Di-
rectors and audit committees, however, need assistance. This assistance should include attorneys, rather than allow attorneys to act as inside management’s confidential advocates.

Based on inaccurate disclosures, directors would be liable for a virtually per se violation of a fiduciary duty even without proof of reliance, causation or quantifiable monetary damages. See id.

In a recent article, Melvin A. Eisenberg has argued that despite the applicability of shield statutes that limit liability of directors, and an expansive business judgment defense as a standard of review, recent process-oriented Delaware case law has had the expressive effect of making directors more careful, independent and diligent. See Eisenberg, supra note 13, at 1278-83.

54. The 1999 Blue Ribbon Committee calls audit committees the “ultimate monitor[s].” Blue Ribbon Committee Report, supra note 17, at 1071.

55. The SEC actively sought this role for transactional lawyers in the 1970s. See SEC v. National Student Mktg. Corp., 457 F. Supp. 682, 712-15 (D.D.C. 1978). The organized bar actively and successfully opposed this position. See Susan Koniak, When Courts Refuse to Frame the Law and Others Frame It to Their Will, 66 S. CAL. L. REV. 1075, 1080-84 (1993). In providing corporations with the option to use MDP attorneys for transactional work if they agree to full disclosure, the SEC would have the chance both to test its policy and to avoid the organized bar’s self-serving self-regulation. The SEC now has an excellent opportunity to advance the effectiveness of auditors in detecting fraud if it encourages cooperation and shared responsibility between the providers of auditing and transactional legal services.

Such a monitoring regime would have numerous advantages. First, the independence of MDPs would become more meaningful because they would have access to more information and accordingly would become more powerful. Knowledgeable auditors and transactional lawyers would share information and expertise about all potentially material developments. Auditors currently have a duty to disclose material information. The combination of this increased knowledge and duty would actually enhance trust. See Wilkins, supra note 41, at 1159 n.57.

Second, senior inside managers, independent boards and audit committees could not use corporate lawyers to keep information from audit committees or to help manage facts and legal arguments favoring managers over the interests of the corporate entity as a whole. If accountants and lawyers can coordinate as multi-party gatekeepers, this would be movement in the direction of the kind of concerted efforts of numerous institutions that are necessary to improve the corporate governance system as a whole. See Werner F. Ebke, In Search of Alternatives in Comparative Reflections on Corporate Governance and the Independent Auditors Responsibilities, 79 NW. U. L. REV. 663, 719-20 (1984).
II. THE CHANGING CONTEXT FOR REPRESENTING CORPORATE CLIENTS

A. RECENT DEVELOPMENTS IN THE THEORY AND PRACTICE OF CORPORATE GOVERNANCE

The realities of corporate governance within large American corporations have undergone dramatic change over the past century.56 The traditional model of corporate governance typically involved shareholder selection of a passive board proposed by a powerful CEO, but in the 1970s the neo-classical school of economics developed a new theoretical model.57 This model presented the large public corporation as a nexus of contracts among suppliers of capital, labor, materials and managerial services.58 The neoclassical school proposed that the modern public corporation minimized problematic agency costs by linking managers' compensation to share price value—a firm's share price reflects the extent to which investors believe that managers will eschew opportunism and work to maximize profits.59 In addition to linking pay to performance, the model proposed that monitoring devices, such as the use of outside directors and independent auditors, further deterred management wrongdoing.60 While the neoclassical model has enabled us to better understand public corporations, it has been heavily

56. In 1932, Berle and Means wrote that large American corporations were no longer merely a private business tool or device, but had instead become a dominant institution with an enormous effect on economic, political and social life. See ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 18 (1932). The tremendous amount of capital necessary for industrial organization had become too great for single entrepreneurs or families to be able to provide, and the administrative task of managing these ventures became so complex that large teams of well-trained, full-time professional managers were necessary. See ALFRED D. CHANDLER, JR., THE VISIBLE HAND—THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 484-90 (1977).

57. See Ira M. Millstein, Introduction to the Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, 54 BUS. LAW. 1057, 1060 (1999). See generally Melvin A. Eisenberg, The Conception That the Corporation Is a Nexus of Contracts, and the Dual Nature of the Firm, 24 J. CORP. L. 819 (1999). Corporations during the first half of the twentieth century were subject to substantial agency costs under the traditional model because powerful managers inevitably acted for their own benefit at the expense of the corporation.

58. See Eisenberg, supra note 57, at 822 (arguing that the corporation is "a nexus of reciprocal arrangements").


60. See 1 COX ET AL., supra note 24, § 9.3.
criticized for not adequately reflecting the behavior of human agents and for minimizing the importance of legal and institutional mechanisms in reducing agency costs. 61

The agency model, in which managers serve as the agents for shareholder principals, has traditionally been linked with the neoclassical "nexus of contracts" corporate model. 62 As such, the agency model has provided a comfortable theoretical justification for the organized bar's view of corporate counsel as deferential servants of inside senior managers. 63 Neoclassical theorists have fueled the bar's perception that powerful inside managers are the client by portraying the relationships between shareholders, boards of directors and individual managers as a nexus of contracts among self-interested individualistic components. Consequently, corporate lawyers routinely treat senior inside managers as surrogates for the corporation and provide these managers with the benefit of the lawyer's loyalty and confidentiality. 64

Recent events, including the hostile takeovers of the 1980s, have gone a long way toward discrediting the agency model of the public corporation. 65 These developments have helped to generate economically informed legal scholarship about the public corporation that seems to better describe how corpora-


62. See Blair & Stout, supra note 61, at 254. The agency model was overly sanguine about the ability of the market to reduce agency costs by aligning the incentives for managers with those of the shareholders. Boards of directors today, instead of being linked with management under the fiction that boards have the ultimate authority to manage corporations, are increasingly composed of independent directors whose primary duty is to monitor the performance of insiders. See Eisenberg, supra note 13, at 1279 ("Today, the monitoring model of the board has been almost universally accepted and adopted in large publicly held corporations."); see also PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS, PROPOSED FINAL DRAFT §§ 3.01, 3.02 (Mar. 31, 1992) (arguing that senior executives should supervise the management of large publicly-held corporations). Directors are now much more active and attentive. See Eisenberg, supra note 13, at 1279.


65. See Kostant, supra note 63, at 215-20.
tions really function and should provide a much richer and more nuanced role for corporate counsel.

The most sophisticated theory for the large public corporation is the Team Production Model. This recent model sees large public corporations as having evolved primarily to solve the team production problem of how to allocate profits. The model is at least in part contractarian because it views the corporation as composed of various stakeholder constituencies that have agreed to provide plenary authority to a non-stakeholder independent mediating hierarch, the board of directors.66 In

66. See David Millon, Communitarians, Contractarians and the Crisis in Corporate Law, 50 WASH. & LEE L. REV. 1373, 1377-78 (1993) (defining contractarians as believers in an anti-regulatory model of corporate governance). Recent changes in corporate law and behavior are consistent with the role that the Team Production Model posits for the board of directors. Thirty states have recently adopted corporate constituency statutes that underscore the importance of board independence, and directors increasingly set policy and monitor insiders. Constituency statutes provide a legal smokescreen for managerial anti-shareholder entrenchment, and represent the end of management's legal obligation to maximize shareholder wealth. See Stephen M. Bainbridge, In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green, 50 WASH. & LEE L. REV. 1423, 1447 (1993); Eisenberg, supra note 57, at 833-34. The statutes can therefore be viewed as reaffirming that directors must act in the long-term best interests of the corporate entity. See Wallman, supra note 36, at 163-70 (arguing that corporate constituency statutes shape the proper standard of directors acting in the best interest of the corporation).

Eisenberg argues that shareholder privacy is required to protect the owners of the corporation and that the Team Production Model requires placing all constituencies "on an equal footing." Eisenberg, supra note 57, at 833. He also suggests that recent constituency statutes like those of Pennsylvania and New York eliminate shareholder privacy. See id. at 833-34. These concerns are overstated. All groups are not equal under the Team Production Model. Further, constituency statutes recognize that it may be necessary to harm shareholders. The long-term best interests of the entity as a wealth-producing going concern must be recognized. This is ultimately consistent with the long-term best interests of shareholders. Note that Pennsylvania provides that directors consider "the best interests of the corporation." Id. at 833 (citing PA. CONS. STAT. ANN. tit. 15, § 1715(a), (b) (West 1995)). New York's statute urges directors to "consider the corporation as a going concern." Id. at 833 (citing N.Y. BUS. CORP. § 717(b) (McKinney Supp. 1998)). The statutes do not enable any group to be favored above the corporation. See Wallman, supra note 36, at 167-68.

The best interests of the corporate entity are "cognizable and identifiable even if they cannot be readily quantified." Id. at 191. The purpose of the corporation is the ongoing, long-term generation of wealth. See id. at 170-71. Private shareholders may own the corporation, and hold the residuary interest, but they are not a monolithic class; their investment horizons differ widely, and the degree of shareholder diversification greatly affects their tolerance for risk. See id. at 173-77. This helps to explain why the long-term in-
the absence of self-dealing, therefore, the board acts as the final arbiter for deciding all corporate policies and allocating profits ex post among the constituents, in what the board believes is the best long-term interests of the corporate entity as a going concern. The Team Production Model can be developed to further emphasize the importance of institutional norms that are generated by cooperation, trust, honesty, transparency and fairness.

The Team Production Model provides a useful perspective from which to view modern corporate governance. A key insight is the importance of preventing any corporate constituency from capturing the board of directors and causing it to act in that constituency's self-interest, rather than in the best long-term interests of the corporate entity. The model, therefore, provides a more nuanced role for the board of directors, as distinguished from powerful inside corporate officers, than the older simplistic agency model in which corporate governance consisted of management agents generating wealth for shareholder principals.

Lawyers must, of course, understand the structure and interests of their corporate clients in order to serve them competently. Legal ethics has traditionally treated corporate management as unitary and has hardly differentiated between

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terests of the corporate entity and the shareholders coincide—even if absolute wealth maximization were somehow possible, no single corporate strategy could maximize the wealth of every individual shareholder. For that matter, we can never really know if wealth has been maximized or merely enhanced. Generating greater wealth is always at least arguably possible. An elderly tailor once declared that if he was Rockefeller, he would be richer than Rockefeller because he would make suits on the side. Who can prove that he was wrong?

Some of the skepticism about the constituency statutes arises from the perception that they give too much additional discretion to management which has abused its discretion, especially in the area of executive compensation. See William H. Simon, Comment: On Kohler, Hansmann, and Chapman, 43 U. TORONTO L.J. 629, 631 (1993). This kind of abuse can be avoided under the Team Production Model if directors are truly independent and if, as argued in this Article, they recognize the importance of not being captured by inside senior managers, the most powerful stakeholders.

67. See Rubin, supra note 7, at 1425-26 (pointing to these values in institutional process analysis).

68. See Blair & Stout, supra note 61, at 252. In this way, the model is very similar to transaction cost economics which recognizes corporate governance as an inexpensive way to protect constituents tied in a long-term, incomplete contracts from opportunism. See Oliver E. Williamson, Calculative Trust, and Economic Organization, 36 J.L. & ECON. 453, 457-59 (1993).
officers and directors. Examining corporations through the lens of the Team Production Model enhances our understanding of the problem of agency costs because it underscores that "management" is composed of two very different groups: inside senior executives that are the most powerful group of stakeholders, and the board of directors, who "are not agents of the corporation but are sui generis."70

The traditional economic analysis of the corporation has greatly under-emphasized the importance of the opportunism of powerful inside senior agents who, as illuminated by the Team Production Model, are the most powerful stakeholders.71 Moreover, the hierarchical nature of the corporation, in which subordinates do what they are told with little effective opportunity to question orders, increases the likelihood that inside managers can behave opportunistically.72 Only corporate counsel, independent directors and auditors are in a position to act as a check on management. Corporate counsel should not act as management's co-conspirators.

