Lawyers' Rules, Auditors' Rules and the Psychology of Concealment

Richard W. Painter

Lawyers' Rules, Auditors' Rules and the Psychology of Concealment

Richard W. Painter†

Entrustment of secrets and deceit have interdependent roles in human relationships. A confidential relationship is based on trust, but can be used for a deceitful purpose: concealment of information that one of the parties has a duty to disclose to a third party or to the public. Because confidential relationships are sometimes used to deceive others, the ethics of secrecy often clash with the ethics of honesty.[1]

Exceptions to secrecy are particularly controversial when a professional is entrusted with the secrets of a client. The legal and the accounting profession have both struggled with this problem, and have settled on different answers. Lawyers' rules favor client secrecy (with a few exceptions), whereas auditors' rules favor measures designed to detect, to prevent, and if necessary, to disclose client concealment. In situations where a client is deceiving other persons—whether investors, lenders or regulators—lawyers and auditors may therefore respond differently.

This and other differences between the legal and auditing professions have led the Securities and Exchange Commission's (SEC) Office of the Chief Accountant (OCA) to take the position that lawyers and auditors practicing in the same firm cannot represent the same client at the same time.[2] Although the SEC

---

† Professor of Law, University of Illinois College of Law. I thank Peter Kostant, John Leubsdorf and Don Langevoort for helpful comments on prior drafts of this Article, and Jeff Rachlinski for helpful discussions on the relevance of prospect theory to legal ethics.

1. *See* SISSELA BOK, SECRETS: ON THE ETHICS OF CONCEALMENT AND REVELATION 116-35 (1982) (discussing the justifications and limits of confidentiality and asserting that values protected by confidentiality are sometimes undermined by practices of secrecy); STANLEY CAVELL, THE CLAIM OF REASON 330 (1979) ("A private conversation is one that I do not want others to hear, not one they necessarily cannot hear.").

2. "OCA would consider a firm's independence from an SEC registrant to be impaired if that firm also provides legal advice to the registrant or its affili-

has said that it will look to the accounting industry's Independence Standards Board (ISB) for leadership on this issue[3] the SEC has made it clear that "the attorney-client relationship is inconsistent with the independence required of accountants in reporting to investors."[4] The SEC apparently fears that lawyers' rules will spill over into the auditing side of multidisciplinary firms and undermine the independence of auditors when they decide what information has to be disclosed.[5]

---

ates." Letter from Lynn E. Turner, Chief Accountant of the Securities and Exchange Commission, to Sherwin P. Simmons, Chair of the American Bar Association Commission on Multidisciplinary Practice (Jan. 22, 1999), *available at* <http://www.abanet.org/cpr/turner.html> (citing Rule 2-01(c) of Regulation S-X, 17 C.F.R. § 210.2-01(c), which 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"); *see also* SEC, CODIFICATION OF FINANCIAL REPORTING POLICIES §§ 602.02.e.i, 602.02.e.ii. (stating that one of the relationships that must be considered in making independence determinations is the relationship created by rendering legal services); Samuel George Greenspan, Securities Act of 1933 Release No. 6097, 49 S.E.C. Docket 1086, 1099 (Aug. 26, 1991) (finding that an auditing firm's independence from a registered company is impaired if that firm also provides legal advice to the registrant); Samuel George Greenspan, Litig. Release No. 12862, 48 S.E.C. Docket 1690, 1691 (May 23, 1991).

3. *See* Letter from Lynn E. Turner, *supra* note 2. She wrote:

> [T]he Commission recently recognized the establishment of the Independence Standards Board ("ISB") and indicated that, consistent with its continuing policy of looking to the private sector for leadership in establishing and improving accounting principles and auditing standards, the Commission intends to look to the ISB for leadership in establishing and improving auditor independence regulations applicable to the audits of the financial statements of Commission registrants. In a letter dated January 7, 1999, I asked the ISB to consider placing the topic of legal advisory services on its agenda and suggested that the ISB consult with your Commission.

Id. (citations omitted).

4. Letter from Harvey J. Goldschmid, SEC General Counsel, Lynn E. Turner, SEC Chief Accountant, and Richard H. Walker, SEC Director of Enforcement, to Philip S. Anderson, President of the American Bar Association (July 12, 1999), *available at* <http://www.abanet.org/cpr/goldschmid.html> ("[W]hile the SEC has taken no position on multidisciplinary practice *per se*, the SEC has long made clear that its independence rules prohibit an auditor from certifying the financial statements of a client with which his firm also has an attorney-client relationship." (citing Charles E. Falk, Accounting and Auditing Enforcement Act Release No. 34-41424, 69 S.E.C. Docket 1916 (May 19, 1999) (disciplining an attorney-accountant who gave legal advice to an audit client of another partner in his accounting firm))).

5. The SEC's position, however, appears to be driven in part by public perception of what would happen in a multidisciplinary firm, rather than what

This concern also provides additional ammunition to opponents of multidisciplinary practice who argue that lawyers and nonlawyer professionals of any kind (not just auditors) should not practice together, even if they do not represent the same client simultaneously.[6] While the SEC seeks to protect the independence of auditors, opponents of multidisciplinary practice fear the legal profession's loss of independence in a world where "auditing masters" will dictate the rules lawyers play by.[7] As Professor Robert Gordon has told the ABA Multidisciplinary Practice Commission (the Commission), these arguments are part of a historical pattern in which the bar invokes "ethical standards" and the "independent judgment of the legal profession" to justify rules protecting lawyers from competition.[8] The

---

actually will happen. *See id.* Goldschmid wrote:

> "The SEC requires the filing of audited financial statements in order to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the nation's industries. It is therefore not enough that financial statements be accurate; the public must also perceive them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional. . . . If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost."

Id. (quoting United States v. Arthur Young & Co., 465 U.S. 805, 819 n.15 (1984)). The public's perception of what could happen in a multidisciplinary firm—and in particular the belief that auditors will not disclose what they are required to disclose—could in turn be driven by the ABA's refusal to adopt a clear crime/fraud exception to the lawyer's duty to keep confidences. *See infra* notes 25-45 and accompanying text.

6. *See, e.g.*, Hearings Before the Commission on Multidisciplinary Practice (Feb. 4, 1999) (written remarks of Lawrence J. Fox, Drinker Biddle & Reath LLP), *available at* <http://www.abanet.org/cpr/fox1.html> [hereinafter Fox Remarks]. Fox and several other witnesses testified in favor of retaining ethics rules that currently prohibit lawyers from practicing in partnerships that include nonlawyers. *See, e.g.*, MODEL RULES OF PROFESSIONAL CONDUCT Rule 5.4(b) (1983) ("A lawyer shall not form a partnership with a nonlawyer if any of the activities of the partnership consist of the practice of law.").

7. Fox Remarks, *supra* note 6.

8. Letter from Robert W. Gordon to Sherwin P. Simmons, Chair, American Bar Association Commission on Multidisciplinary Practice (May 21, 1999), *available at* <http://www.abanet.org/cpr/gordon.html>. As Professor Gordon observes:

> Historically, the sad if hardly surprising fact has been that the organized bar's resistance to new modes of practice, though often clothed in the high-minded rhetoric of protecting the ethical standards and independent judgment of the legal profession, has been to a considerable extent motivated by far less elevated desires to protect the incomes of lawyers from economic competition or their status from erosion by groups perceived as interlopers. Given this history of pro-

venomousness of objections to multidisciplinary practice that have been raised before the Commission demonstrates that this historical pattern is bound to continue. When the Commission's Report reaches the ABA's House of Delegates, the legal and auditing professions' differing approaches to secrecy and concealment thus could become yet one more rationale[9] for excluding the legal profession's most feared competitors, the Big 5 accounting firms, from multidisciplinary practice.

It does not have to be this way. Lawyers and auditors could practice together in the same firm without representing the same client simultaneously. Lawyers and auditors in the same firm could also avoid sharing information about a client across disciplinary boundaries. Each of these two approaches would allow lawyers and auditors to practice together, but at a cost. The first approach sacrifices economies of scale by prohibiting one-stop shopping for legal and auditing services. The second approach (sometimes referred to as constructing a "firewall") will still be opposed by the SEC because it does nothing to assure auditors' independence and because it allows information to be concealed if kept within the legal side of a firm. The "firewall" approach also chokes off intra-firm exchange of valuable information about a client, in essence making both the legal and auditing services less valuable.

There is, however, a third possibility. Clients who choose to be represented by multidisciplinary firms could waive the secrecy rules of the legal profession, allowing their lawyers to work within the disclosure regime of auditors.[10] Indeed, auditors' rules for responding to fraud and other illegal acts may be superior to lawyers' rules, not only from the vantage point of society, but from the vantage point of the client. A client that wants a good relationship with investors, regulators and lend-

---

> tectionist and factional motives, it is reasonable—without for a moment questioning the sincerity and good faith of the critics of multidisciplinary practice—to treat resistance to organizational innovation with some skepticism and to ask whether support for such resistance is more likely to stem from concern for the incomes rather than the independence of lawyers.

Id.

9. The other often mentioned "ethical" argument against multidisciplinary practice is the two professions' differing rules governing conflicts of interest.

10. *But see* Fox Remarks, *supra* note 6. Fox criticized accounting firms for suggesting that lawyers could share confidential information with auditors after obtaining a client waiver of confidentiality. *See id.; see also infra* text accompanying note 123-24 (quoting, in part, Fox's remarks).

ers may decide ex ante that secrets should not be kept by lawyers whom it hires to work on public offerings, mergers and similar transactions.[11] The client might prefer rules that bind these lawyers to disclose crime or fraud to regulators or affected third parties[12] or to its own board of directors,[13] and by similar reasoning, the client might prefer that at least some of its lawyers be required to share information with its auditors.[14] Disclosure by lawyers to auditors would in turn subject the information to auditors' disclosure rules with respect to the outside world.[15] Disclosure to auditors would also discourage an organizational client's officers and other agents from using lawyer secrecy to conceal their own misdeeds from shareholders, and even from the client's own directors,[16] at the client's expense.

Furthermore, auditors' rules may protect the client more effectively than lawyers' rules from risk preferring decisions on a variety of levels, whether by lawyers and auditors themselves or by the client's officers and employees. Psychological re-

---

11. *See generally* Richard W. Painter, *Toward a Market for Lawyer Disclosure Services: In Search of Optimal Whistleblowing Rules*, 63 GEO. WASH. L. REV. 221 (1995) (proposing a voluntary regime in which lawyers can decide ex ante whether they will disclose client crime or fraud, and suggesting that clients can then hire lawyers who have chosen the rules they prefer while investors, regulators and other third parties can in turn adjust their dealings with both the clients and lawyers accordingly).

12. *See generally id.*

13. *See* Richard W. Painter & Jennifer E. Duggan, *Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation*, 50 SMU L. REV. 225, 244-55 (1996) (proposing that SEC registrants specify in their articles or bylaws the body to whom lawyers should report prospective crime or fraud, with the default rule being that lawyers should refer the matter to a higher authority within the registrant up to its board of directors).

