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THE SEVENTH ABRAHAM L. POMERANTZ LECTURE

THE EPISTEMOLOGY OF CORPORATE-SECURITIES LAWYERING: BELIEFS, BIASES AND ORGANIZATIONAL BEHAVIOR*

Donald C. Langevoort†

In this lecture, I want to draw connections from underutilized literature on organizational behavior to the domain of corporate lawyering, especially on matters of disclosure and legal compliance. Theory and research on predictable biases in managerial judgment have much to say to us about the problems that lawyers face when counselling organizational clients. Drawing from these materials, my primary goal is to add something new to the literature on lawyers' professional responsibility and the often-discussed (if dimly understood) virtues of lawyerly independence.

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We tend to think of the problem of independence as the one that faces the corporate lawyer when the client's management is bent on fraud or some other form of legal or moral wrongdoing. My argument here is that the hazards are more subtle and banal, that some of what passes for deliberate fraud and failure to supervise is often more a question of managerial misperception—in good faith, perhaps, but potentially just as harmful to the client corporation and its external constituencies.[1] If such bias is a robust phenomenon, then not only are there important implications for corporate-securities law, but the common understanding of the challenges associated with good corporate-securities lawyering needs to change.

I. COGNITION AND INDEPENDENCE

There are two spheres of knowledge that lawyers must bridge when giving legal advice. One is knowledge of the law: an amalgam of information and insight drawn from precedents, other forms of authority and practical experience. The other is knowledge of the facts: a broad understanding of the situation in which the client finds itself. Volumes have been written about the former kind of knowledge, the process of legal reasoning. In contrast, my interest here is in the latter form of epistemology and its relationship to professional responsibility. I speak here not in the disciplinary sense, but in the aspirational terms of what it means to be a "good" business lawyer.[2] Lawyers are often told, with commonplace attribution

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[1] In making this claim, I do not want to ignore the likelihood that some of what passes for fraud is neither corruption nor misperception, but rather action or inaction that is blameworthy only because it is viewed in hindsight—in other words, a product of the bias of the subsequent observer. *See* MARK BOVENS & PAUL T'HART, UNDERSTANDING POLICY FIASCOES 8-9 (1996); *see infra* notes 92-95 and accompanying text.

[2] That is the focus of most of the literature on professionalism, which recognizes that bar disciplinary efforts play a secondary role in controlling the behavior of business lawyers except in extreme circumstances. *See* William H. Simon, *Ethical Discretion in Lawyering*, 101 HARV. L. REV. 1083 (1988); David B. Wilkins, *Who Should Regulate Lawyers?*, 105 HARV. L. REV. 799 (1992). Indeed, emphasis on rules may detract from what is really important. *See* Heidi Li Feldman, *Codes and Virtues: Can Good Lawyers Be Good Ethical Deliberators?*, 69 S. CAL. L. REV. 885 (1996); Fred C. Zacharias, *Reconciling Professionalism and Client Interests*, 36 WM. & MARY L. REV. 1303 (1995). The knowledge question is insightfully explored

to Louis Brandeis,[3] that they cannot offer sound advice unless they thoroughly understand their client as well as the problem it wants to solve. But apart from some clinical "interviewing and counselling" literature, most of which relates to (often unsophisticated) people as clients, the question of what it means to know the client and the situation remains largely unexplored.[4]

The knowledge problem is especially challenging in my special field of interest, securities law. Lawyers are frequently asked to create documents, filings or press releases that portray the company's business, managerial and financial situation. The client, of course, is a fictional entity, embodied in a large and diffuse collection of people and information. The disclosure will be used by investors whose aim is to predict the issuer's future financial performance. There must be attention to material risks and adverse trends: factors that may affect the business, but which fall far short of certainty, thereby requiring complex and subjective probability assessments.[5]

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with respect to the rules of professional responsibility in William Hodes, *The Code of Professional Responsibility, the Kutak Rules and the Trial Lawyer's Code: Surprisingly, Three Peas in a Pod*, 35 U. MIAMI L. REV. 739, 802-10 (1981).

[3] *See* PHILIPPA STRUM, LOUIS D. BRANDEIS: JUSTICE FOR THE PEOPLE 38-41 (1984).