All of the competing economic theories of the corporation view agency costs and agency theory too narrowly and underestimate the importance of legal rules to control managers.73 Too much of the analysis of agency costs centers on the costs of shirking by subordinates viewed from the principal's perspective.74 "Principal costs"75 are neglected. Corporations are hierarchical institutions in which powerful agents in superior positions really function as quasi-principals.76 The colorful term that Eric Orts coined for opportunistic misconduct by quasi-principals is "sharking," which occurs when managers redistribute assets away from other powerful constituencies.77 Powerful managers are able to "shark," and corporate lawyers cur-

70. Clark, supra note 61, at 56.
71. See Orts, supra note 64, at 317.
72. See Eisenberg, supra note 57, at 828 (noting that instructions to subordinates generally exclude "the subordinate from considering any reason for action except the direction").
73. See Orts, supra note 64, at 327-29.
74. See id. at 315 ("[S]hirking refers to the costs of all agents in a firm who choose to further their own self-interests at the expense of the collective interests of the firm.").
75. Id. at 270.
76. See id. at 267-70. For example, CEOs are agents that act as de facto principals with substantial inherent authority. See id. at 281.
77. See id. at 315.
rently do not adequately interfere with this behavior. Examples of sharking include excessive executive compensation, oppression of minority shareholders, unjustified harm to debtholders or other stakeholders, restructuring the corporation to benefit managers\textsuperscript{78} and earnings management to manipulate financial statements. Managers can often shift at least some of the cost of their conduct to the corporation.\textsuperscript{79}

A moral hazard problem results from such cost-shifting for several reasons. Managers may gain disproportionately from risking corporate funds, a great deal of opportunistic conduct will never be detected, responsibility for misconduct can be easily deflected, and management compensation can never be perfectly tied to performance. Corporations not only suffer when their managers steal, or "shark," but are also vulnerable to more innocent misconduct. Managers will often make misrepresentations to advance their own personal goals.\textsuperscript{80}

The problem of moral hazard intrinsic to corporate insiders is best solved by a multi-party regime of independent gatekeepers.\textsuperscript{81} Corporate lawyers, as fiduciaries to the whole corporate

\textsuperscript{78} See id. at 280.

\textsuperscript{79} Moral hazards arise when one party to a contract passes on the cost of his or her behavior to the other party. See Karl E. Case & Ray C. Fair, Principles of Economics, at G7 (1992).


\textsuperscript{81} Admittedly, it is difficult to achieve complete independence, and to the extent it is possible, complete independence also might make gatekeepers too cautious, thus harming corporations. The best solution seems to be a system of overlapping and redundant gatekeepers. See Eisenberg, supra note 13, at 1283-84. This system should hold gatekeepers liable when they fail to be independent and vigilant. See id.; see also George C. Harris, Taking the Entity Theory Seriously, Lawyer Liability for Failure to Prevent Harm to Organizational Clients Through Disclosure of Constituent Wrongdoing, 11 Geo. J. Legal Ethics 597, 620-36 (1998) (discussing cases in which lawyers and accountants were held liable in negligence for failing to protect their corporate clients from their own senior managers).

Senior inside managers may act recklessly to conceal material information when confronting corporate losses. See Richard W. Painter, Lawyers' Rules, Auditors' Rules and the Psychology of Concealment, 84 Minn. L. Rev. 1399, 1415-16 (2000) (applying prospect theory to demonstrate a possibility of reckless behavior among corporate insiders). This tendency may be exacerbated by the moral hazard problem inherent in agency costs. See id. at 1420. Lawyers in MDPs sharing the strict disclosure duties of auditors would be in a better position to counteract this harmful tendency than would traditional lawyers. See id. at 1420-24. Moreover, the traditional posture of lawyers makes them vulnerable to assisting in concealment when conditions sour, especially if their advice contributed to increased liability exposure. See id.
entity, must be alert to the danger of sharking by powerful inside managers.\textsuperscript{82} Traditionally in corporate practice, and in accordance with the currently vague and permissive Rule 1.13, the board of directors has very little direct contact with corporate counsel.\textsuperscript{83} Powerful insider managers have unfettered use of corporate lawyers. The shield of attorney confidentiality is an enormous aid for management sharking, and makes effective monitoring more difficult. The ambiguous dual agency status of insiders increases the need for transparency and full disclosure. Insiders must not be allowed to hide behind attorney confidentiality.

B. THE IMPORTANCE OF NEW CORPORATE NORMS

In recent years, scholars have recognized that social norms play a very important role in a system of social control.\textsuperscript{84} Re-

\begin{itemize}
\item \textsuperscript{82} Shareholders are quasi-principals. Occasionally they exercise ownership rights of control, but generally they do not. Sharking can be better understood as a product of dual agents and ambiguous principals. The law of agency recognizes that with full disclosure, dual agency is possible, and agents can represent competing or even antagonistic interests. See \textsc{Restatement (Second) of Agency} § 313 cmt. c (1958). Agency law must be carefully examined rather than used in a conclusory fashion to address the problem of sharking.
\item \textsuperscript{83} See \textsc{Model Rules of Professional Conduct} Rule 1.13 (1983).
\item \textsuperscript{84} See Robert C. Ellickson, \textit{Law and Economics Discovers Social Norms}, 27 J. Legal Stud. 537, 540 (1998). Social norms are rules and regularities of behavior that, as a definitional matter, exclude legal rules enforced with legal sanctions and organizational rules enforced by formal sanctions. See Eisenberg, supra note 13, at 1255. There are three types of social norms: descriptive norms (regularities that are not obligatory and not self-consciously followed); conventions (norms that are followed self-consciously but without an obligation to do so); and obligational norms (those which are self-consciously followed but not enforced by a law or an organizational rule). See id. at 1256-58. Norms develop from the formation of belief systems based upon the availability of information, reasoned persuasion, or both. See id. Obligational norms play an important role in compliance with the law. See id. at 1257. They may be followed for instrumental reasons, for example because compliance or noncompliance will have a reputational effect, or they might be internalized so that conscious deliberation is unnecessary for compliance. See id. at 1257-58. Although social norms can sometimes reinforce immoral behavior, they can also play a very important role in supporting compliance with the law.
\end{itemize}

Legal rules and social norms have a complementary relationship. Legal rules can be expressive and supply the information needed for a norm to develop. Also, there is a strong "metanorm" that legal rules should be obeyed. See id. at 1260 n.2. Therefore, even when legal violations are difficult to detect or expensive to enforce, they could still be informally enforced, either through social disapproval or the self-enforced compliance of internalized norms. See id.
cent changes in the behavior of directors of large public corporations have been driven more by the development of new social norms than by the threat of liability or incentives for financial gain. Directors have become more careful, more attentive, more concerned about independence and the structure of corporate governance and more active in setting agendas for corporate strategy.

The evolving norms that apply to public corporations, and especially those of independent directors, institutional investors, and the accounting profession, are increasingly diverging from those of the organized bar. The opportunity for large corporate clients to employ MDPs rather than attorneys who follow traditional legal ethics may be one way clients are using a changing market to reject an ethic that no longer serves them well. This may be occurring because of legal developments that have both clarified the duties of directors and changed organizational structures so that boards behave differently. Although the legal changes may not necessarily have increased directors' exposure to liability, the law has had an expressive function in changing corporate belief systems about directors' duties of care and loyalty.

The fastest changing fiduciary duty, at least in the bellwether state of Delaware, may be the duty to make accurate disclosure of material information. Pressure is coming both from state law cases and from the SEC to ensure that boards fully and accurately disclose material information to investors. The availability of accurate information can also be crucial in the formation of belief systems. Eisenberg has written that "within the last ten years, an inefficient nonobligational norm that licensed and insulated a low level of directorial care".

85. See Eisenberg, supra note 13, at 1253.
86. See id. at 1282.
87. See, e.g., Malone v. Brincat, 722 A.2d 5, 9-10 (Del. 1998) (holding that directors have a fiduciary duty to disclose financial information to shareholders accurately); Zirm v. VLI Corp., 621 A.2d 773, 780 (Del. 1993) (holding that the nondisclosure of material facts to shareholders means material from the standpoint of a reasonable director); Lynch v. Vickers Energy Corp., 383 A.2d 273, 279-80 (Del. 1977) (holding that a tender offer failed to make the required full disclosure); Weinberger v. Rio Grande Indus., Inc., 519 A.2d 116, 126 (Del. Ch. 1986) (holding that, in tender offer and merger transactions, the duty of directors to disclose "soft" information should be determined on a case-by-case basis).
88. These have occurred both by enforcement actions against accountants and by pressure on corporate audit committees. See infra Part II.C (discussing the gatekeeper enforcement regime).
has been replaced by a more efficient obligational norm that requires a higher level of care."

He attributes this to changes in the corporate belief system. What was the source of information from which this superior belief system developed? Partly it resulted from the more stringent state and federal disclosure requirements, which may themselves have resulted from the realization that corporate inside managers were not being either as effective or honest as agency theorists had maintained. This realization stemmed from the takeover frenzy of the 1980s, the savings and loan crisis, and the continuing saga of audit failures and fraudulent financial reporting.

C. THE EXPANDING MULTI-PARTY GATEKEEPER ENFORCEMENT REGIME FOR PUBLIC CORPORATIONS

1. The Audit Committee as "Ultimate Monitor"

Recent developments in corporate governance indicate a greater reliance on monitoring compliance with corporate obligations by using an increasingly sophisticated gatekeeper enforcement strategies. These involve liability or incentives for third parties who are not the primary authors or beneficiaries of misconduct, but who are able to prevent or disrupt it. Public gatekeeper strategies based upon liability have long been common in the law and many private enforcement regimes also exist in which the market offers rewards and subsidies. Gatekeeper regimes can become exceedingly complex and may involve both liability and reputational incentives. Hybrid systems with public and private components can also evolve.

89. Eisenberg, supra note 13, at 1265.
90. The expressive power of law can be very important in generating norms by helping to clarify conduct, make it concrete and add moral weight. See id. at 1269-70. If the norm is inconsistent with a general belief system, however, it will neither be internalized nor instrumentally followed because it will have little reputational payoff. See id.
91. Blue Ribbon Committee Report, supra note 17, at 1071 ("[T]he audit committee is . . . the ultimate monitor of the process.").
92. See Kraakman, supra note 11, at 53.
The role of corporate directors as gatekeepers has expanded enormously in recent years. This has resulted, at least in part, from clearer definitions of the fiduciary duty of care and an expanding fiduciary duty of disclosure and good faith, at least in Delaware. Commentators have argued persuasively that changing social norms within large corporations have also contributed to directors behaving far more energetically as active gatekeepers. Ira Millstein has written that the “evolution of modern corporate governance that began in the 1970s was rooted in financial reporting issues.” In the 1970s, management had enormous discretion in selecting accounting principles for financial reporting. Auditors' opinions might not have reflected information that was somehow not required to be disclosed by specific generally accepted standards. Even in the 1990s, one survey found that forty-seven percent of executives would intentionally misstate financials to show a greater profit. The intractable problem of fraudulent financial reporting thus focused directors' attention both on corporate management and the accounting profession.