14. *See generally* Peter C. Kostant, *Breeding Better Watchdogs: Multidisciplinary Partnerships in Corporate Legal Practice*, 84 MINN. L. REV. 1213 (2000) (proposing that lawyers and auditors within the same firm be allowed to represent the same client simultaneously, provided the lawyers agree to share information with the accountants, who in turn would share information with the client's audit committee).

15. Nowhere do the disclosure rules binding auditors, *see infra* text accompanying notes 54-63, provide for an exception because the auditors learned the relevant information from lawyers.

16. The ABA has so far declined to require that an organizational client's lawyers report prospective illegal acts to the client's board of directors. *See infra* text accompanying notes 31, 41 (discussing the ABA's interpretation of Model Rule 1.13 and the Commission's rejection of proposed amendments to Model Rule 1.13); Kostant, *supra* note 14, at 1232-33 (discussing Model Rule 1.13).

search in prospect theory[17] suggests that concealment of information could be related to individuals' biased assessments of the legal and business risks of concealment. Knowing this, clients might want to protect themselves by hiring professionals who are bound by rules that constrain decisional choices in situations where the client and its professionals are most likely to engage in risk preferring behavior. If so, auditors' rules for disclosure of client fraud and illegal acts may be superior to lawyers' rules.

Part I of this Article briefly discusses the rules that govern the legal profession in a client crime or fraud situation, as well as recent proposals to change these rules.[18] Part II briefly discusses the rules of the auditing profession, which have been codified in the 1995 Private Securities Litigation Reform Act.[19] Because this author has already written on the economic advantages of ex ante waiver of lawyer secrecy by corporate clients within a rational actor framework,[20] Part III moves on to prospect theory's elucidation of the psychological side of concealment.[21] Part IV discusses how professionals and organizational clients can respond to the psychology of concealment, and why auditors' rules may be superior to lawyers' rules in a client crime or fraud situation. Part V discusses ways in which multidisciplinary practice firms could also respond to the psychology of concealment by obtaining ex ante client waiver of lawyers' secrecy rules. Part V then compares the recommendations of the Commission and the position of the SEC with the alternative response of client waiver, which has already been criticized by opponents of multidisciplinary prac-

---

17. See, for example, Amos Tversky & Daniel Kahneman, *Advances in Prospect Theory: Cumulative Representation of Uncertainty*, 5 J. RISK & UNCERTAINTY 297 (1992) and other texts discussed *infra* text accompanying notes 67-79.

18. The philosophical underpinnings of the different rules that shape lawyers' and auditors' responses to client crime or fraud, as well as the professional conduct codes and case law in which those rules have evolved, are discussed more extensively in Kostant, *supra* note 14. *See also* Painter & Duggan, *supra* note 13, at 234-44 (comparing vague whistleblowing rules for lawyers with the clearer and more disclosure-oriented rules for auditors).

19. H.R. 1058, 104th Cong. (1995), *codified at* 15 U.S.C. § 78a (1996).

20. *See generally*, Painter, *supra* note 11.

21. *See generally* Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998) (arguing that human behavior is not determined solely by rational self-interest); Christine Jolls et al., *Theories and Tropes: A Reply to Posner and Kelman*, 50 STAN. L. REV. 1593, 1599 (1998) (same) [hereinafter Jolls et al., *Theories and Tropes*].

tice in testimony before the Commission. The most salient criticism of the waiver solution is that it is inconsistent with the values of the legal profession.[22] Another criticism of any arrangement in which lawyers and auditors in the same firm represent the same client is that the auditors' independence could be sacrificed by the firm's receipt of compensation for legal services. This Article concludes, however, that ex ante waiver of confidentiality by a sophisticated client actually strengthens the values of the legal profession by alleviating tension between professional responsibility rules prohibiting disclosure of client confidences[23] and other rules prohibiting lawyer assistance of client crime or fraud.[24] This Article also concludes that, assuming waiver is obtained, incentives within a multidisciplinary firm to disclose information about a client's crime or fraud should more than offset compensation related incentives not to disclose.

I. LAWYERS' RULES

Courts, bar associations and federal regulators disagree strongly over what a lawyer should do when an organizational client is about to commit, or is already committing,[25] a crime or fraud.[26] Differing language in the ABA Model Rules of Professional Conduct and the earlier ABA Model Code of Professional Responsibility reflect this uncertainty,[27] as do the various rules

22. *See, e.g.*, Fox Remarks, *supra* note 6.

23. *See, e.g.*, MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 (1983).

24. *See, e.g.*, MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2(d) (1983).

25. Ethics rules ordinarily distinguish between the situation where a client has already committed a crime or fraud (in which case disclosure is generally prohibited) and the situation where a client is going to commit a future crime or fraud (in which case jurisdictions differ with respect to whether disclosure is prohibited, permitted or required). This distinction is not so important for the problem addressed in this Article—financial fraud by a reporting company—because failure to disclose a material illegal act that has already occurred is usually itself a violation of the securities laws.

26. *See* Susan P. Koniak, *When Courts Refuse to Frame the Law and Others Frame It to Their Will.*, 66 S. CAL. L. REV. 1075, 1100 (1993).

27. *Compare* MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 4-101(C) (1980) (providing that "[a] lawyer may reveal: . . . (3) the intention of his client to commit a crime and the information necessary to prevent the crime"), *with* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 (1983) (providing that disclosure of confidential client information is permitted only to prevent the commission of a crime likely to result in death or substantial bodily harm).

that have been adopted by the states.[28]

While the ABA's Model Rules prohibit lawyer participation in client crime or fraud,[29] they set forth vague standards on what a lawyer should do affirmatively when confronted with crime or fraud, particularly within an organizational client. The lawyer must act in the "best interests of the organizational client,"[30] but the ABA has consistently refused to affirm that a lawyer for an organization must report illegal acts by the organization's agents to the board of directors or other highest authority in the organization.[31]

Federal administrative agencies, such as the Office of Thrift Supervision (OTS) and the SEC, have sought to impose rules on lawyers that "practice before"[32] the agency (a term that is often loosely construed to apply to any lawyer advising a cli-

---

28. Most states have not adopted the highly restrictive Model Rule 1.6.

29. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2(d) (1983). The rule states:

> A lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law.

Id.

30. *See, e.g.*, MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13(b) (1983). The rule states in part:

> [The lawyer] shall proceed as is reasonably necessary in the best interest of the organization. In determining how to proceed, the lawyer shall give due consideration to the seriousness of the violation and its consequences, the scope and nature of the lawyer's representation, the responsibility in the organization and the apparent motivation of the person involved, the policies of the organization concerning such matters and any other relevant considerations.

Id. Model Rule 1.13 states further that "referring the matter to higher authority in the organization" is one of several measures that a lawyer may take when a fraud or illegal act has been committed by an agent of a client, but the rule does not require such a report and the ABA has been very critical of any attempt by regulators to infer such an obligation. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13(b)(3) (1983).

31. *See* AMERICAN BAR ASS'N, WORKING GROUP ON LAWYERS' REPRESENTATION OF REGULATED CLIENTS REPORT TO THE HOUSE OF DELEGATES 6-7 (1993) (complaining that, among the Office of Thrift Supervision's "novel theories of professional responsibility" in its charges against Kaye, Scholer, was the notion that a lawyer has an obligation to report misconduct to superiors, going "all the way to the client's board of directors") [hereinafter REGULATED CLIENTS REPORT].

32. *See, e.g.*, 17 C.F.R. § 201.102(e) (1999) (providing that the SEC may temporarily or permanently deny to any person the privilege of practicing before the Commission after notice and hearing).

ent on regulatory issues). Agency rules, however, provoke opposition from the bar,[33] particularly when they are construed broadly against lawyers.[34] As a result, agencies sometimes lack the political will to consistently enforce these rules. The OTS, for example, proposed in the early 1990s to standardize, in a "revised attorney letter," the representations made to it by attorneys on behalf of their clients,[35] but the OTS letter was subsequently rescinded.[36]

The ABA has urged attorneys to comply with voluntary standards for lawyer opinion writing,[37] and these standards

33. *See* REGULATED CLIENTS REPORT, *supra* note 31, at 2 (complaining about various "novel theories of professional responsibility" articulated by the Office of Thrift Supervision in the Kaye, Scholer matter); *ABA Report to the House of Delegates, Section on Corporation, Banking and Business Law Recommendation*, 31 BUS. LAW. 544, 545 (1975) (deriding "efforts by the government to impose responsibility upon lawyers to assure the quality of their clients' compliance with the law . . .").

34. *See* Painter & Duggan, *supra* note 13, at 244-55 (discussing how the SEC, in construing the terms "improper professional conduct" in Rule 102(e), has articulated ambiguous standards for both lawyers and accountants, and how these standards have been arbitrarily applied in Rule 102(e) case law).

35. From July 1994 to August 1995, the OTS required a depository institution to send to its attorney a "revised attorney letter" asking the lawyer to confirm that the attorney would respond in accordance with applicable rules of professional conduct to any issue that might arise in connection with conflicts of interest, the institution's compliance with laws or regulations, and fiduciary duties or principles of safety and soundness. The attorney was not legally required to agree to the letter's terms, but the letter specifically provided that if the attorney did not provide the requested confirmations, the examiner would take this failure into account in its evaluation of the institution. *See* Carolyn B. Lieberman et al., *Professional Conduct in Representing a Regulated Industry: The OTS Experience*, 35 S. TEX. L. REV. 607, 632-34 (1994); Revised Attorney Letter, OTS Transmittal No. 113, at 3 (June 24, 1994), *reprinted in* ABA Ad Hoc Committee on OTS Attorney Inquiry Letters, *Guidance for Lawyers Responding to the OTS Revised Attorney Letter*, 50 BUS. LAW. 607, 629 (1995).

36. The OTS Revised Attorney Letter was withdrawn after "three years of wrangling with the bar about requiring attorneys to 'confirm' their agreement with certain OTS views of professional responsibility," and after the OTS decided it was cheaper and easier to obtain the required information directly from the depository institutions. *OTS Cancels "Attorney Letter" Citing Examiners' Lack of Need*, 4 BANK LAW. LIABILITY (LRP Publications) Oct. 1995.

37. *See* ABA Committee on Legal Opinions, *Third-Party Legal Opinion Report, Including the Legal Opinion Accord, of the Section of Business Law, American Bar Association*, 47 BUS. LAW. 167, 169, 176 (1991) [hereinafter *ABA Opinion Report and Accord*] (sometimes referred to as the "Silverado Accord"). By contrast with the approach of the OTS Revised Attorney Letter, the ABA used voluntary mechanisms when it sought to standardize opinion language and procedures. While a legal opinion does not have to conform to the guidelines set forth in the Silverado Accord, the Accord defines preferred opinion writing practice, and an opinion letter may incorporate provisions of

help prevent opinions from being misused (for example, when a literally accurate opinion is rendered on the basis of dubious factual assumptions or is used by the client to further an illegal or fraudulent objective). The ABA, however, also looks with disfavor upon opinions containing "negative assurances" about a client's overall conduct (for example, it is generally considered inappropriate to request an opinion from a lawyer stating that his client is in compliance with all applicable laws).[38]

This author has suggested to the ABA's Ethics 2000 Commission, a committee charged with proposing revisions to the Model Rules, a compromise approach of imposing default rules on lawyers instead of the immutable rules that regulators have sought to impose. For example, the Model Rules could require that a corporation's lawyer report fraud and other illegal acts to the corporation's full board of directors or to any alternative body designated to receive such reports under the client's charter or articles of organization.[39] Clients thus could opt out of the default rule requiring that the report be made to the board of directors by inserting in their articles of organization a provision requiring reports of illegal acts to be made to a specific committee of the board (for example a compliance committee) or to a particular officer.[40] The ABA Ethics 2000 Commission, however, appears to have rejected this proposal in favor of the ambiguity of the status quo.[41]

Lawyer whistleblowing to authorities outside a client's organizational structure is even more controversial. Model Rule 1.6 forbids disclosure, unless life or serious bodily injury are at risk, or unless the client is in a dispute with the lawyer (for example, in a malpractice suit or a dispute over the lawyer's

---

the Accord by reference. *See id.* at 170.

