Sarbanes Oxley – Harris Article Introduction

George Harris of the University of Utah College of Law wrote an excellent article, *Taking the Entity Theory Seriously: Lawyer Liability for Failure to Prevent Harm to Organizational Clients Through Disclosure of Constituent Wrongdoing*, 11 Geo. J. Legal Ethics 597 (1998), that should be a starting point for anyone thinking about the SEC's proposed rules under Sarbanes-Oxley for regulating attorney conduct.

The article provides a thorough review of the current disclosure rights and obligations under the ABA *Model Rules of Professional Conduct* (*Model Rules*), the ALI *Restatement of the Law Governing Lawyers* (*Restatement*), and the laws of the states in the context of constituent misconduct (generally crimes or fraud by managemant) of client corporations.

Harris argues that taking the entity theory of the corporation seriously requires that lawyers consider "loyal disclosure" in such situations, both within the organization (as required by the *Model Rules*, the *Restatement* and the laws of all states) and outside of the organization. He concludes that lawyers should be obligated to disclose management misconduct outside of the corporation when such disclosure is "loyal" (that is, when addressing the misconduct will benefit the corporation by minimizing liability) and when there are "uninformed constituents" who might be adversely affected. The potential for effects on "uninformed constituents" generally arises when the corporation is, or is likely to become, insolvent. Such disclosure outside the corporation is currently the rule in several states.

I do not accept his argument for disclosure outside the organization, particularly as it relates to creditors. Here, his analysis misses the essence of the entity theory. Management and owners of an insolvent corporation benefit, at the expense of creditors, from defensive asset partitioning - what is commonly referred to as "limited liability." But, under the entity theory, limited liability is the price that creditors pay to get the benefit of affirmative asset partitioning (insulation of the assets of the corporation from the claims of the creditors of the owners and management). There is simply no evidence that creditors are ignorant of the risk of lending or unable to adequately protect their interests. I have seen no data showing that the debt cost of capital is artificially low.

In his review of the case law, Harris cites the cases against lawyers brought by receivers of insolvent depository institutions as a result of the "S&L" crises of the late 1980s. These receivers were government enterprises and their losses resulted from a combination of changes in tax policy, regulatory changes in reserve requirements, and the perverse incentives resulting from deposit insurance, the home mortgage loan business and relaxation of regulations limiting investment options. While there may have been some management misconduct at a few institutions, much of it was much clearer when seen in "20/20 hindsight." Imposing additional disclosure obligations on lawyers would not have helped.

While I do not agree with Harris' conclusions, his article is comprehensive and interesting and of particular relevance in the current debate.