The recent trend in corporate governance has been for the board of directors, and especially independent directors, to re-
duce agency costs by monitoring the performance of corporate managers.\textsuperscript{100} The expanding fiduciary duties of corporate directors are increasingly making the directors gatekeepers for detecting and preventing corporate wrongdoing, and accountants are increasingly becoming a crucial part of this multi-party gatekeeper enforcement regime. Indeed, "the evolution of modern corporate governance" has been "rooted in financial reporting issues."\textsuperscript{101}

Despite continuing attempts to improve the quality of financial reporting and to avoid fraudulent practices, however, decades-old calls for reform have yet to prompt an adequate response to the problem of fraudulent financial reporting.\textsuperscript{102} The severity of the problem did not abate even after the Treadway Commission put forward comprehensive recommendations in 1987.\textsuperscript{103} In fact, serious accounting improprieties have recently been on the increase.\textsuperscript{104} Accordingly, in July 1999 the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees issued a comprehensive report and recom-

\textsuperscript{100} See Melvin A. Eisenberg, The Board of Directors and Internal Control, 19 CARDOZO L. REV. 237, 244-50 (1997) (discussing why the responsibility for internal control should be vested in the board). This expanded role for independent directors is set out in the Principles of Corporate Governance, the ABA Corporate Director's Guidebook, and the Business Roundtable's Corporate Governance and American Competitiveness. See id. at 238-39. Eisenberg explains that boards are best suited to act as the ultimate monitors in corporate organizations because of the problems of asymmetrical information in hierarchical organizations and because of the problem of managerial opportunism. See id. at 244-50. Independent directors have been given ultimate responsibility for monitoring because of certain structural advantages. First, outside directors can be more objective than insiders, and have less incentive to slant information in a self-serving manner. See id. at 244-48. Unlike inside managers, independent directors are not dependent upon short-term results for promotion or compensation. See id. Moreover, they can broadly evaluate the welfare of the entire corporate enterprise rather than focusing on a single component for which they are responsible. See id. They are also more likely to be able to make a necessary but unpopular disclosure, because they can do so without losing their livelihood. See id.

\textsuperscript{101} Millstein, supra note 57, at 1060.

\textsuperscript{102} See id. at 1058.

\textsuperscript{103} See generally TREADWAY COMMISSION REPORT, supra note 51; see also Eisenberg, supra note 100, at 243 (discussing the Treadway Commission's report).

\textsuperscript{104} See Laurie B. Smilan, Financial Fraud: The Blue Ribbon Committee's Recommendations, in SECURITIES LITIGATION 1999, at 565 (PLI Corp. Law & Practice Course Handbook Series No. B-1136, 1999). The reasons for the rise in fraudulent reporting are the growing number of new and inexperienced public corporations and the fact that corporations are increasingly "slaves to analyst expectations." Id.
mendations.¹⁰⁵ On December 15, 1999, the SEC endorsed the Committee's work and proposed new rules based upon its recommendations.¹⁰⁶

An analysis of the recommendations contained in the reports of the Treadway Commission¹⁰⁷ and the Blue Ribbon Committee¹⁰⁸ provides two important insights. First, directors, and especially independent audit committee members, must become part of a multi-party gatekeeper regime, together with internal and independent auditors. Independent audit committee members face greater exposure to liability if they are not effective monitors, and they will need help to do their jobs.¹⁰⁹

¹⁰⁵. See generally Blue Ribbon Committee Report, supra note 17.
¹⁰⁶. See Levitt Statement, supra note 51. The proposed rules for enhancing audit committee effectiveness included, among other things, quarterly reviews for early identification of significant accounting issues. See id.
¹⁰⁷. The Treadway Commission Report declared the reporting of financial information in the United States to be the "best in the world," but advised that improvement was necessary to respond to increasing fraudulent reporting. See TREADWAY COMMISSION REPORT, supra note 51, at 5. The recommendations effectively pointed to the need for a multi-party gatekeeper regime of top corporate managers, boards of directors, independent public accountants, the SEC, regulators and other law enforcement agencies. See id. at 1. Corporate counsel were not included in the list. See id. The reporting duty of public corporations flows to all their constituents, and the role of the public auditor in making full disclosure transcends any contractual relationships auditors may have with the corporation. See id. at 5. The report acknowledged that academics needed to assist in helping to formulate a new ethic. See id. at 6. The commission blamed a narrow focus on profits and the need for "smooth earnings" as causes of fraudulent reporting, see id. at 23-24, and recommended the use of audit committees, improving the quality of audits, new SEC sanctions and greater criminal prosecution; see id. at 14-15. The report made six specific recommendations about audit committees because a study of SEC enforcement proceedings found substantially less fraud in corporations that had audit committees. See id. at 39-44. In suggesting that audit committees should review corporate plans, the report acknowledged a role for these committees in important transactions. See id. at 43-44. The commission raised concerns about a loss of auditor independence as a result of performing other functions, but recognized that this could also result in CPAs having better knowledge about their clients. See id.
¹⁰⁸. The Blue Ribbon Committee Report focused on the structure and financial aspects of audit committee duties. See Lorne, supra note 37, at 505. The Audit Committee is to serve as the "ultimate monitor." Blue Ribbon Committee Report, supra note 17, at 1071. The report contains three categories of recommendations: competence, process and transparency. See Harvey L. Pitt et al., Tougher Standards for Audit Committees: The Report of the "Blue Ribbon" Committee, in ADVANCED SECURITIES LAW WORKSHOP, supra note 37, at 527-30. The report lists ten "Best Practices" that nowhere mention a role for corporate counsel. See Blue Ribbon Committee Report, supra note 17, at 1089-93.
¹⁰⁹. It may be disingenuous for SEC Chairman Levitt to suggest that the
Second, like the dog in the Sherlock Holmes story that was conspicuous for not barking in the night, an important role for corporate counsel is notably absent. Accordingly, not only are corporate lawyers not part of the solution, but because lawyers can adhere to the norms of the organized bar, which increasingly differ from those of corporate clients, lawyers remain part of the problem.\textsuperscript{1}

Much of the best criticism of the recent Blue Ribbon Committee proposal is that it does not provide ways for audit committee members to obtain the information they need to do their job.\textsuperscript{11}\textsuperscript{1} The very independence of board members and audit committee members, while vital in one way, assures that inde-
pendent directors may lack knowledge of their companies and perhaps even their industries. In the 1980s, independent directors were recognized as gatekeepers, but hardly as the "ultimate monitors" that audit committees were to become in the Blue Ribbon Committee Report.\footnote{See Pitt et al., supra note 108, at 529 (referring to the "ultimate monitor" recommendation).} Although the committee's proposals are certainly salutory, one important question raised by the report is whether audit committee members can be effective monitors without access to the necessary information.\footnote{See id. at 532.} A former general counsel of the SEC criticized the report for not even addressing this problem.\footnote{See Lorne, supra note 37, at 505-06; see also id. at 516 (noting that the board "does not have the tools to discharge what the SEC or others legitimately view as the board's obligation").} He also suggested that the cases in which boards fired CEOs are not evidence that independent boards are effective, but rather indicators of a failure to identify problems and solve them in a more timely and less drastic fashion.\footnote{See id. at 515-17.}

The information that audit committee members get is "filtered" through senior inside managers,\footnote{See id. at 524.} often with the help of corporate counsel who may contribute to the absence of candor and full disclosure in that process.\footnote{See infra Part III.A (discussing different normative systems).} There are numerous reasons, both reprehensible\footnote{See Seamons, supra note 27, at 273 n.33 (discussing the financial fraud problem).} and understandable,\footnote{See Daniel C. Langevoort, The Epistemology of Corporate-Securities Lawyering: Beliefs, Biases and Organizational Behavior, 63 BROOK. L. REV. 629, 638-48 (1997) (discussing the cognitive psychology of corporate reporting).} that management may be unwilling or unable to provide accurate information. Although the audit committee is asked to be vigilant and "constructive skeptics,"\footnote{Olson, supra note 109, at 1111.} this becomes much more difficult when corporate attorneys are able to assist inside managers in filtering information by using their skills as advocates and by keeping information confidential.\footnote{For example, the ABA Task Force in 1993 concluded that Kaye, Scholer had no duty to advise the Lincoln Savings and Loan Bank about the activities of Charles Keating and Lincoln's inside managers. See Wilkins, supra note 41, at 1167-68 \& n.93 (citing TASK FORCE ON THE LIABILITY OF COUNSEL REPRESENTING DEPOSITORY INSTITUTIONS, AMERICAN BAR ASS'N, FIRST INTERIM REPORT (1992)). This underscores the current state of confu-
Chief executive officers and senior managers presumably prefer not to share information with the board in situations where this would reduce their power. Because corporate counsel continue to behave as though the senior inside manager alone is to receive their loyalty and confidentiality, audit committees of the board get less information. The lawyer as advocate may indeed be advocating on behalf of inside managers against the best interests of the entity. Confidentiality reduces the availability of information, which can result in inefficient norms and belief systems. For audit committees and outside auditors to be successful, they must become part of a concerted action that carefully coordinates the legal, economic and social systems in which the corporation operates. Yet, to a large degree this common-sense idea has been ignored. The Principles of Corporate Governance authorizes audit committees to retain independent legal counsel to assist them, but mandate no role for the corporations' own legal counsel who, as a practical matter, may be assisting opportunistic managers in circumventing disclosure. Not providing information about illegal activities to the board was the very conduct that the ABA Task Force in 1993 concluded did not violate the Model Rules of Professional Conduct.

Although the Blue Ribbon Committee and the SEC do not mention corporate lawyers as part of the monitoring regime, it is clear that requiring their cooperation would help audit com-

sion about the applicability of Model Rule 1.13. Thus, while Kaye, Scholer may have engaged in legally prohibited conduct, "many prominent lawyers insisted that they had not, and for them that fact would have been sufficient to establish the propriety of their conduct." Simon, supra note 19, at 8. Simon described the response of the organized bar as "pervasively disingenuous and irresponsible." See William H. Simon, The Kaye, Scholer Affair: The Lawyers' Duty of Candor and the Bars' Temptations of Evasion and Apology, 23 L. & SOC. INQUIRY 243, 243 (1998). The bar did not examine the charges objectively. The ABA appointed a "Working Group on Lawyers' Representation of Regulated Clients," which issued a report concluding that the allegations were baseless. See id. at 263-65. The report stated that Rule 1.13 did not require the law firm to advise the board of directors that senior managers were engaged in fraud. See id., at 263 n.29. Rather than discussing a duty to protect the entity from harm, the report treats the inside managers who were engaged in massive fraud as though they were the client, and speaks of "interference . . . that the client entity may not welcome." Id. 122. See Eisenberg, supra note 13, at 1271.