38. *See id.* at 228.

39. *See* Richard W. Painter, Proposal to the ABA Ethics 2000 Commission for the Amendment of Model Rule 1.13 (May 1998) (on file with author) n(urging that Model Rule 1.13 require a lawyer to report prospective illegal acts to the client's full board of directors unless an alternative body to receive such a report is specified in the client's articles of organization).

40. Corporations could contract out of the default rule by specifying ex ante (before the illegal conduct occurs) in their articles of incorporation the person or committee to whom such disclosure by the lawyer should be made instead of to the full board. *See id.*

41. The Ethics 2000 Commission has not recommended any revisions to Model Rule 1.13. *See* Ethics 2000 Commission, *Model Rule 1.13—Reporter's Explanation of Changes* (Feb. 21, 2000), *available at* <http://www.abanet.org/cpr/rule113memo.html> (explaining that the Commission is not recommending any substantive changes to the rule or its comments).

fee).[42] Model Rule 1.6 is unclear about whether a client can, by prior agreement with its lawyer, prospectively waive confidentiality in the crime or fraud context, so the lawyer may later disclose if the need should arise. The rule preferred in most states, however, is the earlier Model Code rule which permits, but does not require, a lawyer to disclose client fraud.[43] A lawyer practicing in this optional disclosure regime could theoretically announce ex ante that the lawyer intends to disclose information outside the client's organization if necessary to prevent a prospective or ongoing crime or fraud.[44] This policy could then be communicated not only to the lawyer's client, but to third parties, who—if they trust the lawyer to disclose—might look more favorably on both the lawyer and the client as a result.[45] So far, however, few if any lawyers have tried this approach and the ABA appears to be in no hurry to encourage them to do so.

A lawyer, however, may with a client's consent disclose material facts about the client's conduct to assist with an external evaluation of the client,[46] such as when auditors request

---

42. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 (1983).

43. *See* MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 4-101(C) (1980). Only two states, New Jersey and Florida, require disclosure of all or most client crimes. *See* N.J. RULES OF PROFESSIONAL CONDUCT Rule 1.6(b)(1) (1994) (requiring a lawyer to disclose information necessary to prevent a client "from committing a criminal, illegal or fraudulent act that the lawyer reasonably believes is likely to result in death or substantial bodily harm or substantial injury to the financial interest or property of another"); FLA. RULES OF PROFESSIONAL CONDUCT Rule 4-1.6(b)(1)-(2) (2000) (requiring a lawyer to disclose client intent to commit a crime). Some other states, such as Illinois, require disclosure to prevent death or serious bodily harm. *See* ILL. RULES OF PROFESSIONAL CONDUCT Rule 1.6(b) (1999) ("A lawyer shall reveal information about a client to the extent it appears necessary to prevent the client from committing an act that would result in death or serious bodily harm."). *But see* Balla v. Gambro, Inc., 584 N.E.2d 104, 111, 113 (Ill. 1991) (holding that corporation could, under the employment-at-will doctrine, fire its general counsel for telling its President that he would "do whatever was necessary to stop the sale" of dialyzers that were dangerous and did not comply with FDA regulations).

44. *See* Painter, *supra* note 11, at 267-74.

45. *See id.* (suggesting that the chosen rule would signal to third parties—such as regulators, transaction participants and investors—the probability that lawyers will blow the whistle should client misconduct occur; that rational third parties would adjust their expectations accordingly and sometimes reward clients whose lawyers have chosen expansive whistleblowing rules; and that rational clients would choose their lawyers in anticipation of third-party responses).

46. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 2.3 (1983) (stating that a lawyer may, with a client's consent, "undertake an evaluation of a

information, usually in the form of a letter.[47] The lawyer can refuse to provide the information, and must refuse if the client so requests,[48] but this would likely lead the auditors to resign. The lawyer, furthermore, probably must also resign if the client refuses to abide by the lawyer's advice to disclose.[49] This audit letter procedure, however, can be awkward and time consuming, delaying disclosure of important information. Furthermore, because lawyers who do not share financial gains and losses with auditors are probably unaffected by auditors' liability exposure under Section 11 of the 1933 Act[50] and other provisions of the securities laws, they may not worry so much about the consequences of a client concealing information from its auditors.[51] Unscrupulous lawyers may even collude with clients to keep information from their auditors.

---

matter affecting a client for the use of someone other than the client"); *id.* cmt. 1 (stating that the "evaluation may be performed at the client's direction but for the primary purpose of establishing information for the benefit of third parties"). *But see id.* cmt. 3 (stating that, when the lawyer is retained by the person whose affairs are being examined, "the general rules concerning loyalty to client and preservation of confidences apply").

47. *See* American Inst. of Certified Public Accountants, Statement on Auditing Standards Number Twelve §§ 337.01, 337.08 (1976) (stating that "the letter [of audit inquiry] to the client's lawyer is the auditor's primary means of obtaining corroboration of the information furnished by management concerning litigation, claims and assessments"); *id.* § 337.05 (naming items that should be included in the letter, including a list prepared by the client's management or lawyer that "describes and evaluates pending or threatened litigation," and another list that evaluates unasserted claims).

48. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 2.3 (1983) (requiring client consent). One concern that clients might have is that lawyer responses to audit letters can "strip" a client of the protection of the attorney-client privilege and work product doctrine. *See generally* American Bar Ass'n, *Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information*, 31 BUS. LAW. 1709 (1976); James J. Fuld, *Lawyers' Responses to Auditors—Some Practical Aspects*, 44 BUS. LAW. 159 (1988); Arthur B. Hooker, *Lawyers' Responses to Audit Inquiries and the Attorney-Client Privilege*, 35 BUS. LAW. 1021 (1980).

49. *See* American Bar Ass'n, *supra* note 48, at 1725 (stating that the lawyer should withdraw from representing the client in the event that the client rejects the lawyer's advice to disclose).

50. 15 U.S.C. § 77k(a) (Supp. IV 1998) (listing accountants, but not lawyers, among the persons who can be held liable for material misstatements or omissions in a registration statement).

51. Although auditors might plead ignorance, Section 11 requires the auditor to show "reasonable investigation." *Id.* § 77k(b)(3)(B).

II. AUDITORS' RULES

The confidentiality obligations of accountants are in many respects similar to those of lawyers. Accountants, including accountants acting as auditors, must keep the confidences of their clients.[52] Although courts have generally not recognized an accountant-client privilege, a privilege has in some instances been created by statute.[53] When, however, accountants perform the auditing function, their obligation to disclose illegal acts of their clients, including violations of securities disclosure laws, is clear.

Section 10A of the 1934 Securities Exchange Act,[54] as added by Section 301 of the Private Securities Litigation Reform Act of 1995,[55] specifies procedures that auditors must follow to detect and disclose fraud and other illegal acts (including violations of the securities laws) by a registered company. Each audit must include procedures designed to discover illegal acts that would have a material effect on financial statements and to identify related party transactions:

> Each audit required pursuant to this title of the financial statements of an issuer . . . shall include . . . procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts . . . [and] procedures designed to identify related party transactions that are material to the financial statements . . . .[56]

Furthermore, once an auditor "detects or otherwise becomes aware of information indicating that an illegal act . . . has or may have occurred," the auditor is required to determine "whether it is likely that an illegal act has occurred."[57] If so,

52. American Inst. of Certified Public Accountants & Nat'l Ass'n of State Bds. of Accountancy, *Uniform Accountancy Act and Uniform Accountancy Rules* (visited Mar. 17, 2000) <http://ftp.aicpa.org/public/download/states/naa/final11.doc>. A Certified Public Accountant (CPA) "shall not voluntarily disclose information communicated to [the CPA] by the client relating to and in connection with services rendered to the client." *Id.* "A member in public practice shall not disclose any confidential client information without the specific consent of the client." American Inst. of Certified Public Accountants, *AICPA Code of Professional Conduct ET Section 301* (visited Mar. 17, 2000) <http://www.aicpa.org>.

53. *See, e.g.*, I.R.C. § 7525, (added by Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3411, 112 Stat. 206, 750).

54. 15 U.S.C. § 78j-1 (Supp. IV 1998).

55. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 301, 109 Stat. 737, 762 (1995).

56. *Id.*

57. *Id.* § 301, 109 Stat. at 763.

the auditor is also required to determine the effect of the illegal act on the corporation's financial statements, as well as to report this information to the appropriate level of management unless the illegal act is clearly inconsequential.[58] If management does not remedy the problem, the auditor must then report the information to the company's full board of directors, and the directors must report the information to the SEC within one day. If the board of directors does not so report to the SEC, the auditor must make the report.[59]

Section 10A(d) provides that the SEC may sanction an auditor for violating these provisions by imposing a cease and desist order under Section 21C of the 1934 Act or by imposing "a civil penalty against the independent public accountant and any other person that the Commission finds was a cause of such violation" under the standards in Section 21B.[60] Although the Act specifically provides that there shall be no private right of action for violating Section 10A,[61] compliance with Section 10A could be very relevant to an auditor's defense in suits brought under existing causes of action in the securities laws. Despite the threat of sanctions and possibly even enhanced exposure to civil liability for violations of Section 10A, the auditing profession supported its enactment,[62] in part because Sec-

---

58. *See id.*

59. *See id.* As The Joint Explanatory Statement of the Committee of Conference for the 1995 Reform Act explains:

> This [Conference Report] provision requires independent public accountants to adopt certain procedures in connection with their audits and to inform the SEC of illegal acts of their auditing clients. These requirements should be carried out in accordance with generally accepted auditing standards for audits of SEC registrants—as modified from time to time by the Commission—on the detection of illegal acts, related party transactions and relationships, and evaluation of an issuer's ability to continue as a going concern.

S. REP. NO. 104-98, at 23, *reprinted in* 1995 U.S.C.C.A.N. 679, 702.

60. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, § 301, 109 Stat. 737, 764 (1995).