[4] There is beginning to emerge a behavioral literature on lawyers' judgment. *See, e.g.*, Paul Brest, *The Responsibility of Law Schools: Educating Lawyers as Counsellors and Problem Solvers*, 58 LAW & CONTEMP. PROBS. 5 & nn.2-3 (1996); Lynn M. LoPucki, *Legal Culture, Legal Strategy and the Law in Lawyers' Heads*, 90 NW. U. L. REV. 1498 (1996); Gary L. Blasi, *What Lawyers Know: Lawyering Expertise, Cognitive Science, and the Functions of Theory*, 45 J. LEGAL EDUC. 313 (1995). There is also a body of writing (largely non-behavioral) on the factual knowledge of the lawyer as it relates to questions of professional liability, with the common recognition that lawyers can sometimes hide behind lack of knowledge for protection. *See, e.g.*, Hodes, *supra* note 2; John P. Freeman & Nathan M. Crystal, *Scienter in Professional Liability Cases*, 42 S.C. L. REV. 783 (1991). I have explored this latter question with reference to the literature on social cognition. *See* Donald C. Langevoort, *Where Were the Lawyers?: A Behavioral Inquiry into Lawyers' Responsibility for Clients' Fraud*, 46 VAND. L. REV. 75 (1993) [hereinafter Langevoort, *Where Were the Lawyers?*].

[5] The standard test for assessing the materiality of uncertain information is the probability/magnitude test, which requires a balancing of the likelihood of the event coming to pass against the magnitude of impact on the issuer should it do so. *See* Basic Inc. v. Levinson, 485 U.S. 224 (1988). Obviously, required disclosure is often highly formalized, with line-item requirements divorced from any assessment of materiality. Still, materiality and risk disclosure is at the heart of disclosure regulation, especially with respect to potential liability for fraud or nondisclosure. For a good sense of the practical challenges in this area, see Dale E.

At the risk of venturing into postmodern rhetoric, it should be plain that discovering the "truth" about an issuer—especially when the truth is reflected in a mosaic of probabilistic and forward-looking data—is an exercise in social constructionism.[6] There are always multiple meanings that can be drawn from all the little bits of data that go into the total mix of materiality. The process of arriving at a single meaning cannot be divorced from the collective perceptions and interests of the people engaged in the process; and in business organizations, those people are large in number and far from single-minded. The aggregation and assessment of information from diffuse sources is an extraordinarily difficult task for a lawyer. Yet law schools and law firms largely assume that securities lawyers will confront this interpretive task intuitively, or through training and experience drawn from others who, though considered experts, have not developed a systematic theory of what they do either.[7] To be sure, many lawyers do their job well, exercising what Donald Schön describes as the practitioner's reflective wisdom.[8] What is missing is both a candid acknowledgement of the epistemological difficulty of corporate-securities practice and a rigorous effort to study it in context to aid the profession as a whole.

My aim here is to begin to fill that gap by exploring the process of coming to know the organizational client, especially as it relates to giving advice on disclosure-related questions. By necessity, this first requires an understanding of how businesses understand themselves and their environment, drawing heavily on work in managerial behavior about corporate belief systems. In turn, the epistemological question relates to what is the most focal topic in the lawyers' professionalism debate these days, the role of "independence." Our profession works from the assumption that lawyers are to maintain some inde-

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Barnes, Jr. & Constance E. Bagley, *Great Expectations: Risk Management Through Risk Disclosure*, 1 STAN. J. L. BUS. & FIN. 155 (1994).

[6] PETER L. BERGER & THOMAS LUCKMANN, THE SOCIAL CONSTRUCTION OF REALITY (1966).

[7] For a rare and insightful inquiry into the nature of corporate counselling, see JAMES C. FREUND, ADVISE AND INVENT: THE LAWYER AS COUNSELOR-STRATEGIST AND OTHER ESSAYS (1990).