123. See Principles of Corporate Governance § 3.05 (1992).

124. See Wilkins, supra note 41, at 1167-68 & n.93 (citing Task Force on the Liability of Counsel Representing Depository Institutions, American Bar Ass'n, First Interim Report (1993)).
mittees. Lawyers serving the corporate entity as a whole should be expected to make full disclosure to audit committees and never use reliance on confidentiality to justify non-disclosure. This would help to modify greatly the usual understanding of the vague duties set forth in Model Rule 1.13.\textsuperscript{125} Although lawyers are not immune from bias and the possibility of cognitive confusion,\textsuperscript{126} they are trained to be probing and skeptical. Independent directors and audit committee members may lack knowledge of the company or its industry.\textsuperscript{127} They are generally not trained as lawyers or accountants, and they often lack the time to be thorough.\textsuperscript{128} Corporate lawyers, on the other hand, do have the necessary time and training, but because they are co-fiduciaries with management to the corporation (co-agents and not sub-agents)\textsuperscript{129} they are the vital “inside outsiders” needed to advise and augment audit committees. There is no clear rule that lawyers must act for audit committees rather than inside senior managers, and this is not part of the behavioral norms of corporate lawyers. One way for corporate audit committees to get the full benefit of all legal services paid for by the corporation would be to hire MDPs to provide these services, if the SEC would allow the practice subject to the understanding that lawyers would make full disclosure to audit engagement partners.\textsuperscript{130}

\textsuperscript{125} See Model Rules of Professional Conduct Rule 1.13 (1983); supra notes 81-83 and accompanying text (discussing the rule).

\textsuperscript{126} See Langevoort, supra note 119, at 647-48 (discussing the lawyer's role).

\textsuperscript{127} One recent quantitative study found that increasing insider representation on board finance and investment committees significantly increased contemporaneous stock returns and returns on investment. See April Klein, Firm Performance and Board Committee Structure, 41 J.L. & ECON. 275, 275 (1998). The possible explanation for this is that outside directors have less knowledge about corporate activities and less time to devote to their jobs. See id. at 278. If this explanation is accurate, placing outside directors on the audit committee may not be a panacea. One critic of the Blue Ribbon Committee Report believes that it overloads outside directors with a duty to micro-manage and fails to recognize that they are neither lawyers nor accountants. See Olson, supra note 109, at 1106-07.

\textsuperscript{128} See Olson, supra note 109, at 1106-07.

\textsuperscript{129} See 1 Hazard & Hodes, supra note 1, § 1.13:105.

\textsuperscript{130} One may well ask why it is necessary to use MDPs rather than just pass a board resolution instructing the company's lawyers to report to the audit committee. The answer is that it is not necessary, but that initially using MDPs, which have an institutional history of full disclosure, seems less radical and can be better integrated into a system with which the participants are familiar. It is also a way to avoid the protestations of the organized bar.
It is very surprising that the Blue Ribbon Committee Report does not mention corporate lawyers because like directors, lawyers owe an independent fiduciary duty to the corporation. Lawyers are trained to use constructive skepticism, a skill that auditors should also have. In addition, only lawyers are licensed to analyze certain issues that must be addressed in audits, such as legality, scope of fiduciary duty and materiality. Thus corporate lawyers, if made independent of managers, would have the time, training and objectivity to act as the “inside outsiders” necessary to enable audit committees to function effectively.131

2. The Changing Role of Independent Auditors

While studies, reports and commissions have focused on the responsibilities of the board, and especially independent audit committees, to act as monitors of financial reporting, new legal obligations and norms within a new belief system are also developing for accountants. The traditional view was that accountants could assume that corporate management was honest, but this view has changed dramatically.132 Formerly, the auditor was viewed as “a watchdog, not a bloodhound”133 and auditors were not supposed to act as “detectives hired to ferret out fraud, but if they chance[d] on signs of fraud they may not avert their eyes . . . .”134 This perception has changed, at least for the auditors of public corporations registered with the SEC.

Accountants have traditionally been corporate gatekeepers because of their position as “public watchdog[s].”135 Although the effectiveness of accountants in ensuring corporate accountability has been criticized for at least sixty years, there has been a continuing trend to require accountants to play a more aggressive role as external independent monitors.136 Independ-
ent accountants play an important role in assuring the accuracy and fairness of the financial statements and in providing corporate accountability. The AICPA Cohen Report stressed that the primary role of accountants is no longer to report irregularities to management, but to act as external, independent evaluators. As conventional, internal controls have failed, accountants are seen as an important alternative device for control.

In the terse terms of Joel Seligman: "[i]n the real world, the language of corporate governance is accounting." Accordingly, much actual corporate regulation is done through accountants. Whereas state corporate law rarely concerns accounting, the SEC can regulate accounting standards, and since 1983 the SEC has frequently invoked violations of the federal securities laws for audit failures resulting from management misleading auditors. At least for the large public corporations that must report to the SEC, failure of internal controls to measure and describe corporate performance, is no longer merely a possible violation of the state law fiduciary duty of care—it can also be prosecuted in SEC auditing proceedings. These proceedings generally focus on the work of corporate audit committees and outside auditors. Most of the cases involve misrepresentations or omissions in financial

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137. See id. at 674-75; cf. TREADWAY COMMISSION REPORT, supra note 51, at 23-24 (discussing causes of breakdowns in financial reporting, and concluding that managers who were under performance pressure cooked the books and treated independent auditors as fair game to be deceived). Instead, accountants have become "agent[s] of social control" who should function as independent evaluators. Ebke, supra note 55, at 674-75 (citing COMMISSION ON AUDITORS' RESPONSIBILITIES, REPORT, CONCLUSIONS, AND RECOMMENDATIONS 4 (1978)).

138. See Ebke, supra note 55, at 674-75.

139. See id. at 702-03.


141. See id. at 949 (offering an illustration of an SEC auditing proceeding). The remedies that the SEC may seek include judicial injunctions, discipline against professionals under rule 2(e) of the Commission's Rules of Practice, proceedings against registrants under § 15(c)(4) of the Securities Exchange Act, cease and desist orders against accountants or registrants, and reference to the Department of Justice for criminal prosecution. See id. at 950. Numerous enforcement actions that were brought against accountants were really intended to have a deterrent effect on the corporation. See id. at 950-51; cf. Ebke, supra note 55, at 683 (arguing that financial liability of accountants should not be expanded because rather than detecting wrongdoing, such liability merely socializes losses while profits remain individualized).
statements. While the state law fiduciary duty of care has traditionally provided little real control on management, SEC enforcement proceedings against accountants are common and are really intended to deter misconduct by corporations.142

When Kraakman first wrote about the “anatomy” of gatekeeper enforcement regimes in the 1980s, he starkly contrasted gatekeepers with whistleblowers.143 Kraakman concluded that gatekeeper duties are common while whistleblowing requirements, which include a duty to disclose wrongdoing, are rare.144 He attributed this to a cultural aversion to informing and the drastic results that it produces.145 The dichotomy between gatekeepers and whistleblowers has become less clear because of recent developments in corporate governance. The 1991 Federal Sentencing Guidelines for corporate crimes greatly increase the penalties of corporations found guilty of criminal violations, while offering powerful incentives for detecting and reporting wrongdoing and cooperating fully with prosecutors.146 Therefore, corporate directors, as part of their fiduciary duty of care, may be required to blow this whistle on employees and managers.147

Independent auditors, the classic gatekeepers,148 also now have a greater whistleblowing role, at least when they are dis-

142. See Seligman, supra note 140, at 950.
143. See Kraakman, supra note 11, at 58; see also Bernhard Grossfeld & Werner Ebke, Controlling the Modern Corporation: A Comparative View of Corporate Power in the United States and Europe, 26 AM. J. COMP. L. 397, 421 (1978) (acknowledging the inefficiency of shareholder control devices like proxy voting and derivative suits, and concluding that “[t]he most important and most effective devices of control are today imposed from outside the corporate system”).
144. See Kraakman, supra note 11, at 58.
145. See id. at 58-59.
148. See Kraakman, supra note 11, at 64. Even attorneys, whose duty to maintain client confidences is strict, have a rather large loophole through which they can act as whistleblowers by making “noisy withdrawals.” See 1 HAZARD & HODES, supra note 1, § 1.6:315. The organized bar has opposed the use of this remedy, and the extent to which courts or regulators will require its use is unclear. Nevertheless, it at least provides a basis for attorney whistleblowing. See id.
charged by reporting companies. The 1995 amendments to the securities laws substantially expand the legal requirement for whistleblowing-type disclosure. These disclosure duties increase the responsibility of accountants to be effective gatekeepers. Section 301 of the Private Securities Litigation Reform Act of 1995 requires audit procedures “designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on... financial statement[s].” Auditors are no longer merely “watchdog[s],” but now “bloodhound[s]” or “detective[s]” whose duty it is to ferret out fraud.

Rather than presenting a stark dichotomy, gatekeeping (with the preservation of confidences) and whistleblowing (with a duty to disclose confidences) are best seen as points on a continuum in which the potential to disclose will often increase the effectiveness of the ability to deter wrongdoing. Similarly, Kraakman’s distinction between two types of gatekeepers, the bouncers and the chaperones, is also becoming less distinct.

149. See infra note 152 (discussing Form 8-K filing requirements).


151. Id. § 301; see also Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 454 (7th Cir. 1982) (noting that auditors are not detectives to ferret out fraud); Bily v. Arthur Young & Co., 834 P.2d 745, 762 (Cal. 1992) (stating that auditors are watchdogs, but not bloodhounds). One reason for the new duty is that in California 28 of 30 savings and loans that failed had received clean audit opinions. See supra note 27.

152. Seamons, supra note 27, at 259. Pursuant to Section 10A of the Securities Act of 1933, the SEC may modify audit procedures and discipline accountants who fail to meet these new standards. See id. at 261. Today’s auditors must be whistleblowers. See id. at 262. After detecting or becoming aware of information indicating that an illegal act may have occurred, regardless of materiality, accountants must determine the likelihood of whether an illegal act occurred, whether the act is “clearly inconsequential,” and its possible effect on financial statements. See id. Illegal is defined broadly and includes regulatory violations and violations of foreign law. See id. at 265. The accountant must, “as soon as practicable,” inform the appropriate level of management and assure that the audit committee (or board of directors if no audit committee exists) is adequately informed. If the accountant concludes that the illegal act has a material effect on the financial statements, “but senior management and the board have not taken timely and appropriate remedial action, and such nonaction is reasonably expected to warrant departure from a standard audit report or resignation,” the accountant must state this conclusion in a § 10A Report to the board of directors. Id. at 262-63. The board then must notify the SEC within one business day of receipt of the report. See id. at 263. If the board does not act within one business day, the accountant must resign, triggering the requirement that the client file a Form 8-K within one business day, thus notifying the SEC. See id.

153. See Kraakman, supra note 11, at 62-66.
for corporate governance. Bouncers are gatekeepers that must withdraw their services and thereby exclude a wrongdoer from the market,\textsuperscript{154} while chaperones remain in a continuing long-term relationship with the potential wrongdoer during which time they endeavor to detect and disrupt wrongdoing.\textsuperscript{155} Accountants act as bouncers when corporations cannot undertake a transaction without a clean audit opinion.\textsuperscript{156} Because accountants are involved in long-term relationships and are subject to the 8-K filing requirement, they also serve as chaperones. The 1995 Amendments increase the requirement that accountants act as bouncers, but this probably makes them more effective as chaperones as well.