61. "Nothing in this Act . . . shall be deemed to create or ratify any private right of action." *Id.*

62. The AICPA said that the measure "should bolster public confidence in the nation's financial reporting system by requiring auditors to provide earlier public notification of possible misconduct." *Amended Fraud Detection Bill Approved by House Subcommittee*, 25 Sec. Reg. & L. Rep. (BNA) 400 (Mar. 19, 1993). Representative Edward Markey (D-Mass) commented that the bill also enjoyed the support of the Big Six accounting firms. *Kerry Introduces Financial Fraud Bill with Safe Harbor for Whistleblowers*, 25 Sec. Reg. & L. Rep. (BNA) 500 (Apr. 2, 1993). It should be noted that an important quid pro quo for auditors in the 1995 Reform Act was the proportionate liability provision in

tion 10A corresponded closely with the profession's existing rules for reporting illegal acts and fraud.[63]

III. PROSPECT THEORY AND THE PSYCHOLOGY OF CONCEALMENT

Psychological research identifies cognitive biases that cause decision-makers to make choices differently, and not always "rationally." Psychologists thus recognize that the same prototype—whether Holmes's "bad man"[64] or Posner's "rational actor"[65]—may not define the typical human response to every given situation.[66] Different characteristics of the human psyche (greed, fear, jealousy, guilt, and self-esteem to name a few) shape human decision-making at different times and in different situations. When these characteristics create cognitive biases that are widespread and predictable, psychology offers a powerful tool to predict how human beings, including lawyers and their clients, will respond to given situations and how laws, including rules of professional conduct, can alter these responses.

Prospect theory posits that decision-makers are risk averse when deciding between two decisions that result in a gain, but

---

section 201 of the Act. This provision eliminated joint and several liability in securities fraud litigation except for defendants who engage in knowing fraud.

63. *See* AICPA CODE OF PROFESSIONAL CONDUCT Rule 301 (Interpretation) (American Inst. of Cert. Pub. Accountants 1995). It states:

> The prohibition against disclosure of confidential information obtained in the course of a professional engagement does not apply to disclosure of such information when required to properly discharge the member's responsibility according to the profession's standards. The prohibition would not apply, for example, to disclosure, as required by Section 561 of the Statement on Auditing Standards No. 1 [AU section 561], of subsequent discovery of facts existing at the date of the auditor's report which would have affected the auditor's report had he been aware of such facts.

Id.

64. *See* Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 459 (1897).

65. *See* Richard A. Posner, *Rational Choice, Behavioral Economics, and the Law*, 50 STAN. L. REV. 1551, 1556-57 (1998) (assuming irrational smokers respond randomly to an increase in the tax on cigarettes, "[i]f the distribution of these random behaviors has the same mean as the rational smokers' reaction to the tax, the effect of the tax on the quantity demanded of cigarettes will be identical to what it would be if all cigarette consumers were rational").

66. *See* Jolls et al., *Theories and Tropes*, *supra* note 21, at 1599 (1998) ("[Judge Posner's argument] is a common response to behavioral economics, and conceivably it could be true; but there is absolutely no reason to think it is, and (as is usually the case) none is offered by the source of the criticism.").

risk preferring when deciding between two decisions that result in a loss.[67] A person confronted with a choice between (a) receiving $10 and (b) a 1 in 2 chance of receiving $20 is thus more likely to take the $10, whereas someone choosing between (a) a sure $10 loss and (b) a 1 in 2 chance of suffering a $20 loss is more likely to take his chances. Numerous psychological studies have confirmed this bias, showing that the nature of a decision, or the "frame" that casts it as a choice between gains or a choice between losses, is a critical determinant of decisional outcomes.[68] Expertise in the subject matter of a decision does not mitigate this framing effect,[69] and this bias influences judgments (or evaluations) as well as decisions.[70]

Prospect theory has been used by Professor Rachlinski to develop a framing theory of litigation[71] positing that plaintiffs are risk averse when weighing settlement offers against taking their chances in litigation for even larger potential gains, whereas defendants are risk preferring when weighing the certain costs of a settlement offer against taking their chances in litigation that could result in even larger potential losses.[72]

---

67. *See* Daniel Kahneman & Amos Tversky, *Choices, Values and Frames*, 39 AM. PSYCHOLOGIST 341, 342-44 (1984); Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263, 263 (1979); Tversky & Kahneman, *supra* note 17, at 297; *see also* John C. Hershey & Paul J.H. Schoemaker, *Risk Taking and Problem Context in the Domain of Losses: An Expected Utility Analysis*, 47 J. RISK & INS. 111 (1980) (offering additional empirical support for Kahneman & Tversky's theory).

68. *See* Jeffrey J. Rachlinski, *Gains, Losses, and the Psychology of Litigation*, 70 S. CAL. L. REV. 113, 124 (1996) (citing over a dozen studies confirming this cognitive bias in monetary gambles, life-threatening choices, purchasing decisions and other situations).

69. *See id.* at 124-25.

70. *See id.* at 125 n.52 (citing studies analyzing the judged incidence of cheating and the judged quality of the taste of hamburger meat).

71. *See generally* Chris Guthrie, *Better Settle Than Sorry: The Regret Aversion Theory of Litigation Behavior*, 1999 U. ILL. L. REV. 43 (discussing Rachlinski's framing theory of litigation); Rachlinski, *supra* note 68.

72. *See* Rachlinksi, *supra* note 68, at 128-30 (discussing framing of decisions in litigation). This pattern seems to reverse itself when decision-makers overestimate the probability that low probability (1 in 10 or less) gains or losses will occur. Tversky and Kahneman thus observed risk seeking by subjects faced with low probability gains and risk aversion by subjects faced with low probability losses. *See* Tversky & Kahneman, *supra* note 17, at 306. Overestimation of the likelihood of very low probability events perhaps explains in part why consumers purchase both lottery tickets (risk seeking) and insurance (risk aversion) at the same time. *See* Chris Guthrie, *Framing Frivolous Litigation: A Psychological Theory*, 67 U. CHI. L. REV. 163 (2000) (explaining plaintiffs' risk preferring behavior in litigation that has a low probability of success). By contrast, lawyers who file suits with moderate to high

Professor Rachlinski demonstrated the robustness of this theory in three studies, including two surveys of Cornell Law School students[73] and a comparison of rejected settlement offers with litigation outcomes in 722 northern California state court cases that proceeded to trial.[74] All three studies pointed in the same direction: "People facing potential losses from litigation make riskier choices than people facing potential gains."[75]

This effect is observed not only in litigation settlement decisions, but in ethical risk taking as well. Psychological studies have demonstrated that taxpayers who owe money are more

---

probability of success tend to represent risk averse plaintiffs who have difficulty persuading risk preferring defendants to settle. *See id.* at 182; Rachlinski, *supra* note 68, at 128-30. Transactional lawyers also are usually retained in situations in which there is a moderate or high probability of gains (low probability gains would not justify their fee), and less often when there is a moderate or high probability of losses such as a corporate workout. Concealment by a client of material information from its auditors in violation of the securities laws–the subject of this Article–almost always is triggered by a moderate to high probability of losses (otherwise the information that the client seeks to conceal probably would not be material) and the concealment itself almost always involves a moderate to high probability of losses because of the likelihood that the concealment will eventually be discovered.

73. *See* Rachlinski, *supra* note 68, at 135-50. The first survey asked students to decide between taking a settlement offer and going to trial when the settlement offer equaled the total stakes multiplied by the chance of winning. The overall percentage of plaintiffs deciding to settle was 81.3%, and the overall percentage of defendants deciding to settle was 45.5%. *See id.* at 137. The second survey told students that they were representing a defendant drug company in a product liability suit that the plaintiff had offered to settle for $3 million prior to seeing some documents that the defendant had withheld in discovery (the plaintiff would inevitably get to see the documents later if the case did not settle, and the defendant's withholding of the documents, if the case did settle before they were turned over, would arguably open up the case to relitigation and could expose the defendant's lawyers to sanctions). Subjects were also told either (a) that their client's in-house counsel believed that the litigation had been going "well" because he originally had expected it to settle for $5 million, or (b) that their client's in-house counsel believed that the litigation had been going "badly" because he originally had expected it to settle for $1 million. Only 12.5% of the first group, deciding in a "gains frame" chose the risky (and arguably unethical) course of settling before the documents were turned over, whereas 45% of the second group, deciding in a "losses frame," opted for this course of action. *See id.* at 142.

74. *See id.* at 150-60. The mean cost to the plaintiffs in the sample of plaintiffs' errors (rejection of settlement offers higher than or equal to the amount won at trial) was $154,100, and the mean cost to the defendants in the sample of defendants' errors (rejection of settlement offers lower than or equal to the judgment imposed at trial) was more than twice as high at $376,500. *See id.* at 158.

75. *Id.* at 144.

likely to cheat on their taxes than taxpayers who expect a refund.[76] One of Rachlinski's student surveys furthermore suggests that defense lawyers who are told that litigation is progressing worse than their clients' prior expectations are more likely to cheat in discovery than defense lawyers whose clients are pleased with better than expected progress thus far.[77]

If these studies are reliable—and the substantial amount of research done to date suggests that they are—prospect theory is a powerful tool for predicting when managers of public companies are likely to illegally conceal material facts from investors and regulators, and also when lawyers are likely to help them do it. Prospect theory suggests that managers and lawyers who evaluate disclosure decisions in a loss frame, in which concealment offers the possibility of avoiding all or most of the threatened losses, are likely to be more risk preferring than managers and lawyers deciding whether to conceal information simply in order to increase gains.

Because prospective gains and losses from concealment can affect managers and lawyers (professional prestige, salary, fees and value of stock holdings, etc.) differently than an organization (profits, business reputation, etc.), agency problems within a rational actor model may explain concealment that is irrational for the organization.[78] Agency problems, however, do not explain concealment in all cases and sometimes only partially explain it. Prospect theory explains another side of concealment by suggesting that, even in situations in which agents and their organizational principals have parallel gains and losses, decision-making in loss frames may result in conceal-

---

76. *See id.* at 124 n.50 (citing Henry S.J. Robben et al., *Decision Frame and Opportunity as Determinants of Tax Cheating: An International Experimental Study*, 11 J. ECON. PSYCHOL. 341 (1990)).

77. *See supra* note 73 (discussing Professor Rachlinski's second student survey).