[8] *See* DONALD A. SCHÖN, THE REFLECTIVE PRACTITIONER: HOW PROFESSIONALS THINK IN ACTION (1983).

pendence from their clients, both in order to offer more objective advice and, at least arguably, because of competing public responsibilities.[9] As debates have made clear over the last quarter century within both corporate and securities law (*National Student Marketing* being an early trigger point[10]) and the profession at large (e.g., the Kutak Commission's whistle-blowing recommendations in the early 1980s[11]), there are still strong differences of opinion about how much independence is appropriate, and what the proper posture of independence is, especially when the client is an entity.[12] Anthony Kronman's recently-celebrated image of the "lawyer-statesman,"[13] which canonizes the virtues of detachment and independence, has been attacked both by those who think that it pays too little attention to the need for loyalty and zealous advocacy[14] and

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[9] The classic article on this subject is Robert W. Gordon, *The Independence of Lawyers*, 68 B.U. L. REV. 1 (1988). *See also* Robert L. Nelson & Peter Trubek, *Arenas of Professionalism: The Professional Ideologies of Lawyers in Context*, *in* LAWYERS' IDEALS/LAWYERS' PRACTICES 177 (Nelson et al. eds., 1992).

[10] SEC v. National Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978); *see also* The Emerging Responsibilities of the Securities Lawyer, [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,631 (January 1974) (speech by then-SEC Commissioner A.A. Sommer, Jr.); Joseph C. Daley & Roberta S. Karmel, *Attorneys' Responsibilities: Adversaries at the Bar of the SEC*, 24 EMORY L.J. 747 (1975); Simon M. Lorne, *The Corporate and Securities Adviser, the Public Interest and Professional Ethics*, 76 MICH. L. REV. 423 (1978). This was followed by other celebrated cases, most notably *In re Carter & Johnson*, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847 (1981) and *In re OPM Leasing Services, Inc.*, 32 Bankr. L. Rep. 199 (Bankr. S.D.N.Y. 1983). Most recently, of course, the involvement of lawyers in the savings and loan scandals has generated extensive debate about the lawyer's proper role.

[11] The original recommendations of the American Bar Association's Kutak Commission was to impose a whistle-blowing obligation on lawyers faced with client fraud, a proposal ultimately rejected by the ABA. *E.g.*, Geoffrey C. Hazard, *Rectification of Client Fraud: Death and Revival of a Professional Norm*, 33 EMORY L.J. 271 (1984); Stephen Gillers, *What We Talked About When We Talked About Ethics: A Critical View of the Model Rules*, 46 OHIO ST. L.J. 243 (1985).

[12] The Model Rules, like other professional conduct standards, make clear that a corporate lawyer represents the *entity*, not any of its constituents as such. *E.g.*, MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.13 (1994). Nonetheless, the board of directors ultimately speaks for the client, at least absent an obvious conflict of interest, and the lawyer may not in any event violate client confidentiality by going public with information about disloyalty. Obviously, this puts lawyers in difficult positions when transactions tempt managers to act disloyally. *E.g.*, Roberta S. Karmel, *Duty to the Target: Is the Attorney's Duty to the Target a Paradigm for Directors?*, 39 HASTINGS L.J. 677 (1988).

[13] ANTHONY T. KRONMAN, THE LOST LAWYER: FAILING IDEALS OF THE LEGAL PROFESSION 11 (1993).

[14] *See* James M. Altman, *Modern Litigators and Lawyer-Statesmen*, 103 YALE

those who argue that it posits an inherently reactionary role of preserving existing hierarchies of power and privilege dominated by lawyerly self-interest.[15]

I do not want to try to resolve this tension so much as consider it along another dimension. Different strategies of both proximity to and detachment from the client have differing consequences for the possibility of coming to an understanding of what passes for objective truth about the client and the situation. These postures constitute the range of possibilities for what I refer to as the "cognitive independence" of the corporate lawyer. I am postmodern enough not to stake out the position that there is some single objective reality to "the corporation" and its prospects. But at some point—and in hindsight—investors, competitors, judges, juries, administrative agencies and other significant audiences may well construct one, and the good lawyer earns her living anticipating that exercise.

A reasonably high level of detachment is assumed, of course, in the process securities lawyers call due diligence. As the courts have described it in Securities Act cases,[16] due diligence involves an attitude of skepticism and devil's advocacy, ferreting out facts from underlying documentation and other sources without undue reliance on any one person or group. But due diligence is expensive and fairly atypical in corporate representation;[17] and even when called for, there is still a

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L.J. 1031 (1994) (reviewing ANTHONY T. KRONMAN, THE LOST LAWYER: FAILING IDEALS OF THE LEGAL PROFESSION (1993)).