The same salutary effect can be expanded to the role of a lawyer in the MDP context. If directors hire MDPs to provide legal services, and require all material information that MDP transactional lawyers learn to be provided to the audit partner, the directors would conflate the roles of transactional attorney and accountant. It is logical for the board to use lawyers as supplemental monitors given both the heightened liability of directors for failure to monitor and accurately disclose material information, and the corporate norms of caution and attentiveness. By using MDPs to provide both auditing and legal services, clients are effectively requiring the lawyers to be more active as chaperone gatekeepers.\textsuperscript{157}

\textsuperscript{154} See id. at 63.
\textsuperscript{155} See id at 62-63.
\textsuperscript{156} See id. at 62; Painter, Toward a Market, supra note 32, at 255-61 (explaining that the short turn around time for accountants to report misconduct would seem to make them unable to insist that clients take corrective action). On the other hand, the threat of exit and disclosure may enable accountants to succeed without triggering the one day window. See id.
\textsuperscript{157} Albert O. Hirschman has written eloquently about how institutional problems can sometimes be cured by various applications of “exit” or “voice” by constituents. See generally ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES (1970). “Exit” occurs when “customers stop buying the firm’s products or some members leave the organization.” Id. at 4. As a result, “revenues drop, membership declines, and management is impelled to search for ways and means to correct whatever faults have led to exit.” Id. “Voice” occurs when “[t]he firm’s customers or the organization’s members express their dissatisfaction directly to management . . . or through general protest addressed to anyone who cares to listen.” Id. As a result, “management once again engages in a search for the causes and possible cures of customers’ and members’ dissatisfaction.” Id. Loyalty, which is functionally very similar to the relational trust needed for joint ventures, can reduce exit and increase the effectiveness of voice. See id. at 76-105. By making exit much more costly for a corporation whose gatekeeper must resign (acting as a whistleblower), corporations have
Judicial innovation has been very important in developing gatekeeper regimes.\(^{158}\) Raising the penalties for both primary and third parties can be an effective way to make gatekeeping regimes work.\(^{159}\) This has been done by greatly increasing the penalties for corporate crimes,\(^{160}\) expanding liability for director gatekeepers who fail to monitor effectively\(^{161}\) or make candid disclosure of material information,\(^{162}\) and recognizing liability for lawyer and accountant gatekeepers who negligently fail to prevent harm to corporate clients caused by corporate managers.\(^{163}\) In addition, by greatly reducing the penalties for corporations that detect and disclose criminal activities, and requiring directors to cooperate in the prosecution of wrongdoers, the Federal Sentencing Guidelines offer a "legal bribe" to encourage gatekeeping.\(^{164}\) Moreover, because correctly settling the sanctions for misconduct is never more than an educated guess, lowering the sanctions as the duty approaches strict liability can be effective.\(^{165}\) This may explain why actual liability for directors is decreasing while the norms are requiring greater care to protect one's reputation.\(^{166}\) Thus, recent developments in an incentive to increase the loyalty of their gatekeepers (staying on as chaperones) and remonstrating with revitalized voice. See id. at 92-105; see also Bruce Chapman, Trust, Economic Rationality, and the Corporate Fiduciary Obligation, 43 U. TORONTO L.J. 547, 560-71 (1993); Kostant, supra note 63, at 240-45. But cf. Wilkins, supra note 41, at 1172 (arguing that whistleblowing duties for lawyers for federally-insured thrifts might result in weaker compliance reviews by "reduc[ing] the lawyer's ability to wield clout as a powerful and knowledgeable insider for the purpose of encouraging thrifts to comply with legal limitations").

\(^{158}\) See Kraakman, supra note 11, at 85.

\(^{159}\) See id. at 70-71.

\(^{160}\) See generally U.S. SENTENCING GUIDELINES MANUAL (1997).


\(^{163}\) See infra notes 216-17 and accompanying text (discussing cases in which lawyers and accountants have been found negligent for failing to prevent harm to their corporate clients).

\(^{164}\) Kraakman, supra note 11, at 70-71 (describing how legal bribes can encourage gatekeeping).

\(^{165}\) See id. at 78.

\(^{166}\) See Eisenberg, supra note 13, at 1280-82. In Malone, the materiality test for disclosure approaches strict liability, but the candor cases can be read as aspirational because despite the strict duty, no cases have actually found directors liable. See Malone, 722 A.2d at 11-12. Similarly, although the Caremark duty of care is rigorous, the directors of the company that paid $250 million in criminal fines and damages were found not to have violated the duty of care. See Caremark, 698 A.2d at 960-61, 971-72.
corporate law seem to be leading to a community of gatekeepers, consisting of directors, accountants and lawyers.¹⁶⁷

3. Advantages of MDP Transactional Lawyers in Multi-Party Gatekeeper Enforcement Regimes

Corporations benefit from using MDP transactional lawyers in two primary ways. First, lawyers working within the ethical constraints of MDPs would follow rules that are better suited to protecting corporate clients rather than just senior inside managers. The norms of MDPs better fit the evolving corporate belief system of care, transparency, trustworthiness and accurate disclosure than does the traditional legal ethic of selective nondisclosure. Second, if we examine the institutional process-related capabilities of large MDPs, as contrasted with traditional law firms, the MDPs appear to offer clear advantages.¹⁶⁸

The strict duties of confidentiality and the attorney-client privilege, though important for an attorney's litigation role, actually make transactional lawyers less effective as reputational intermediaries and therefore harm their honest clients. Clients suffer because the absence of a duty of reasonable full candor creates an adverse selection problem, or a "lemons market," in which high quality clients cannot distinguish themselves through the use of truly trustworthy attorneys.¹⁶⁹ This imperfect information causes inefficient results. Markets, however, can sometimes adjust in order to create incentives that will produce better information. For example, despite opposition from the organized bar in both its rules and its rhetoric, corporate clients in the newly competitive market for legal services are hiring MDPs for legal services even if they must waive traditional attorney-client confidentiality. These corporate clients

¹⁶⁷. See Ebke, supra note 55, at 719.
¹⁶⁸. See Rubin, supra note 7, at 1424-33 (calling for a micro-analysis of institutions).
¹⁶⁹. The economist George A. Akerlof described how unequal information can cause the adverse selection problem that results in a "lemons market" for automobiles. See George A. Akerlof, The Market for "Lemons": Quality, Uncertainty and the Market Mechanism, 84 Q.J. ECON. 488, 489-92 (1970). Because sellers of lemons know that they are lemons while buyers do not, more lemons are sold because sellers of lemons will be paid somewhat more than the value of a lemon. See id. Buyers eventually realize that they have a greater chance of buying a lemon, and the price of cars falls. See id. Good car owners become less likely to sell and eventually only lemons are sold. See id.
are getting instead lawyers who are better reputational inter-
mediaries.

Independent directors may prefer hiring lawyers employed
by MDPs because MDP lawyers are members of powerful insti-
tutions that can better serve large corporations. Today's pow-
eful and sophisticated corporate clients seldom use only one
law firm, or give their attorneys a free hand in determining the
means for achieving the client's goals. In fact, there is evidence
that lawyers for large corporations are less independent than
lawyers with large numbers of individual clients, and generally
more "client motivated" and less "public motivated."\footnote{170} As law-
yers become less independent, they can become vulnerable to
strategic opportunism by senior managers of corporate cli-
ents.\footnote{171} Managers willing to risk corporate welfare may try to
get weaker lawyers to assist them or divide work among nu-
merous law firms to hide their overall strategy. To avoid this,
large public corporations and their lawyers may become a kind
of "joint venture" in which both parties need to cooperate and
not use their power opportunistically to harm each other.\footnote{172}
This mutual forbearance is based upon a social bargain em-
ploying "relationship capital," or trust, that the client will use
the legal services for a legitimate legal purpose in return for
the lawyer giving the client access to "one of society's most pre-
cious and important resources: the law."\footnote{173}

\footnote{170. See David B. Wilkins, Do Clients Have Ethical Obligations to Law-

\footnote{171. See id. at 886-88. The most egregious example of this type of strategic
abuse of a corporate lawyer can be found in \textit{Balla v. Gambro, Inc.}, 584 N.E.2d
104 (Ill. 1991). The Supreme Court of Illinois concluded that attorneys were
not entitled to the same protections afforded to laypersons. See \textit{id.} at 111.
The ACCA, fearing a "caste system" of in-house and outside corporate counsel,
argued that lawyer independence requires the absence of protections from cli-
ent overreaching. Amicus Brief for the American Corporate Counsel Associa-
tion at 11-12, \textit{Balla v. Gambro, Inc.}, 584 N.E.2d 104 (Ill. 1991) (No. 70942).
On the other hand, Kaye, Scholer and Jones, Day strategically used their
reputations as prestigious law firms to reap extravagant fees from clients en-
gaged in illegal activities. See \textit{In re American Continental Corp./Lincoln Sav.
& Loan Sec. Litig.}, 794 F. Supp. 1424, 1449-54 (D. Ariz. 1992) (describing the
involvement of Jones, Day in the Lincoln Savings and Loan failure); Sympo-
sium, In the Matter of Kaye, Scholer, Fierman, Hays & Handler: A Symposium
on Government Regulation, Lawyers' Ethics, and the Rule of Law, 66 S.
CAL. L. REV. 977, 979-84 (detailing the chronology of events leading to the
Kaye, Scholer scandal); see also Kostant, supra note 63, at 214.}

\footnote{172. Wilkins, \textit{supra} note 170, at 887.}

\footnote{173. Id. at 888, 891.}
How can the development of such trust be encouraged, when it is natural for lawyers and clients to mistrust each other? Perhaps one way is to hold lawyers liable for failing to use reasonable efforts to discover and disclose client wrongdoing—by using their skills to engage in a "sustained, probing, honest conversation with the client," lawyers can open a dialogue that creates a relationship of real trust with the client, not to mention a powerful incentive for clients to comply with the law. Independent directors thus have an incentive to seek lawyers who will help uncover management misconduct.

Although the norms of the organized bar may do little to generate trust, other models are becoming available. Independent boards (if not their senior inside managers) can derive real benefits from a reciprocal relationship with powerful and independent lawyers. In this context, some of the terminology of professional responsibility takes on a clearer meaning for corporate representation. For example, independence, becomes "interdependence" in a process to discover and disclose material information, loyalty flows to the corporate entity as represented by the independent board of directors, and confidentiality cannot be used as a shield for opportunistic misconduct by senior inside managers.