78. Rational actor models analyze concealment of corporate information as an agency problem. *See generally* Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on the Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691; Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047 (1995). Rational actor models similarly analyze breaches by lawyers of their professional responsibilities as agency problems. *See* Geoffrey P. Miller, *Some Agency Problems in Settlement*, 16 J. LEGAL STUD. 189, 202-03 (1987); *see also* Painter, *supra* note 11, at 284-85 (suggesting that an ex ante commitment by lawyers to blow the whistle on client fraud could help overcome agency problems).

ment by corporate clients and complicity in concealment by lawyers.[79]

A. CLIENT CONCEALMENT

When an individual client is planning a transaction involving his own money, for example selling a business, the client is usually choosing between gains when deciding how much risk to incur. Sometimes, however, the client is choosing between losses, for example in the sale of an unsuccessful business. Prospect theory predicts that the client choosing between gains would be more risk averse than the client choosing be-

---

79. Cognitive biases other than the risk preferences identified by prospect theory also underlie concealment of material information by an organization's managers. *See generally* Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101 (1997). Langevoort points to several psychological phenomena, including "cognitive conservatism and decision simplification" that leads decision-makers to develop simplified explanations of occurrences, or "schemas," that resist evidence of change, a tendency that is exacerbated in group settings where stress comes from challenging commonly held beliefs. *See id.* at 135-39, 135 n.114 & 136 n.118 (citing Dennis A. Gioia, *Pinto Fires and Personal Ethics: A Script Analysis of Missed Opportunities*, 11 J. BUS. ETHICS 379 (1992) (discussing why Ford Motor's product recall personnel missed danger signs associated with the Pinto's on-road performance because of a "normalcy" schema); Sara Kiesler & Lee Sproull, *Managerial Response to Changing Environments: Perspectives on Problem Sensing from Social Cognition*, 27 ADMIN. SCI. Q. 548, 549 (1982)). Another phenomena pointed out by Professor Langevoort is "overoptimism," or the tendency of organizations to promote an optimistic frame of view in order to promote hard work and long-term commitment by employees, even though this mindset deflects or rationalizes evidence of negative developments. *See id.* at 139-41 (citing MARTIN E.P. SELIGMAN, LEARNED OPTIMISM 100-12 (1991); Edward J. Zajac & Max H. Bazerman, *Blind Spots for Industry and Competitor Analysis: Implications for Interfirm (Mis)perceptions for Strategic Decisions*, 16 ACAD. MGMT. REV. 37 (1991)). Langevoort also points to the concept of "commitment" which leads people, once they have made a commitment to a person or course of conduct, to consistently adhere to that commitment even if later confronted with evidence that the commitment was a bad choice. *See id.* at 142 n.142 (citing Barry M. Staw, *The Escalation of Commitment to a Course of Action*, 6 ACAD. MGMT. REV. 577 (1981)). Finally, Langevoort points to "self-serving beliefs," or the fact that when there is sufficient ambiguity to allow it, people will infer facts that do not threaten their self-esteem or career prospects. *See id.* at 143-46 (citing Dennis A. Gioia, *Self-Serving Bias as a Self-Sensemaking Strategy in Explicit vs. Tacit Impression Management, in* IMPRESSION MANAGEMENT IN THE ORGANIZATION 219, 230-33 (Robert A. Giacalone & Paul Rosenfeld eds., 1989)). Although "overoptimism" bias might be negligible in a loss frame, the other psychological biases identified by Langevoort would generally reinforce the risk preferring choices, including concealment, that prospect theory identifies as attractive to corporate managers choosing between prospective losses.

tween losses. Thus, the client selling a business at a gain might prefer a buyer paying cash to a buyer offering a higher price but paying with an IOU. The client selling at a loss is more likely to prefer the buyer offering the higher price, even though there is more risk that the seller will not actually receive all of the money. If prospect theory also predicts ethical risk taking—as earlier studies of taxpayer behavior[80] and Professor Rachlinski's study of lawyer behavior in responding to discovery requests[81] suggest it does—a client selling his business at a loss is not only more likely to take risks with an unreliable buyer than the client selling his business for a gain, but is also more likely to take the risk of making misrepresentations about the business to the buyer.

If, however, the client is an organization, risk preferences in both loss and gain frames are complicated by the agency problems that affect rational decision-makers regardless of cognitive biases. A corporation's shareholders, for example, are usually more risk preferring than its bondholders, for the simple reason that equity capital gets most of the gains when risk pays off whereas debt capital bears a substantial portion of the losses when a business fails. Although managers are chosen by shareholders rather than bondholders (unless the company is in default), managers, because their human capital and often their financial capital are not diversified, are sometimes more risk averse than diversified shareholders would prefer. On the other hand, managers who own stock options may be risk preferring, knowing that they are essentially gambling with the shareholders' (and the creditors') money. A public corporation, a business with substantial borrowed capital, or a close corporation controlled by majority shareholders is thus likely to be operated in a manner that, for perfectly rational reasons, incurs a different level of risk than at least some of the owners of the capital at risk would want. Cognitive biases may change the risk preferences of the owners of capital and of managers, depending upon whether the business is in a gain frame or a loss frame, but these biases coexist with the rational calculations of decision-makers who do not themselves bear all of the gains and losses from the risks they incur. Agency problems in such circumstances may reinforce or offset distortions resulting from cognitive biases.

---

80. *See* Rachlinski, *supra* note 68, at 124 n.50 (citing studies).

81. *See id.* at 142; *supra* notes 73-75 (discussing Rachlinski's survey results).

When an organization is in financial trouble, however, rational actor incentives will usually reinforce the risk preferring bias predicted by prospect theory. Businesses in financial trouble are usually heavily in debt and may even have negative shareholder equity. Financial institutions that are failing take their gambles almost entirely with customers' money, or with federally insured deposits. In these situations, shareholders' rational preference for risk taking is enhanced. Managers in turn may shift from risk aversion toward risk preference if, for them, losing the shareholders' money is as devastating professionally and financially as losing both the shareholders and the creditors' money. These rational incentives thus point in the same direction as the bias predicted by prospect theory—risk taking in a loss frame, to the extent permitted by the law and perhaps beyond what is legally permitted, is attractive.[82] If such business risk cannot be incurred openly, the business's managers may also decide to incur the additional risk of concealment.

Finally, even if an organization does not affirmatively incur additional business risks in a loss frame, its managers may still prefer to take the risk of concealing the fact that the business is facing losses, whether from poor financial results or violations of the law, hoping that the business cycle, remedial measures, or sheer luck will bail them out. The legal risks of concealment and the risk that the problem could get worse while it is concealed might be preferred over the more certain

---

82. *See* James D. Cox, *Private Litigation and the Deterrence of Corporate Misconduct*, LAW & CONTEMP. PROBS., Autumn 1997, at 1, 5-8 (applying prospect theory to misconduct of corporate managers). Professor Cox wrote:

> Under prospect theory, aversion to or preference for risk depends upon the outcomes of choices in relation to the target point. For example, studies have with fair consistency demonstrated that managers are risk preferring whenever most of the outcomes posed by the choices facing them fall below the target point. In such a situation, managers tend to prefer the choice that affords a chance of meeting or surpassing the target point. Correlatively, risk aversion is typical when the expected values are above the target point.

Id. at 6 (citing Duncan M. Holthausen, *A Risk-Return Model with Risk and Return Measured as Deviations from Target Return*, 71 AM. ECON. REV. 182 (1981); John W. Payne et al., *Further Tests of Aspiration Level Effects in Risky Choice Behavior*, 27 MGMT. SCI. 953 (1981)). Cox posits that, if illegal conduct is the only choice that can put a manager above a target point set by the endowment effect—for example an already announced performance bonus—the manager acting according to prospect theory will likely choose the risk-preferring choice of violating the law, regardless of the potential sanctions. *See id.*

costs of prompt disclosure. Sometimes rational actor models will point in this direction (particularly if agency problems encourage concealment), but sometimes they will not. Prospect theory suggests that, even in the latter case, managers may still choose to conceal even though concealment is not in their own, or the organization's, best interests.

B. LAWYER CONCEALMENT

Prospect theory also has important implications for the practice of law. For example, Professors Langevoort and Rasmussen have observed that lawyers overstate legal risk when they advise business clients in transactions.[83] Agency problems explain part of this risk aversion—lawyers are unlikely to share most of the upside from their clients' risky decisions, but if something goes wrong, lawyers are likely to share much of the blame.[84] Caution's importance as a sociological norm of the legal profession could also be a factor.[85] Psychological biases also might cause lawyers to overestimate risk,[86] although other psychological biases point in the opposite direction.[87] It is noteworthy, however, that Langevoort and Rasmussen limit

---

83. *See* Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375, 377 (1997).

84. *See id; see also* Donald C. Langevoort, *The Epistemology of Corporate-Securities Lawyering Beliefs, Biases and Organizational Behavior*, 63 BROOK. L. REV. 629, 655 (1997). Professor Langevoort wrote:

> A lawyer loses far more by giving the go ahead to a course of action that is later subject to legal sanction than she gains from advice that is not challenged. On the other hand, there is frequently no reputational penalty from too much caution because the client lacks the knowledge and expertise to second-guess the lawyer's judgment. In sum (and subject to some predictable exceptions), lawyers are motivated to overstate legal risk.

Id.

85. *See* Langevoort & Rasmussen, *supra* note 83, at 413-19 (discussing caution as a norm in the legal profession and the possibility that overstating legal risk could be a technique to influence clients toward caution).

86. *See id.* at 423-26 (discussing "defensive pessimism," or the tendency to overweigh negative outcomes); *id.* at 426-28 (discussing "accountability" bias, or the tendency toward caution when it is known that the evaluation will likely be evaluated ex-post); *id.* at 428-30 (discussing "self interest-ego" bias, or the tendency to find risk when the evaluator benefits from its presence).

87. *See id.* at 422-23 (discussing "cognitive conservatism" that resists new law or facts contradicting a prior "schema" that is in turn likely to be constructed around the client's intended course of action, "commitment" bias that sticks with this schema and with the client even in the face of adverse law or facts, and bias toward overoptimism).

their study to advice given in business settings, which usually, although not always, involve decisions that are made in a gains frame for both lawyers and clients.[88] Even without taking risks, the client is likely to make money from the transaction and the lawyer-client relationship is likely to remain intact. Langevoort's and Rasmussen's observations about overestimation of risk do not extend to litigation, and Rachlinski's studies suggest that lawyers who advise corporate defendants choosing between losses in litigation tend to be risk preferring.[89]

Prospect theory also could predict when lawyers are likely to get into trouble.[90] A lawyer may be more likely to assist a client who is using the lawyer's services to violate the law (a violation of Model Rule 1.2(d))[91] in situations where the facts are already bad, either for the client, for the lawyer or for both.[92] An important deal about to collapse, as in *SEC v. National Student Marketing*,[93] or an ongoing securities fraud by a nearly insolvent client, as in *In re Carter and Johnson*,[94] are al-

88. Langevoort and Rasmussen mention psychological differences in the ways people approach possible gains and losses. *See id.* at 425 n.111. But they limit this discussion to a footnote and do not discuss how prospect theory might predict *under*estimation of risk in a loss frame.

89. *See supra* text accompanying notes 71-77.

90. Once again, other cognitive biases may also come into play. *See* Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry into Lawyers' Responsibility for Clients' Fraud*, 46 VAND. L. REV. 75, 101-11 (1993) (positing that lawyers may not be good monitors of their clients' conduct because, having agreed to represent a client, they are motivated by biases—such as commitment, overoptimism and cognitive conservatism in processing new information that contradicts existing schema—to see the client's activities as permissible and thus to ignore red flags).

91. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2(d) (1983).

92. Professor Rachlinski and this author plan to conduct surveys designed to test the hypothesis advanced here with respect to client fraud, as well as the hypothesis that lawyers are, in a wide range of ethics dilemmas, more likely to take risks in a loss frame than in a gains frame.

93. SEC v. National Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978). The attorneys representing National Student Marketing (National) discovered that National's earnings had been overstated in financial statements, yet allowed a merger of National into another company to go forward without resoliciting approval from both companies' shareholders. *See id.* at 712-13. The court held that the attorneys aided and abetted their client in violation of Section 10-b of the 1934 Act because the attorneys neglected their duty to protest National's decision to go ahead with the merger. *See id.* at 715. "Their silence was not only a breach of this duty to speak, but in addition lent the appearance of legitimacy to the closing." *Id.* at 713 (citation omitted).