[15] *See* David B. Wilkins, *Practical Wisdom for Practicing Lawyers: Separating Ideals from Ideology in Legal Ethics*, 108 HARV. L. REV. 458 (1994)(reviewing ANTHONY T.KRONMAN, THE LOST LAWYER: FAILING IDEALS OF THE LEGAL PROFESSION (1993)). Brandeis is often viewed as the archetypal lawyer-statesman, but even he has come under criticism along similar lines. *See* Clyde Spillenger, *Elusive Advocate: Reconsidering Brandeis as People's Lawyer*, 105 YALE L.J. 1445 (1996).

[16] Section 11 of the 1933 Act gives persons associated with a public offering who would otherwise be liable for misrepresentations or omissions in a registration statement a defense if after reasonable investigation they had no reason to believe that the statement was false or misleading. That is known as the due diligence defense. *See* Escott v. BarChris Constr. Co., 283 F. Supp. 643 (S.D.N.Y. 1968); Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971).

[17] Notwithstanding occasional curiosities like FDIC v. O'Melveny & Myers, 969 F.2d 744 (9th Cir. 1992), it is generally assumed that in most transactional settings, the lawyer is under no duty to investigate its client to assure the accuracy of information provided by management. *See* ROBERT J. HAFT, LIABILITY OF ATTORNEYS AND ACCOUNTANTS FOR SECURITIES TRANSACTIONS § 5.05 (1995-96 ed.).

good bit of pragmatic judgment associated with choosing which of many possible avenues should be explored to gain an accurate picture of the company's business condition. In sum, reliance on people within the organization as the primary, sometimes sole, source of information is the norm in corporate practice, especially with respect to questions like product and market risk factors. Again working mainly from intuition and experience, most lawyers—especially at the outset of representation—decide who can be trusted as reasonably objective, and piggy-back on their thoughts and perceptions.

Throughout the process of representation, some lawyers will seek to blend both professionally and socially into the culture of the significant organizational insiders, valuing proximity as a way of truly understanding the client and its environment and (not coincidentally) bonding with the client's management personnel in a way that will generate continued or additional business.[18] Others will be more distant, following the Brandeisian insight that detachment produces better quality advice, not to mention a greater degree of personal and professional autonomy. I suspect that in today's highly competitive and fluid market for elite legal services, the "quick bonding" approach of the former is an increasingly common strategy.

My aim in the Parts II and III is to describe the risks and benefits associated with the various postures of cognitive independence. Although these have broad implications for the practice of corporate law generally, most of my case studies will be drawn from the process of risk assessment for purposes of full disclosure. The analysis will deliberately be more descriptive than normative. I am reasonably convinced that many lawyers do a poor job of subjective risk analysis, and that this relates, in part at least, to judgmental biases associated with derivative information-gathering and compromised independence.[19]

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[18] On the competitive pressures on client relationships in business lawyering, see, for example, Ronald J. Gilson, *The Devolution of the Legal Profession: A Demand Side Perspective*, 49 MD. L. REV. 869 (1990); KRONMAN, *supra* note 13, at 283-91.

[19] In his influential work, Robert Nelson has shown that corporate lawyers' ideologies and attitudes come to conform to their clients. *See* ROBERT L. NELSON, PARTNERS WITH POWER: THE SOCIAL TRANSFORMATION OF LARGE LAW FIRMS (1988). My emphasis here on factual inference is different, but not unrelated.

In this sense, my claim will support those who have called for renewed emphasis on lawyerly independence in corporate practice.[20] At the same time, however, I admit the costs and burdens associated with detachment, and so point in the end to something of a compromise. For reasons that are interesting in and of themselves, this middle ground will not be easy to stake claim to, making it all the more important that we discuss the issue openly and carefully. Part IV will then turn to ways in which certain substantive legal issues of concern to corporate-securities lawyers may be influenced by the insights we have developed.