Trust and loyalty are functionally similar, and corporations that have a high trust culture may be more efficient and profitable. In the joint venture model, trust is increased because each participant may be liable if it fails to discover misconduct. A venerable example of this model is the Section 11 liability of issuers, their senior managers, underwriters, counsel and accountants in a public offering. The energetic and

175. Id. at 1033; see also SIMON, supra note 19, at 138-69 (discussing the advantages of using the contextual tort law standard to govern legal ethics).
176. See Burt, supra note 174, at 1033. Burt believed that the ABA lost the opportunity to build this into the Model Rules. See id. at 1026-55.
177. Incentives for this kind of questioning dialogue with corporate clients is evolving because courts have begun to hold lawyers and accountants liable for negligently failing to protect corporate clients from the misconduct of their managers. See infra notes 216-17 and accompanying text (discussing conclusions to be drawn from cases in which lawyers and accountants have been found negligent for failing to prevent harm to their corporate clients).
179. See Burt, supra note 174, at 1030-31; see also SIMON, supra note 19, at 57 (asserting that mandatory disclosure increases legal compliance).
overlapping due diligence investigations of the powerful participants, which utilize constructive skepticism, has built cooperation and trust and helped to prevent fraudulent or materially erroneous disclosure. The important reputational capital that underwriters and accountants have developed in the securities markets can expand to corporate financial disclosure as directors—especially audit committee members and transactional lawyers for MDPs—become participants.\footnote{norms such as trust might play as important a role in preventing fraudulent or erroneous disclosure as financial liability. See \textit{Chapman}, supra note 157, at 588 (noting that loyalty to an organization can actually arise from an “irony of Adam Smith’s invisible hand” in institutions like corporations where the exercise of “private and highly localized virtues of loyalty and trust . . . at least as much as the unconstrained pursuit of self-interest through contracts, can also add up to the unconscious attainment of a greater good for all”). Indeed, the expressive function of law can do more to clarify and reinforce norms than the actual dollar amount of liability. In \textit{Caremark}, for example, the court clarified and heightened the duty of care for directors without holding the directors in that case liable, though the corporation itself did pay a substantial fine. \textit{See \textit{In re Caremark Int’l Inc. Derivative Litig.}}, 698 A.2d 959, 960-61, 971-72 (Del. Ch. 1996); \textit{see also \textit{Eisenberg}}, supra note 13, at 1266 (discussing how the level of care has increased while exposure to liability has decreased).}

Sophisticated corporate clients should recognize the benefit—better legal services and assistance with monitoring as part of their law compliance regime—that may be gained by requiring MDP lawyers to disclose all material information to the audit engagement partner. Such clients would be able to hold their transactional attorneys to an appropriate ethical standard in the context of the corporate client’s (and especially its outside directors’) needs for an effective gatekeeper regime. Disinterested corporate directors, acting in the best interest of the corporation, could be sure that their transactional lawyers, audit committees and auditors were cooperating fully in giving them accurate information about the corporation. The demand side of the market for legal services would achieve something that the organized bar has repeatedly failed to do—recognize that the practice of law is not unitary, and that different ethical rules are needed for different practice contexts.\footnote{Cf. New York Trust Co. v. Eisner, 256 U.S. 345, 349 (1921) (Holmes, J.) (“[A] page of history is worth a volume of logic.”).}
III. THE INCREASING DISSONANCE BETWEEN THE BELIEF SYSTEM OF CORPORATE LAWYERS AND CORPORATE CLIENTS

A. DIFFERENT NORMATIVE SYSTEMS

The norms of important constituents of corporate governance have recently begun to change dramatically. Corporate directors are no longer acting as passive rubber stamps to senior inside managers and are instead the ultimate monitors of corporate operations.\textsuperscript{183} In addition, institutional investors have become more active as monitors and auditors recognize that they have an affirmative obligation to detect fraud.\textsuperscript{184} These norms are driven by instrumental concerns such as the avoidance of liability or harm to reputation, and are gaining strength by becoming internalized and self-enforcing. The norms and belief system of corporate lawyers and the law that governs them, however, remain at odds with the new norms of corporate governance. This may explain why corporate clients, or at least their independent directors and audit committees, are more comfortable using MDPs to provide transactional legal services.

There are several possible reasons that the norms of lawyers have not yet changed. First, lawyers take their norms, in part, from court opinions. Only a few cases have explained the duties of corporate lawyers, however. Courts have therefore failed to describe the norms that lawyers must follow and make these norms concrete.\textsuperscript{185} Second, the belief system of lawyers is so powerful that little reputational harm will occur if it is followed, and there is small reason to consider, much less internalize, new values.\textsuperscript{186} Under the unitary model of legal ethics based upon an adversary ideal, clients that are self-interested and intent on exploiting others may be rewarded if their lawyers stonewall. The problem is even greater for self-interested managers within a corporation. Opportunistic managers intent on "sharking" may have the corporation's lawyers practice

\textsuperscript{183} See supra notes 57, 95 and accompanying text.
\textsuperscript{184} See supra Part II.C.2.
\textsuperscript{185} See Koniak, supra note 55, at 1079-91.
\textsuperscript{186} For example, even after Kaye, Scholer paid $41 million to settle a lawsuit, the organized bar declared that the firm had not violated ethical norms. See Kostant, supra note 27, at 494-97; see also supra notes 121, 171 (discussing the Kaye, Scholer affair and the bar's response).
"loophole lawyering" and employing creative ignorance. Such tactics can prevent boards from getting the information they need. The bar's interpretation of ethical rules governing the conduct of lawyers accused of keeping harmful information away from independent boards is not one to fill an independent director with confidence.

Rules of legal ethics that are intended to advance basic principles of professional conduct, like loyalty or independence, have become disassociated from the norms to which such ethical conduct should conform. The meaning of "loyalty" becomes even more suspect for a lawyer representing an organization, as opposed to an individual. Although making disclosure of a client's intended illegal behavior to save a third party may be deemed necessary but "disloyal" disclosure, Rule 1.13 does not even allow "loyal" disclosure outside the corporate entity for the purpose of protecting the entity itself—even taking action within the organization is discouraged. The "loyal" refusal to interfere with the authority of inside managers means that corporate lawyers have been unable (or unwilling) to protect their corporate clients. A meaningful duty to the entity, and not to senior inside managers, has hardly been recognized. The special needs of organizational clients to be pro-

187. See Kostant, supra note 27, at 526-27 (describing "loophole lawyering"); supra notes 77-79 and accompanying text (describing "sharking").

188. See Robert W. Gordon, The Independence of Lawyers, 68 B.U. L. REV. 1, 54-56 (1988). For example, Rule 5.4 ("Professional Independence of a Lawyer") has been largely ignored in connection with MDPs that provide legal services. The rule states that lawyers shall not share legal fees with nonlawyers. See MODEL RULES OF PROFESSIONAL CONDUCT Rule 5.4 (1983). The purported rationale for the rule is that lawyers must not compromise their independent judgment. See 2 HAZARD & HODES, supra note 1, § 5.4:101. In fact, the true rationale of the rule as adopted is economic protectionism, because the rule rejects the meaningful Kutak Commission proposals that would have allowed attorneys to practice with nonlawyers as long as they continued to meet their professional obligations. See id. § 5.4:101-02; see also Green, supra note 1, at 1127-33; Charles W. Wolfram, The ABA and MDPs: Context, History, and Process, 84 MINN. L. REV. 1625, 1628-31 (2000).

189. The right of corporate counsel to go up the chain of command shows that the bar's emphasis on strict confidentiality to insure full disclosure to counsel is flawed because it recognizes that attorneys might nevertheless disclose confidential information. See SIMON, supra note 19, at 57. At any rate, this right may have little importance in reality, because lawyers tend to keep the secrets of managers that can hire and fire them, and seldom actually report harmful information up to the ultimate corporate authority, the board of directors.
tected from managers who will reap disproportionate benefits from risky or improper conduct has not been addressed.190

Traditionally, independence for a lawyer meant the ability to analyze and act objectively, and to balance obligations to the client with public responsibilities to the legal system.191 Objective analysis was necessary for a lawyer to meet the duty of competence in correctly applying rules of law to what were determined to be the legally relevant facts. Learning the "truth" about such facts when representing a large corporation is no easy matter, however.192 Rather than deferring to senior managers, lawyers must exercise the same kind of skepticism as accountants and remain aware of the full range of managerial misconduct. Lawyers must recognize their own tendencies either to bond with corporate representatives and thereby possibly share their biases, or to appear aloof and independent and thereby risk being viewed as disloyal and kept out of the loop.193 In corporate practice, independence seldom has the classic meaning of protecting the entity from managers who act illegally. Rather, the lawyer must be involved in the more "complex and subjective" exercise of evaluating the manager's perceptions.194 Accordingly, corporate lawyers must recognize that organizational clients behave nonrationally, and must not be overly deferential.

Neither the language of Rule 1.13 as finally adopted, nor its interpretation by the bar, further ethical representation of corporate entities as much as they should.195 The duty of a lawyer to a business client necessarily goes somewhat beyond the private interests of the client because in transactional and regulatory practice lawyers are lending their reputations to

190. See supra note 121 (discussing the confusion surrounding Model Rule 1.13, as illustrated by the bar's response to the Kaye, Scholer affair).
191. See Langevoort, supra note 119, at 631-33.
192. Id. at 632.
193. See id. at 638.
194. Id. at 631.
195. The norm that Rule 1.13 encourages is a "don't ask, don't tell" regime that expressly forbids loyal disclosure, even when there is no other way to protect the client. See MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13 (1983). Corporate lawyers have legal and moral responsibilities for how corporations act, however. Corporations are not autonomous individuals that can be trusted to take responsibility for their own acts. Independent directors have an incentive to hire professional gatekeepers because ferreting out wrongdoing by inside managers helps directors meet their heightened fiduciary duties and protect their reputations. See supra Part II.C.1.
their clients.\textsuperscript{196} The mantra that strict confidentiality—an exception to the general rule of not withholding material information\textsuperscript{197}—is essential to a lawyer's ability to discourage future client misconduct fails to carry persuasive weight.\textsuperscript{198} First, there is little reason to believe that a strict rule of confidentiality is necessary to be able to help prevent client misconduct.\textsuperscript{199} Second, in cases like the Kaye, Scholer scandal, the law firm seemed to make little or no attempt to discourage wrongdoing, so the need for a strict rule becomes even more doubtful.\textsuperscript{200} Finally, the strict categorical rule is especially dangerous in the context of corporate practice, because it can actually harm the client. Although the lawyer should defer to the business decisions of managers, what constitutes illegality, breach of fiduciary duty or materiality are legal decisions that lawyers are forbidden to delegate.\textsuperscript{201} The fact that corporate managers and corporate lawyers are co-agents of the corporation means lawyers have an independent fiduciary duty to the entity that is, arguably, breached by excessive deference to management.\textsuperscript{202}

Although Model Rule 1.13 purportedly adopts the “entity” theory,\textsuperscript{203} according to which the attorney represents the corpo-
rate entity rather than a particular group that controls it, the rule "contributes little in the way of specific dictates" about how to protect the entity,\textsuperscript{204} and may even do harm. It provides no guidance when a fellow agent is harming the entity, when the loyal attorney is discharged by a disloyal manager, or when the authority of the board is under attack. Attorneys are forbidden to make loyal disclosure outside the corporation even if all internal review has been exhausted and outside disclosure could protect the entity.\textsuperscript{205} The cases in which lawyers have been held liable for negligence in failing to protect the client from its managers do not even discuss Rule 1.13.\textsuperscript{206} The rule generally

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\textsuperscript{204} 1 Hazard & Hodes, supra note 1, § 1.13:101. The proposed rule originally provided some protection to the corporate entity, but was revised after sharp criticism from groups having little expertise in corporate or securities law. \textit{See generally} Schneyer, supra note 203. The American Trial Lawyers Association took an absolutist position on maintaining client confidences, on ideological grounds. \textit{See id.} at 710-12. Because they viewed law practice from an adversarial rather than transactional or cooperative model, they viewed the public interest as just an aggregate of individual clients. \textit{See id.} at 711. Another, very different segment of the litigation bar, the prestigious American College of Trial Lawyers (ACTL) opposed the right of disclosure as well, using the old saw that if clients believed that their lawyers might not keep their confidences, clients would not make full and candid disclosures. \textit{See id.} at 719. According to ACTL, lawyers should not be permitted to disclose wrongdoing by corporate management either to prevent harm to the client or others, or to rectify harm that had been done utilizing the lawyer's services, because it was presumptuous for lawyers to "play God." \textit{Id.} at 720. The rule as finally adopted contained none of the original provisions that would have protected a corporate client from its managers. \textit{See id.} at 721. The original language proposed was that the lawyer represented the entity "as distinct from" its directors, officers and other constituents. \textit{Id.} This was changed to "the organization acting through its duly authorized constituents," again placing management in the position of unchallenged power. \textit{Id.}
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\textsuperscript{205} See Wolfram, supra note 69, at 745. Wolfram describes Rule 1.13 as "too solicitous of organization charts and customary corporate etiquette." \textit{Id.} at 746. The question of exactly when agents for a corporation should be able to disclose adverse information outside the corporation in order to protect the corporation ("loyal" disclosure) is a difficult one and has generated great confusion. \textit{See 1 Hazard & Hodes, supra note 1, § 1.13:111.} The line between loyal and disloyal disclosures is somewhat amorphous for corporations because some constituents may benefit from risking illegal activities while others may not. Nevertheless, Model Rule 1.13 never allows attorneys to make loyal disclosures to protect corporations, and the ABA has interpreted the rule not to require that attorneys make disclosures to the board. \textit{See Model Rules of Professional Conduct} Rule 1.13 & cmt. (1983).
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\textsuperscript{206} See Gillers, supra note 41, at 306-09 (discussing two cases from the Seventh Circuit); Weinstein, supra note 20, at 55-60 (discussing the Kaye, Scholer case).
\end{quote}
allows the attorney to "assume that corporate officers and employees are performing their duties in good faith."207 In this way it undermines the role that attorneys can play as part of the monitoring regime of the board of directors.