94. *In re* Carter & Johnson, Exchange Act Release No. 17,597, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,145 (Feb. 28, 1981). Carter and Johnson represented National Telephone (National) over almost

ready no-win situations for lawyers bound to lose their client, their unpaid legal bills and possibly their reputation. Lawyers who never would have facilitated the conduct that got their clients into trouble to begin with (and who even advised against the illegal conduct[95]), when deciding how to cut their losses, may help conceal the client's violations and take other risks that a "rational" lawyer would not. In both *Carter and Johnson* and *National Student Marketing*, the lawyers' participation in client concealment almost certainly was not rational from the vantage point of the lawyers' professional reputations (and the concealment probably was not rational for their clients either), yet the concealment occurred anyway. The client, or the client's transaction, however, was already in deep trouble before any of the lawyer wrongdoing alleged by the SEC took place. Prospect theory may explain what happened in these cases, and more generally may explain why, sometimes, the worse things get, the more likely a lawyer is to compound his own and his client's troubles with violations of ethics rules, violations of law or both.[96]

Prospect theory may also explain why lawyers take big risks to conceal their own errors. As risk averse as lawyers are when tempted with the gains of assisting a client crime or fraud to begin with, once they are pressured into participation in the client's misconduct, or because of their own negligence fail to notice it in time, they may be willing to bear the additional risk of concealing the problem by lying or telling half truths to outside auditors, to regulators, or even to their own client's board of directors. In these situations, it is easy to at-

two years during which National ignored Carter and Johnson's legal advice and persisted in repeated violations of the securities laws, including issuing false press releases, sending misleading letters to shareholders, and filing misleading disclosure statements with the SEC. *See id.* at 84,153-64. The SEC found that Carter and Johnson each had an obligation to take affirmative steps to correct National's disclosure violations, such as approaching other members of National's board of directors or resigning. *See id.* at 84,172. Carter and Johnson had warned National about its conduct, but did not resign or inform the National's board of their client's violations until the company was nearly bankrupt. *See id.* at 84,162-64.

95. This was clearly the case in *Carter & Johnson.*

96. Escalating commitment of economic resources (such as unbilled or unpaid for lawyer time) to a particular client could also change economic payoffs and make unethical conduct more attractive to the "rational" lawyer. This is unlikely, however, because previous investment of time or money in a client does not often change the *prospective* payoffs likely to arise from continuing to represent that client, and unless the payoffs do change, "sunk costs" should be irrelevant to rational decisions about what a lawyer does in the future.

tribute lawyer concealment to the bad judgment that got a lawyer into trouble to begin with, but something else may also be at work. Prospect theory explains what that something else may be.

Decision-making in a loss frame is further affected if decision-makers conceal risk preferring behavior from themselves by adjusting their estimates of risk artificially downward to make it appear that they are making risk neutral or risk averse decisions when in fact they are not.[97] A lawyer thus may convince himself that the facts or the law are different than they really are. In the *Carter and Johnson* case, for example, the lawyers fooled themselves into believing that their client's problems were more hypothetical than real, and that they as lawyers were in any event doing the right thing.[98] Selective reading of ethics rules, reading rules out of context and other methods of artificially deflating risk convince the lawyer that she is acting according to the norms of her profession, even if her interpretation of her ethical obligations would be rejected by a neutral outsider (and perhaps also by a lawyer making ethical decisions in a gains frame).

As Professors Langevoort and Rasmussen observe, rational incentives, social norms and even cognitive biases ordinarily point in the direction of lawyer conservatism and unwillingness to take risks in a business setting.[99] Lawyers who thus overestimate risk also would not ordinarily take the risk of participating in the initial stages of a client crime or fraud, and indeed very few suits or disciplinary actions are brought against lawyers for conspiring with their clients from the outset to vio-

---

97. *See* Rachlinski, *supra* note 68, at 134-35 (discussing how subjects in litigation settlement negotiation simulation studies overestimate their chances of winning and therefore perceive their own risk preferring reservation prices to be risk averse) (citing George Loewenstein et al., *Self-Serving Assessments of Fairness and Pretrial Bargaining*, 22 J. LEGAL STUD. 135 (1993) (detailing a study of overconfidence in evaluation of litigation prospects)).

98. *See* Richard W. Painter, *The Moral Interdependence of Corporate Lawyers and Their Clients*, 67 S. CAL. L. REV. 507, 566 (1994) (discussing how Johnson fooled himself into believing that he had fulfilled his responsibility by noting his disapproval on a copy of National Telephone's misleading quarterly report that he then sent to his law firm's files, without mentioning his disapproval to National; and how Carter and Johnson both phrased their legal advice to National in hypothetical language in order to avoid confronting the fact that the securities laws required National to disclose accurate information to its shareholders and the fact that National was nearly insolvent).

99. *See* Langevoort & Rasmussen, *supra* note 83, at 377, 413-25.

late the law or to defraud third persons. When things go wrong, however, and the gains frame shifts to a loss frame, even a small loss of income or professional prestige can loom large in a lawyer's mind, and the lawyer may find herself taking unreasonable risks not only to save the client's skin but because she believes that she has to save her own.

IV. RESPONDING TO THE PSYCHOLOGY OF CONCEALMENT

What, if anything, can be done about the psychology of concealment? Although pervasive risk preferring behavior in loss frames has been detected by psychological studies, only a few of these studies go beyond simulating decisions between prospective monetary gains and losses to simulate ethical decisions as well.[100] More research thus clearly needs to be done on ethical decisions in loss frames, and in particular on loss frames where not only loss of money but also professional prestige and reputation are at stake. As a preliminary matter, however, it appears safe to conclude that risk preferring bias in decisions exists, but can also be mitigated by both professional responsibility rules and private arrangements between lawyers, auditors and clients.

First, if lawyers are likely to underestimate the risks of concealment in a loss frame, ethics rules that minimize lawyer discretion when a client is in trouble may be preferable to discretion laden rules. A specific requirement, for example, that a lawyer must report crime or fraud to the full board of directors of a corporate client,[101] or to the client's auditors, might overcome the lawyer's bias toward risk taking in bad situations, even though there is no guarantee that the lawyer will obey the rule. Vague standards such as Model Rule 1.13's requirement that the lawyer "proceed in the best interests of the organization"[102] might, on the other hand, invite the lawyer to collaborate with client concealment, particularly if management

100. *See* Rachlinski, *supra* note 68, at 124 & n.50 (citing psychological studies demonstrating that taxpayers who owe money are more likely to cheat on their taxes than taxpayers who expect a refund); *id.* at 140-44 (discussing surveys of Cornell Law School students suggesting that defense lawyers who are told that litigation is progressing worse than their clients' prior expectations are more likely to cheat in discovery than defense lawyers whose clients are pleased with reports of better-than-expected progress).

101. *See supra* text accompanying notes 39-41.

102. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13 (1983).

makes a credible case that concealment is in the best interests of the organization. Even if the risks of concealment are not in the best interests of the organization—or of the lawyer for that matter—the lawyer may underestimate these risks and convince herself that they are worth it. Although auditors' rules allow some discretion to resolve ambiguity, for example the discretion to determine at what point "it is likely that an illegal act has occurred,"[103] auditors' rules for disclosure of client crime and fraud allow for less discretion than lawyers' rules. To the extent discretion is likely to be used to incur additional risk in loss frames, auditors' rules may discourage risk taking that clearly violates a rule, whereas the indeterminacy of lawyers' rules may encourage rationalization by lawyers in borderline cases.

A second response to risk preferring behavior in a loss frame is for the decision-maker to decide at an earlier point in time how to respond to a future choice between losses, and then prospectively to lock in this decision with a rule. This approach is useful if the decision-maker is less risk preferring when facing hypothetical losses rather than actual losses, or the decision maker is aware that he is vulnerable to risk preferring behavior in a loss frame and wants to take precautionary steps before decisions between losses actually have to be made. Although a risk preferring decision-maker still may choose to violate the rule when confronted with a loss frame later on, the rule could sometimes be a valuable deterrent to risk seeking behavior, at least in borderline cases. The managers of a corporate client thus might decide that disclosure is preferable to the risks of concealment, even if, when actually confronted with potential losses later, they might prefer to take their chances with concealment. Lawyers also might want to protect themselves from their own risk preferring behavior if something goes wrong later. They could seek to do this by obtaining a client waiver of confidentiality in advance and then perhaps taking the additional step of committing themselves to disclose material information about a client to its auditors.

Yet another response is to use risk assessments from evaluators who are not deciding in a loss frame. Lawyers and auditors can check a client's decisions when the client is in trouble, but, if the predictions of prospect theory are correct,

103. 1934 Act, Section 10A(b)(1)(A)(i); 15 U.S.C. § 78j-1(b)(1)(A)(i) (Supp. IV 1998).

they are only likely to assess risk more conservatively than their clients if they are not also in trouble. If some of the professionals are also in trouble or identify too closely with the client's loss frame, other professionals may be required to check their assessments of risk. Second legal opinions and second opinions on auditing issues may be requested.[104] Lawyers and auditors can sometimes even check each other's decisions. If the lawyers are making decisions in a loss frame (for example, the client's problems result from previous legal error), the auditors may still be in a gains frame, and vice versa (the financial statements could be wrong, even though the client has done nothing illegal—yet). Effective correction by lawyers and accountants of each other's decisions, however, assumes that each professional has some expertise in the other's evaluative criteria as well as knowledge of the underlying facts, two improbable contingencies if expertise and information are not commonly shared across professional boundaries.[105]

V. RESPONSES TO THE PSYCHOLOGY OF CONCEALMENT IN MULTIDISCIPLINARY PRACTICE

Lawyers and auditors who practice together will have to accommodate the different rules that the two professions play by. When lawyers' and auditors' confidentiality rules conflict, which shall trump the other?

This issue was raised before the ABA Commission on Multidisciplinary Practice by opponents of multidisciplinary practice,[106] and is divisive enough within the ABA that it could derail the Commission's proposal to permit multidisciplinary

104. *See generally* Michael Klausner, Geoffrey Miller & Richard Painter, *Second Opinions in Litigation*, 84 VA. L. REV. 1411 (1998) (discussing agency and other problems with legal advice, and some of the reasons clients do and do not obtain second opinions in litigation).

105. Yet another way to counteract bias toward risk taking in "no win" situations is to reward risk reduction. Corporate sentencing guidelines, for example, decrease financial penalties when a defendant has control mechanisms in place to detect and prevent illegal acts. Some ethics codes provide for mitigation of discipline for lawyers who promptly take steps to report their own misconduct or to rectify injury caused by themselves or a client in connection with their misconduct. These rational incentives may or may not overcome the risk preferences that perpetuate concealment. *See* text accompanying *supra* notes 80-82.