B. A NEW CONTEXTUAL ROLE FOR CORPORATE COUNSEL: FROM SERVANT TO STATESMAN

As this Article shows, the unitary ethic governing traditional legal practice fits badly into corporate practice. The contradictions inherent in this model, when confronted by the reality of the more contextual MDP transactional legal practice, might make corporate lawyers the first to break away from the traditional ethics of the organized bar.

There are two primary reasons that this might occur. First, corporate clients are the wealthy targets of MDP competition, and the MDPs, which are held to different ethical standards than members of the legal profession, are powerful and savvy.208 Second, both public corporations and the legal profession are hybrid institutions that have both public and private attributes. The public dimensions of each have gained increasing recognition.209 Just as past emphasis on the private nature of corporations is increasingly seen as harmful to corporations and the society of which they are a part, lawyers representing corporations may likewise recover more of their public function. There is a growing consensus that corporations have duties beyond the narrow self-interest of their owners.210

207. 1 HAZARD & HODES, supra note 1, § 1.13:301. Note that this is the very assumption that auditors are no longer permitted to make.

208. See supra text accompanying note 15 (discussing the "de maximus" rule).

209. See Alan Wolfe, The Modern Corporation: Private Agent or Public Actor, 50 WASH. & LEE L. REV. 1673, 1698 (1993). In the nineteenth century, corporate law was viewed as part of public law and linked to a tradition of economic republicanism that stressed investment in human capital, reinforced community ties, the importance of cooperation, and the avoidance of concentrated power or sudden change. See William H. Simon, Contract Versus Politics in Corporation Doctrine, in THE POLITICS OF LAW 511, 519-23 (David Kairys ed., 1998). In the twentieth century, corporations became a province in private contract law, as a nexus of contracts disciplined by capital markets. See id. at 512. At least in theory, lawyers have both a private duty to serve their clients, and a public duty as officers of the court. See MODEL RULES OF PROFESSIONAL CONDUCT Preamble (1983). Under the traditional rules and norms of practice the first duty has overwhelmingly trumped the second, but in the evolving context of corporate representation these disparate duties may become easier to reconcile.

210. The public nature of corporations is being recognized as states adopt
Similarly, lawyers could serve meaningful public as well as private purposes in representing powerful corporations by occupying what some have called the role of lawyer-statesman of the past, rather than being simply business servants.

The legal system is a public good, like roads and a public education system, but some have observed that the ethics that govern legal practice are also a public good. Facilitative norms assist in the development of private law, like most of corporate law, but this private law is supported by the coercive power of the state. Thus, when lawyers act in the traditional fashion, they may help their private clients to exercise rights that inflict unjust and disproportionate harm on others. This tension between public and private would be clearer for public corporations if their attorneys insisted on enforcing the express and implied contracts among the corporate constituencies, and never assisted in opportunistic breach. Recognition of this duty would help to expand the narrow concept of client representation in the direction of serving broader interests of complex organizations without harming society or the system of justice.

constituency statutes, pension funds become important institutional investors, and the need to meet sudden, global competition again places a premium on cooperation. See Simon, supra note 209, at 528-35 (discussing institutional investment by pension fund managers); supra note 66 (discussing constituency statutes).

211. See generally KRONMAN, supra note 21.

212. JAMES A. CAPORASO & DAVID P. LEVINE, THEORIES OF POLITICAL ECONOMY 12-14, 89-95 (1992)

213. See Wilkins, supra note 170, at 891 (discussing the ethics of the joint venture model in which lawyers provide “exclusive access to one of society’s most precious and important resources: the law”).

214. See SIMON, supra note 19, at 26.

215. Rule 1.13 goes to great lengths to assure that corporate lawyers do not act in a manner too independent of corporate managers, but transaction costs economics nevertheless recognizes the possibility for opportunistic breach within the corporation and the rule makes such misconduct by inside managers (called “sharking”) exceedingly difficult to check. See Williamson, supra note 68, at 458. These breaches will rarely be detected or remedied. Lawyers may come to harm when managers behave opportunistically, by either incurring liability for not protecting the corporation despite reliance on the bar’s interpretation of Rule 1.13, or getting discharged by corrupt managers for trying to protect their client and being left without a remedy. As a mechanism allowing corporate counsel to favor powerful managers who act opportunistically in ways that could harm corporations or others, Rule 1.13 became detached from ethical norms of corporate governance. As Robert Gordon has written, “the order of rules and norms, policies and procedures . . . is not some alien excrescence” but what allows “basic ground rules for profit seeking in commerce and other exercises of personal autonomy.” Gordon, supra note 196, at 321. When these principles are not served, practices need to change.
Without even mentioning the Model Rules, some important cases have held attorneys and accountants liable for negligence for failing to protect their clients from the illegal activities of corporate managers. Despite inconsistencies, the cases indicate four things. First, at least some courts are rejecting the universalist tenets of legal ethics and holding lawyers in corporate practice to a contextual duty of care and candor. Second, these courts have moved to advance a multi-party gatekeeper regime in which lawyers and accountants, as well as corporate directors, may be liable to the corporate entity for failure to protect it. Third, corporate lawyers who rely on Model Rule 1.13 and the ABA's interpretation do so at their peril because they may be found liable in negligence for conduct that does not violate the Model Rules. Fourth, independent directors may now have a natural ally in corporate lawyers, who are beginning to be held to a higher standard than that required by the Model Rules.

By using MDPs to provide legal services, corporations are able to receive important benefits. First, the board of directors can enlist transactional lawyers in the monitoring process and get useful additional assistance in carrying out their fiduciary duty of care. Use of MDP legal services can help prevent inside managers from using corporate counsel to mislead the directors, who might face liability for breach of their fiduciary duty of care or candor due to the managers' misconduct. Second, because the bar refuses to require corporate lawyers to serve clients by making candid and complete disclosure to the board, the corporations can turn to an institutional source of legal services that will do so.

The non-contextual ideology of legal practice has been used to support a system of norms that rejects values like loyalty,
independence and the furtherance of justice.\textsuperscript{220} The recent developments in areas of law outside professional responsibility that are discussed above have had an expressive effect on the norms of corporate governance, and these new norms are beginning to change how corporate lawyers behave. Activist and independent boards expect different conduct from their counsel. MDP attorneys are well suited to serve the new values of the corporate community.

One key failure of the traditional professionalism paradigm was society's eventual recognition that it could not trust lawyers to place its interests above those of lawyers' clients, especially large corporations. This belief came about at least in part because of the conspicuous role of lawyers in the savings and loan debacle\textsuperscript{221} and the corporate takeover frenzy of the 1980s.\textsuperscript{222} Corporate governance also changed in response to these developments, and independent boards began to demand different legal services. Sophisticated corporate clients no longer suffered from the same asymmetries of legal information—lawyers no longer had special knowledge that their clients lacked.\textsuperscript{223}

In the developing new contextual paradigm corporate lawyers, whether they work for MDPs, law firms, or in house, may be growing more independent, because they serve an increasingly independent board rather than powerful inside managers. In helping the board mediate among corporate constituencies, lawyers might be able to engage in a deliberative process that bears some resemblance to Kronman's lawyer statesman.\textsuperscript{224} To the extent that there were once republican lawyers able to engage powerful corporate owner-entrepreneurs in a dialogue

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\textsuperscript{220} See Simon, supra note 19, at 3 (arguing that only law as an intellectual discipline clings to formalism and rejects complexity and factual particularity). Simon describes the bar's ethical ideology as "stunting" the moral quality of legal practice. \textit{Id.} at 25.
\textsuperscript{221} See Kostant, supra note 1 (manuscript at 715, on file with author).
\textsuperscript{222} See Millon, supra note 66, at 1375.
\textsuperscript{223} See Gilson, supra note 10, at 900-01; cf. Bates v. State Bar, 433 U.S. 350, 371-72 (1977) ("[T]he belief that lawyers are somehow 'above' trade has become an anachronism.").
\textsuperscript{224} See supra note 21 (discussing Kronman's lawyer-statesman ideal). By having real independent power as part of the joint venture model described above, corporate lawyers in MDPs could perhaps really remonstrate with powerful clients. Geoffrey Hazard has called Gordon's view of independent nineteenth-century lawyers a fantasy, see Hazard, supra note 21, at 1279, but perhaps it can become a reality in the twenty-first century.
\end{flushleft}
about corporate means and ends, that role was lost when lawyers began to serve inside managers as though they were the true clients. Respecting client autonomy became a euphemism for deferring to a powerful manager. Today, as increasingly independent directors actively mediate among constituencies in furtherance of the best interests of the entity, corporate governance is becoming a more deliberative governance process. As experts on disclosure and procedure, lawyers can play a meaningful role in governance. Doctrinally, corporate lawyers are co-agents with management, not sub-agents, and they therefore owe a fiduciary duty to the entity that is independent of management's duty. If corporate lawyers focus on meeting this fiduciary duty, independence and loyalty will take on a richer meaning.

C. THOUGHTS ON THE DYNAMICS OF CHANGE

The SEC should consider some of the dynamics of how favorable legal changes can be encouraged. The interests of three groups need to be analyzed in order to make an effective transition from the current system and accelerate beneficial change: the MDPs; the accounting profession, corporate directors, and lawyers in traditional firms; and government and professional regulators or adjudicators.