106. COMMISSION ON MULTIDISCIPLINARY PRACTICE, AMERICAN BAR ASS'N, REPORTER'S NOTES n.77 (1999), *available at* <http:/www.abanet.org/cpr/mdpappendixc.html> (citing several authors who raised these concerns, including Lawrence J. Fox, Sydney M. Cone, and Edward Lamar Taylor).

practice when it reaches the House of Delegates. How the confidentiality issue is resolved, however, will also determine whether multidisciplinary firms can respond more effectively than do lawyers and accountants practicing separately to concealment in a client fraud scenario. In turn, this could have a significant impact on the SEC's future attitude toward multidisciplinary practice, and in particular on whether the SEC might reconsider its stand against lawyers and auditors representing the same client simultaneously.[107]

A. THE MULTIDISCIPLINARY PRACTICE COMMISSION'S RESPONSE

The Commission addressed the confidentiality issue by coming down squarely on the side of lawyers' rules on client secrecy. As the Commission notes in its Report:

> Concerns were expressed about the possible inappropriate disclosure of confidential client information within an MDP, since there is not uniformity among different professions about the circumstances under which client information may, must, or must not be disclosed to a third party. The Commission recommends that no change be made to the lawyer's obligation to protect confidential client information. Acknowledging that a nonlawyer in an MDP may be subject to an obligation of disclosure that is inconsistent with the lawyer's obligation of confidentiality (*e.g.*, the disclosure obligations of mental health care workers in cases of suspected child abuse or the disclosure obligation of accountants performing the attest or audit function), the Commission specifically recommends several safeguards to assure that a nonlawyer who works with, or assists, a lawyer in the delivery of legal services will act in a manner consistent with the lawyer's professional obligations.[108]

Lawyers' rules on client secrecy thus should, according to the Commission, trump the disclosure rules of other professions, even in situations where bodily injury such as child abuse might result from nondisclosure (although lawyers are permitted under Model Rule 1.6 to disclose in cases where death or bodily injury might result, they are not required to do so[109]). In situations where only financial injury can result and lawyers are forbidden to disclose (under the current version of Model Rule 1.6[110]), once again lawyers' secrecy rules are supposed to

107. *See supra* text accompanying notes 2-5.

108. COMMISSION ON MULTIDISCIPLINARY PRACTICE, AMERICAN BAR ASS'N, REPORT (1999), *available at* <http://www.abanet.org/cpr/mdpreport.html> [hereinafter REPORT].

109. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 (1983).

110. *See supra* note 43 and accompanying text (explaining how most juris-

trump auditors' disclosure rules when lawyers and auditors practice together. To reinforce this point, the Commission also proposes additions to the comments to Model Rule 1.6 governing confidentiality:

> [23] A lawyer in an MDP who provides legal services to the MDP's clients may encounter confidentiality problems that require special attention. The lawyer should scrupulously observe the rules of professional conduct relating to the protection of confidential client information.
>
> [24] A lawyer in an MDP who delivers legal services to the MDP's clients and who works with, or is assisted by, a nonlawyer in the MDP who is delivering nonlegal services in connection with the delivery of legal services to a client should make reasonable efforts to ensure that the nonlawyer behaves in a manner that discharges the lawyer's obligation of confidentiality. (See Comment, Rule 5.3)
>
> [25] In the context of an MDP, there is a particular concern about the potential loss of the attorney-client privilege, arising out of the possibility that the MDP's clients might not be properly informed as to the separate functions performed by the MDP and that the members of the MDP would not treat legal matters in a fashion appropriate to the preservation of the privilege. A lawyer in an MDP should take special care to avoid endangering the privilege by either the lawyer's own conduct or that of the MDP itself, or its nonlawyer members, and should take such measures as shall be necessary to prevent disclosure of confidential information to members of the MDP who are not providing services in connection with the delivery of the legal services to the client. (See Comment, Rule 5.1).[111]

Although the Commission contemplates that lawyers will represent clients simultaneously with professionals who have broader disclosure obligations (for example, mental health care workers), the Commission's Report takes a more guarded position on whether lawyers and auditors should represent a client simultaneously, and the Commission in a later statement sided with the SEC on this issue.[112]

---

dictions have, however, adopted the Model Code rule which permits, but does not require, the lawyer to disclose).

111. COMMISSION ON MULTIDISCIPLINARY PRACTICE, AMERICAN BAR ASS'N, APPENDIX A (1999), *available at* <http://www.abanet.org/cpr/mdpappandixa.html> (providing illustrations of possible amendments to the Model Rules of Professional Conduct).

112. *See* REPORT, *supra* note 108, at n.3. The ABA Commission noted that:

> In a letter from the Office of the Chief Accountant (OCA) of the Securities and Exchange Commission (SEC), this Commission was advised that the SEC has asked the Independence Standards Board (ISB) to place the topic of legal advisory services on its agenda. The SEC intends to look to the ISB for leadership in establishing auditor independence regulations applicable to the audits of the financial state-

One alternative, discussed in the Commission's Reporter's notes and urged by some auditing firms that want to merge with law firms, is to construct a "firewall" between the lawyers and auditors so each of the professions can continue to play according to its own rules.[113] The "firewall" approach, however, only delays disclosures that the lawyers usually will be required to make to the auditors in response to an audit letter.[114] If the "firewall" is successful at reinforcing the psychology of concealment beyond that point, the lawyers may expose themselves to substantial liability for participating in the client's concealment if they do not resign from the representation. Finally, the "firewall" approach is sure to exacerbate the SEC's concerns about nondisclosure when lawyers and auditors within the same firm represent the same client.

B. THE WAIVER RESPONSE

A second approach would be for the lawyers to obtain client consent to their sharing with auditors practicing within their firm any information that is material to the audit. The audi-

---

> ments of SEC registrants. According to the letter, the SEC auditor independence regulations specifically state that the roles of auditors and attorneys under federal securities laws are incompatible. The OCA would consider an auditing firm's independence from an SEC registrant to be impaired if that firm also provides legal advice to the registrant or its affiliates. The Commission believes that this issue is correctly initially discussed in those fora. When the ISB completes its study, appropriate ABA entities will wish to comment on its recommendations and, possibly, to take formal positions.

See id. The Commission later supported the SEC's position in an explanatory statement:

> The Commission shares the SEC's position and regrets that it did not make this point sufficiently clear. Finally, the Commission notes the concerns expressed by SEC Commissioner Norman S. Johnson, who views the expansion of accounting firms into legal services as problematic. Commissioner Johnson's concerns focused on many of the same issues as did this Commission's Report and Recommendation, such as the preservation of a lawyer's independent professional judgment and the lawyer's duty to preserve a client's confidences and avoid conflicts of interest.

See COMMISSION ON MULTIDISCIPLINARY PRACTICE, AMERICAN BAR ASS'N, UPDATED BACKGROUND AND INFORMATION REPORT AND REQUEST FOR COMMENTS (1999), *available at* <http://www.abanet.org/cpr/febmdp.html> (citing *SEC Commissioner Johnson Addresses Auditor Independence*, SEC TODAY, Oct. 13, 1999, at 5).

113. COMMISSION ON MULTIDISCIPLINARY PRACTICE, AMERICAN BAR ASS'N, REPORTER'S NOTES n.76 (1999), *available at* <http:/www.abanet.org/cpr/mdpappendixc.html>.

114. *See supra* text accompanying notes 46-49.

tors would then be required to play by their own rules in responding to the information, meaning that illegal acts might have to be disclosed outside the client organization.[115]

Once the client agrees to permit disclosure, liability concerns should induce disclosure by the lawyers to the auditors of facts material to the audit. The SEC will probably never agree to permit one firm to provide both auditing and legal services to the same client unless information known to the lawyers about the client is legally attributable to the auditors. If so, liability will be a powerful incentive for multidisciplinary firms to implement information sharing policies designed to overcome the psychology of concealment.[116] The discretion laden mandate of Model Rule 1.13, requiring the lawyer to "proceed as is reasonably necessary in the best interest of the organization," will be carried out against the backdrop of auditor partners' insistence on being informed pursuant to the terms of the ex ante agreement with the client that its lawyers may keep the auditors informed.

While liability concerns might necessitate lawyer-auditor communication within a multidisciplinary firm, this regime is not mandatory for clients. Clients have a choice—they can shun one-stop shopping and hire a separate law firm whose relationship with accountants is governed by the existing audit letter procedure and accountants who are unlikely to have lawyers' knowledge attributed to them for liability purposes. Only clients that want auditing and legal services from the same firm will have to consent to direct and uninhibited communication between auditors and lawyers about information that is material to the audit. This arrangement will be avoided by some clients, but should be attractive to others that want to assure investors, regulators and third parties that they have en-

---

115. *See supra* text accompanying notes 54-59. Because of auditors' disclosure obligations, clients would have to understand that the attorney-client privilege would almost certainly be waived with respect to information disclosed by lawyers to auditors pursuant to such an arrangement.

116. *See supra* note 50-51 (pointing out that auditors but not lawyers are routinely exposed to liability under Section 11 of the 1933 Act, and that auditors must affirmatively establish "reasonable investigation" as a defense). For purposes of satisfying this "reasonable investigation" defense, auditors normally do have to follow through with conventional audit letter procedures, but the knowledge of their clients' lawyers is not generally attributable to the auditors if the lawyers choose to misrepresent facts that the auditors would not have ordinarily uncovered in a reasonable investigation.

hanced procedures for detection and prevention of fraud and other illegal acts.[117]

C. CRITIQUES OF THE WAIVER RESPONSE

1. Inconsistency with the Values of the Profession

Arguably, confidentiality is a core value of the legal profession that should not be subject to irrevokable client waiver ex ante (before all of the circumstances become known). Some ethics rules clearly cannot be contracted around. For example, a lawyer cannot, even with client consent, acquire a financial interest in the subject matter of litigation,[118] or commingle client funds with his own.[119] Other rules can be waived, but are usually waived ex-post. For example, waiver of conflicts between clients generally is not obtained by the first client when she retains counsel, but instead when the second client seeks representation,[120] although in some circumstances a sophisticated client is permitted prospectively to waive conflicts with other clients.[121] Although Model Rule 1.6 clearly permits a cli-

---

117. *See generally* Painter, *supra* note 11 (discussing the advantages of an ex ante opt-in disclosure regime).

118. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.8(j) (1983).

> A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client, except that the lawyer may: (1) acquire a lien granted by law to secure the lawyer's fee or expenses; and (2) contract with a client for a reasonable contingent fee in a civil case.

Id.

119. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.15 (1983). Model Rule 1.15 does, however, allow the client to opt out of the provision requiring that attorney trust accounts be kept in the state where the lawyer's office is situated. *See id.*

120. Many courts are skeptical of advance conflict waivers. *See, e.g.*, Westinghouse Elec. Corp. v. Gulf Oil, 588 F.2d 221, 229 (7th Cir. 1978) (refusing to enforce an alleged understanding between Gulf and a law firm hired by Gulf that the firm could continue to represent another longstanding client with potentially adverse interests to Gulf if a dispute between the two should arise). Advance conflict waivers are discussed more extensively in Richard W. Painter, *Advance Waiver of Conflicts*, 13 GEO. J. LEGAL ETHICS (forthcoming May 2000).

121. Some recent cases endorse a more flexible approach to ex ante conflicts waivers. *See, e.g.*, Unified Sewerage Agency v. Jelco, Inc., 646 F.2d 1339, 1346 (9th Cir. 1981) (holding that a client's "longstanding" consent to a conflict coupled with reliance by others can amount to estoppel); Fisons Corp. v. Atochem N. Am., Inc., No. 90 Civ. 1080, 1990 WL 180551, at *7 (S.D.N.Y. Nov. 14, 1990) (approving of advance consent to a conflict); Interstate Properties v. Pyramid Co., 547 F. Supp. 178, 183 (S.D.N.Y. 1982) (approving of an advance

ent to consent to disclosure of confidential information, few lawyers have tried arrangements where consent is irrevokable, and few courts of have ruled on this issue.[122]

Ex ante waiver of confidentiality was denounced by Larry Fox, one of the staunchest opponents of multidisciplinary practice, in his testimony before the ABA Commission:

> Just when a legal client may most want to preserve a confidence, lawyers working at these accounting firms will be compelled to disclose it—running directly afoul of our most cherished professional value. Recognizing the fact that their lawyers really are practicing law and the inherent conflict in roles and rules, the Big 5 responds by explaining that they receive waivers of confidentiality from their clients before each engagement. But this is no cure. A lawyers [sic] duty of confidentiality is not waiveable for the benefit of the lawyer and, even if it were, a prospective waiver would be void since by definition it could never be knowing and intelligent.[123]

Fox does not consider the possibility that waiver could be for the benefit of *the client*, as well as the lawyer, and particularly for the benefit of the client's shareholders. Neither does he consider the fact that most clients using both legal and auditing services are businesses that are sophisticated enough to decide for themselves whether prospective waiver is appropriate. Fox also does not cite case law to support his argument that a prospective waiver would be void, particularly if the waiver merely states that the lawyer will disclose information material to the client's financial statements to its auditors. Finally, Fox does not explain why concealment of information from auditors, particularly information that could concern client fraud and illegal acts, should be included among the profession's "most cherished" values, or a public policy reason why prospective waiver of secrecy by a public company should be void.

Indeed, a publicly-held company is already bound to disclose information material to its financial statements to its auditors and ultimately to its investors. Prospective waiver of

---

conflict waiver on the ground that there was little evidence that the client communicated confidential information to the law firm).

122. Relevant case law is sparse and arises almost exclusively in the context of a prospective waiver of confidentiality with respect to other clients, not a waiver of confidentiality with respect to auditors. *See, e.g.*, *Westinghouse Elec. Corp.*, 588 F.2d at 227-29 (finding that the claimed agreement would impermissibly result in the lawyer's breach of the duty to keep confidences); *Interstate Properties*, 547 F. Supp. at 183 (finding that, based on the facts before the court and the language of the prior lawyer-client agreement, there had been no confidential communications in the first place).

123. Fox Remarks, *supra* note 6.

lawyer confidentiality only affects who discloses and when. Fox, however, minimizes the significance of this inevitability:

> Demonstrating both the weakness of their waiver argument and their callous disregard for our values, the auditors then argue that confidentiality is really no big deal. After all, if a public company has a duty to disclose, all that Big 5 lawyers are getting their clients to agree to is the disclosure by the lawyer of information to the auditors that the client would be obliged to tell the auditors anyway.
>
> The argument is as outrageous as it is indifferent to our core values. All lawyers know that in order to be effective at what we do a client must know that the lawyer-client relationship is sacrosanct. One need look no further than how we viewed Ken Starr's attack on the deceased Vince Foster's privileged communications to understand how fragile our assurances of confidentiality can be and how jealously we must guard them. The profession rightly rose as one to argue that our clients will be inhibited even by knowing that disclosure of their confidences will only follow death. Here the possibility of disclosure is more likely, guaranteed to be timely, and obviously something that the client will be forced to live with.[124]

The Office of Independent Counsel is a convenient foil, but Kenneth Starr's unsuccessful effort to obtain Vincent Foster's communications with his attorneys[125] has little to do with ex ante voluntary waiver by a public company of lawyer secrecy with respect to information that the company is already legally obligated to disclose. Indeed, the relationship between a lawyer and a client corporation that is making a securities filing usually already contemplates that the lawyer will be asked for this information by the accountants in an attorney letter and that the lawyer will truthfully respond.

Finally, Fox argues that lawyers should not have to deal with the uncertainties of materiality when determining whether information must be disclosed:

> Moreover, information is ambiguous and materiality a term of art, not a mathematical formula. To place a lawyer in a trap between a duty to a client and a duty to his non-lawyer auditing masters creates an impossible dilemma whose only product can be second-rate legal services and a compromise of ethical principles. Advocates (and by that term I include all lawyers, transactional and trial), and auditors, as in that old Sesame Street song, don't "go together," especially when the topic is preserving confidences.[126]

---

124. *Id.*

125. *See* Swindler & Berlin v. United States, 524 U.S. 399, 406 (1998) (holding that the attorney-client privilege survives the death of the client).

126. Fox Remarks, *supra* note 6.

Transactional lawyers, however, advise their clients all the time with respect to materiality in securities filings, and often are ready to resign if there is serious disagreement with a client about whether information is material enough to be disclosed. Here, however, the issue is disclosure only to the auditors, who in turn must decide if the information is material to the client's financial statements and, under the 1995 Act, whether an illegal act has occurred that must be disclosed.[127] The difficult decision thus lies with the auditors, not the lawyers. When lawyers represent a client that has voluntarily waived secrecy with respect to communications with its auditors, it is not unreasonable, or particularly difficult, for the lawyers to disclose to the auditors information that might be material to the job that the auditors were hired to do.

Far from undermining the values of the legal profession, ex ante waiver of client confidentiality in lawyer communications with auditors helps avoid inconsistencies in the rules of the legal profession. A firm that receives a prospective waiver has contracted around the arguable inconsistency between Model Rule 1.6 and similar rules prohibiting disclosure of client confidences except in the narrowest of circumstances,[128] and Model Rule 1.2 prohibiting lawyer assistance of client crime or fraud.[129] Although it is possible to avoid assisting a client's crime or fraud without disclosing it, many lawyers do not realize how a corrupt client has used their services until it is too late, and disclosure to auditors is often the easiest way to prevent, or at least mitigate the effects of, the client's actions.

Particularly in view of ambiguity in the bar's own rules in the crime or fraud situation (and the fact that a majority of states have rejected the restrictive disclosure rules in Model Rule 1.6), it seems unreasonable for the bar to prevent lawyers from voluntarily assuming the responsibility of communicating with auditors on behalf of clients who have voluntarily asked them to do so. The possibility of a voluntary disclosure regime in which lawyers and clients could mutually agree ex ante to lawyer disclosure of confidences to prevent fraud was raised in the academic literature five years ago.[130] Now, this possibility emerges as a market solution to the ethical dilemmas of multidisciplinary practice. The most substantial barrier is not the

127. *See supra* text accompanying notes 55-59.

128. *See, e.g.*, MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6 (1983).

129. *See, e.g.*, *id.* Rule 1.2(d).

130. *See generally* Painter, *supra* note 11.

disciplinary practice. The most substantial barrier is not the question of whether lawyers and clients will agree to this solution, but the question of whether the organized bar will allow it.[131]

2. Perverse Economic Incentives from Multidisciplinary Practice

A more serious concern is that prospective waiver of client confidences simply will not work because multidisciplinary practice reinforces with rational economic incentives the already existing psychological biases in favor of risk taking and concealment. Arguably, any arrangement in which lawyers and auditors within the same firm represent a client simultaneously sacrifices auditor independence because the firm receives compensation for legal as well as auditing services. If a substantial portion of the firm's billings from a single client are attributable to legal services, the firm's auditors could be pressured by their lawyer colleagues not to comply with the auditors' obligation to disclose illegal acts or fraud. Instead of the auditors convincing the lawyers to play by their rules, everyone could end up playing by the lawyers' rules.

This scenario is possible, but not very likely. An auditing firm's most valuable asset is usually its reputation, and an auditor who would not jeopardize his firm's reputation in return for an auditing fee probably would not change his mind merely because his firm was earning a legal fee from the same client. Most lawyers also would think twice before pressuring an auditor with whom they share profits, losses *and liabilities* to violate an important legal duty. Furthermore, if information known to lawyers is legally attributable to auditors with whom they practice, the lawyers have strong incentives to provide accurate information to the auditors. Bringing lawyers into auditing firms thus enhances the quality of the information that auditors are likely to receive about their clients, enabling them to make the required disclosures. While internal lawyer-auditor communication will differ from firm to firm, communi-

131. It would also be necessary for the SEC to consent to lawyers and accountants in a multidisciplinary setting representing a client at the same time. Although the SEC at this point appears adamant not to allow lawyers and auditors in the same firm to represent a client simultaneously, the SEC might, and probably should, show flexibility if it were clear that lawyers and accountants could work together under a regime of full communication and full disclosure.

cation is likely to be more complete and prompt when lawyers and auditors practice together than when the more formal and cumbersome procedure of obtaining auditor letters from outside law firms is used. On balance, it appears that once a multidisciplinary firm obtains a waiver of confidentiality from a client, the incentives for the lawyers to disclose material information to the auditors and for the auditors to disclose more than offset compensation related incentives for the auditors not to disclose.

Finally, the Big 5 accounting firms already engage in multidisciplinary practice by frequently providing consulting, accounting and other services in addition to auditing services for the same client. Adding legal practice to the mix only compounds compensation related incentives that are already there. Compensation related incentives that undermine auditor independence are thus probably best dealt with not by exclusion of lawyers from multidisciplinary practice, but by (i) requiring disclosure in a client's securities filings of amounts paid to its auditing firm that are attributable to nonauditing services, and perhaps (ii) designation by the SEC of a percentage of total compensation attributable to nonauditing services—whether legal, accounting or consulting services—that an auditing firm receives from a single client, above which the auditors will no longer be considered independent.

CONCLUSION

Lawyers' rules for disclosure of client crime and fraud are particularly inept at facilitating a risk averse response to the situation in which a lawyer and his client are most likely to act in a risk preferring manner—the loss frame in which the client is in financial trouble or has already violated the law. Auditors' rules allow less flexibility in responding to the situation, but for this reason are more effective than lawyers' rules at overcoming psychological bias toward risk taking that is unlikely to be in the client's or the professional's best interest.

Far from undermining the values of the legal profession, prospective waiver by sophisticated clients of lawyer secrecy rules for communications with auditors strengthens these values by alleviating tension between conflicting values. The firm that receives the waiver no longer has to agonize over apparent inconsistency between rules that prohibit lawyer facilitation of crime or fraud and rules that prohibit lawyer disclosure of confidential information. Furthermore, assuming waiver is obtained, the lawyers' liability driven and other incentives to disclose material information about a client to their auditor partners and the auditors' incentives to compel disclosure by the client, should more than offset compensation related incentives the lawyers and auditors could have not to disclose. Finally, if the confidentiality waiver is obtained before a loss frame arises, and lawyers and auditors in the same firm make some effort to check each other's evaluations of the client, progress may be made toward overcoming psychological bias toward excessive risk taking when a client is in trouble.