MDPs, first, are moving into an increasingly dominant position in the market for legal services. Their growing success will provide an incentive for these firms to make the emerging system work and use all of their knowledge and expertise, provided the SEC allows them to offer legal services to audit clients that waive confidentiality. At the same time, however, other groups involved with issues of corporate compliance must confront increasing disadvantages. Corporate

225. See Gordon, supra note 188, at 14-16.

226. The Supreme Court of Delaware recently described the purpose of the fiduciary duty of corporate directors as enabling them to act as a "compass" for the corporation. Malone v. Brincat, 722 A.2d 5, 10 n.12 (Del. 1998). Likewise, corporate counsel can be thought of as "gyroscopes" for the board and the corporation. Kostant, supra note 63, at 245 & n.265 (defining a gyroscope as a navigational device that keeps a vehicle on course, and drawing an analogy to corporate law practice, where lawyers can facilitate disclosure and effective dialogue). Perhaps together with independent accountants and directors, lawyers may serve in an effective multi-party gatekeeper regime.

227. In the words of Saul Levmore, MDPs might be called "the new winners" because they are benefiting from legal changes currently taking place, whereas accountants, directors and lawyers in traditional firms are "the new losers," because of their increasing exposure to liability. Levmore, supra note 12, at 1657-69.
directors face expanding liability exposure for breaches of their fiduciary duties of care and disclosure.228 Likewise, auditors were given greater responsibilities under Section 10A when Congress amended the securities laws in 1995.229 Finally, corporate law firms may have to deal with greater liability for non-disclosure of material information.230

Nevertheless, lawyers in traditional law firms, at least, might gain some incentives and benefits from the evolving system. First, many lawyers will become gainfully employed by MDPs. At the same time, lawyers in law firms will have a clear competitive advantage because they can provide litigation services that require strict confidentiality and the attorney-client privilege. Most importantly, at some level corporate attorneys are in the best position to have the contextual knowledge about what their corporate clients really want and need.231

228. Following Delaware's raising of the standard for the duty of disclosure, directors may benefit by having transactional lawyers working within MDPs as well as auditors assisting them with their heightened monitoring and disclosure duties. See supra notes 24, 94 (discussing Malone v. Brincat and Delaware's expansion of directors' fiduciary duties); see also supra note 166 (suggesting that the Malone duty to disclose material information approaches strict liability, but may be merely aspirational). By relying on a better monitoring apparatus, it is less likely that directors will ever be found to have personally breached their fiduciary duties. See supra notes 166, 181 (discussing the Caremark case, in which the directors were found to have exercised sufficient care but the corporation itself had to pay $250 million in criminal fines).

229. See supra Part II.C.2 (discussing the 1995 amendments to the securities laws). Congress was able to gain the support of the accounting profession by giving them incentives to accept their greater responsibilities. These included some protections from liability, including proportional liability, the end of joint and several liability, and no exposure to a private cause of action for violating Section 10A. Accountants could also use the clearer rule governing their investigating and reporting duties as leverage against powerful but uncooperative clients who could not easily discharge them. Finally, the broader scope of audits would yield larger fees for audit services.

230. See FDIC v. Clark, 978 F.2d 1541, 1549-51 (10th Cir. 1992) (finding a corporate law firm liable for not protecting corporate clients from the illegal acts of senior inside managers); FDIC v. O'Melveny & Meyers, 969 F.2d 744, 752 (9th Cir. 1992), rev'd on other grounds 512 U.S. 79 (1994) (finding that a corporate law firm owed a duty to its corporate client to ferret out the fraud of its corporate officers). In O'Melveny & Meyers part of the negligence was failure to insist upon obtaining arguably privileged and confidential information from the corporate client's prior law firm. See id. at 746-47. This duty is common for accounting firms, but traditionally did not apply to lawyers.

231. By increasing liability for nondisclosure of material information on those with the greatest skill and knowledge—corporate lawyers—enhanced compliance will be encouraged. This is a far cry from the vague and permissive Model Rule 1.13 which arguably rewards ignorance, gullibility and lack of
Once the self-serving normative structure of a unitary profession serving inside managers is stripped away, corporate lawyers will find ways to compete by offering independent boards and audit committees what they really want and need. An end to the "lemons market" problem\(^\text{232}\) will enable law firms to compete as reputational intermediaries.

The more broadly-based market currently emerging is allowing more varied bargaining among those providing and using the services now offered by MDPs. As more institutions compete to practice law, it has become harder for the bar, as a comparatively small interest group, to dominate the regulation of widely needed services. When bar associations and courts have exclusive power to make regulations, there is relatively little political accountability.\(^\text{233}\) In areas in which both lawyers and nonlawyers are permitted to provide services (i.e. tax, patent, lobbying, bill collecting), courts and bar associations have less authority, and standards may be higher.\(^\text{234}\) The same has been true in SEC practice, in which lawyers and nonlawyer accountants have largely been held to the same high ethical rules,\(^\text{235}\) and a high standard applies. As broader groups of participants recognize that a great deal is at stake, the best aspects of the democratic process can come into play, and narrow, inefficient opposition to constructive change may become less effective.\(^\text{236}\)

Perhaps the clearest example of one group of lawyers being held to consistently high ethical standards of candor in a non-litigation context is the patent bar, where both lawyers and nonlawyers can act as patent agents. This provides a fine illustration of how well a system like that evolving in the MDP context can work. In making a patent application, the client and the attorney each have an independent duty\(^\text{237}\) to report "all facts concerning possible fraud or inequitableness underlying the [patent] applications in issue."\(^\text{238}\) Courts have described the relationship between applicant and government examiner in diligence. See supra Part III.A (discussing and criticizing Rule 1.13).

\(^{232}\) See supra note 169 (explaining the lemons market problem).


\(^{234}\) See id. at 36.

\(^{235}\) See supra Part I.

\(^{236}\) See Levmore, supra note 12, at 1681-86.

\(^{237}\) See 37 C.F.R. § 1.56 (1999).

fiduciary duty terms because the relationship is a confidential one and not at "arms' length." Complete candor about anything material is therefore necessary. If such a duty applies in patent practice, how can any corporate lawyer have a less rigorous duty to make affirmative disclosures to corporate directors when both owe fiduciary duties to the corporation?

Finally, the SEC should also consider forces of change beyond recent economic developments and professional ethics. Norms of behavior among lawyers and corporate constituents are shifting as well. An example is the phenomenon of snowballing—once a critical mass of individuals disobeys a rule without penalty, their successful defiance changes the norm of behavior. This seems to explain the widespread breaching of Model Rule 5.4, which prohibits lawyers from practicing in professional associations controlled by nonlawyers. A possible reason this norm has been breached with such impunity is that it purports to support independence, whereas under the larger contemporary system of social meaning, which views attorneys as "servant[s] of business," lawyers are anything but independent.

D. TEMPERING THE OPTIMISM: SOME REASONS TO BE FEARFUL

Substantial dangers exist which could prevent market forces from eventually squeezing out lawyers who violate the principle of loyalty to all of the interests they represent in corporate practice.


240. Moreover, directors may be strictly liable for failure to disclose material information. See supra notes 24, 94 (discussing Malone v. Brincat).


242. See id.

243. See Model Rules of Professional Conduct Rule 5.4 cmt. (1983) (noting that the rule's limitation on sharing fees is "to protect the lawyer's professional independence of judgment"); Fox, supra note 5, at 20.

244. See Lawrence Lessig, Social Meaning and Social Norms, 144 U. Pa. L. Rev. 2181, 2182 (1996) (stressing the importance of placing norms in a specific context of social meaning).

245. See Hazard, supra note 21, at 1260-61 n.116.

246. With thanks to Ian Dury and the Blockheads, Reasons to be Cheerful (Part 3) (in memoriam, 1942-2000).
First, with respect to MDP independence, the SEC must recognize that MDPs may provide transactional legal services if corporate clients agree ex ante that all material information must be shared with the audit engagement partners. The problem of MDP independence is certainly a serious one, but MDPs are already closely tied to their corporate clients, and adding transactional legal services should not pose an increased threat. Instead, it will make auditors more aware of material information, and materiality and legality are legal judgments best made by lawyers with a duty to the MDP.

Second, MDPs must not be able to control law firms without the law firm being required to share material information with audit engagement partners. Ernst & Young’s recent acquisition of a law firm in Washington, D.C., the one United States jurisdiction with legal ethics rules allowing this, is very disturbing, despite the firm’s purporting to “keep a wall between the lawyers and Ernst & Young.” MDPs must also not be allowed to spin off consulting services into separate entities, especially if transactional legal service is part of consulting.

Third, if corporations employ different MDPs that provide transactional legal services and audits, the MDPs might not devise consistent disclosure protocols for material information that its lawyers may learn. To avoid this result, there must be a requirement for an agreement, ex ante, to supply all material information to the audit committee of the corporate client, regardless of which firm discovers it.

Finally, the courts must take action. Cases that weaken the ability of corporate attorneys to protect their clients, such as Balla v. Gambro, must not continue to spread. The ABA's self-serving recommendations for multidisciplinary practice

247. See Painter, supra note 81, at 1404-05 (criticizing the SEC for its focus on public perceptions rather than actual results).
248. Siobhan Roth, Inside the Ernst & Young Deal, LEGAL TIMES, Nov. 8, 1999, at 1. The recent scandal at PricewaterhouseCoopers, in which many members of the firm violated rules intended to prevent conflicts of interest, is cause for concern. See Floyd Norris, Accounting Firm Is Said To Violate Rules Routinely, N.Y. TIMES, Jan. 7, 2000, at C1.
249. See Painter, supra note 81, at 1402 (criticizing the “firewall” concept because of the loss of valuable intra-firm information).
250. See 584 N.E.2d 104, 107-08 (Ill. 1991) (denying legal protection to a lawyer who protected the corporate clients from the illegal activity of senior management).
must be rejected. Last but not least, attempts to de-emphasize contextual legal ethics by courts must not succeed.251

CONCLUSION

Despite many possible impediments to progress, there are reasons for optimism as MDPs step in to provide legal services for corporations. This Article has shown how the changing market can improve the effectiveness of legal services by allowing corporations to select the services they need.252 Although much traditional discourse about market-driven competition has emphasized a race to the bottom, recent developments among well-informed corporate clients could foster belief systems that enhance norms of cooperation, transparency and trust, especially if less information is hidden by ending the abuse of confidentiality. Corporate lawyers, as honest brokers and “gyroscopes,”253 may have an important role to play in this new system.

The implementation of a regime requiring that transactional lawyers share material information with the audit engagement partner of their MDP, and with the audit committee of their corporate client, would lead to better compliance with the laws and to more accurate financial disclosure to investors. Corporate lawyers would no longer be able to act as advocates for inside managers seeking to avoid compliance or full disclosure. Under this system, the norms of corporate legal practice will better conform with the evolving norms of corporate governance.

251. In part, courts can help to prevent this by following recent cases holding lawyers and accountants liable if they negligently fail to protect their clients from the illegal activities of insiders. See supra note 230 (discussing Clark and O'Melveny & Meyers).

252. MDP competition may bring numerous advantages to the market. Lawyers, with liability exposure for failure to detect some fraud, can use their skepticism to balance excessive client optimism. MDPs have a long history of compliance with the law and making full disclosure. Thus, the costs of establishing a new system are avoided. Accountants are also unable to abuse confidentiality and have a somewhat meaningful tradition of peer review. Finally, by employing MDPs, corporate clients are “opting up” and avoiding the current default rule of the organized bar. But see SIMON, supra note 19, at 206-10 (pointing to four problems with the current structure of the market for developing contextual legal services, including its overly optimistic psychology, the greater initial expense if lawyers act honestly, the difficulty of obtaining information and enforcing higher standards, and a low commitment to trustworthiness).

253. See supra note 226.