II. THE RISK OF PROXIMITY: COGNITIVE BIAS AND CORPORATE DISCLOSURE

Lawyers learn about their entity clients and their situations in many ways. Some of it is documentary: reading files, letters and accounting reports. But putting aside the formal exercise of due diligence, most learning comes from talking to people associated with and usually employed by the company. Those people have the first-hand knowledge of the business and problems that require legal assistance, and hence the lawyer's "schema"—the term psychologists use to describe mental roadmaps that people use to make sense of a situation[21]—is initially driven by theirs'. During interviews and more informal (even gossipy[22]) conversations, savvy lawyers will try to figure out who seems reliable and trustworthy, and

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[20] *See* Robert W. Gordon, *Corporate Law Practice as a Public Calling,* 49 MD. L. REV. 255 (1990); Harold M. Williams, *Professionalism and the Corporate Bar,* 36 BUS. LAW. 159 (1980); Zacharias, *supra* note 2. Richard Painter has called for a notion of lawyer-client *inter*dependence, a posture that recognizes the moral responsibility for proactive behavior that comes from the indispensable role the lawyer plays within the organization. Richard W. Painter, *The Moral Interdependence of Corporate Lawyers and their Clients,* 67 S. CAL. L. REV. 507 (1994). I agree with his view; my emphasis on cognitive independence is simply a way of describing the need to avoid infection by the biases of the client. Painter's focus is on the need for such a lawyer to engage the organizational client vigorously.

[21] *See* SUSAN T. FISKE & SHELLEY E. TAYLOR, SOCIAL COGNITION 98 (1984).

[22] Long suspect, gossip has increasingly come to be treated by social scientists as a mechanism for learning about the thought processes of others and opening lines of communication with them, something that becomes quite functional in a business setting. *See* JAMES G. MARCH, DECISIONS AND ORGANIZATIONS 432-35 (1988).

weigh their accounts accordingly. The schema will evolve and become more elaborate as the lawyer has more and more contact with people and information. But its largely derivative nature will persist.

In pursuing the concept of cognitive independence, I recognize that there is a vast array of postures that lawyers assume vis-a-vis the client in the course of information-gathering. Some of this is a matter of choice, some of circumstance. A lawyer called into to advise a new client on a discrete, short-term matter rarely has the opportunity to come to know the client well—one or two interviews (sometimes over the phone), perhaps a lunch or dinner, will have to suffice. But continuous disclosure questions under the federal securities laws and comparable high-level legal judgments are usually answered by lawyers with a close, on-going relationship with the company. For purposes of discussing the risk of proximity, therefore, I simply want to posit a relationship in which the lawyer successfully "blends into" the clients' management group culture. This is most likely the case with respect to some in-house counsel,[23] or outside counsel that has built a long-term working relationship with an important client, where key lawyers in the firm spend a significant amount of their time on that client's business and interacting both socially and professionally with the client's managers. To be sure, no blending is ever absolute. As we shall pursue later on, lawyers do have a self-interest that is subtly at odds with their clients', and competing claims to their time and attention. I am sure, however, that there are commonplace situations where the lawyer does blend in to the corporate culture for all practical purposes.

If so, we can assume that the lawyers' perceptions of the client and its circumstances will be influenced heavily by the prevailing corporate belief system. That is not to say that the lawyer will always think like everyone else: disagreements

[23] It is important not to overgeneralize about in-house counsel, for the nature of the relationship between in-house lawyers and company managers varies greatly. *See* Robert Eli Rosen, *The Inside Counsel Movement, Professional Judgment and Organizational Representation*, 64 IND. L.J. 479 (1989); Ted Schneyer, *Professionalism and Public Policy: The Case of House Counsel*, 2 GEO. J. LEGAL ETHICS 449 (1988). No doubt there are many in-house counsel—especially in large, highly bureaucratized companies—whose independence exceeds that of outside counsel who have close social and business ties to senior management.

within groups are natural and often testy. Still, as discussed below, group bonding processes create centripetal pressures toward shared perceptions and explanations.[24] Remember that what the lawyer knows about the clients' business will usually be highly derivative: the lawyer who has blended well into the group may accept those perceptions and explanations fairly willingly. He is committed to the client, and wants to be a team player. Psychologists have shown that commitment heavily influences attitudes;[25] we are also motivated to like and believe those upon whom our success depends.[26]

This, then, describes a lawyer who is cognitively dependent on the client. And it follows that assessing the risks associated with cognitive dependence is first a matter of identifying the biases commonly associated with management groups as they interpret the risks and realities of their business. In other words, we must temporarily shift our focus away from the lawyer as such, and turn to corporate inference generally.

A. *Managerial Inference, Client Bias*

Most litigation involving corporate concealment or misrepresentation in the secondary markets—i.e., when the issuer is not buying or selling its own stock and thus has nothing directly to gain from deceit—involve situations where information is available to the company that indicates that finances are deteriorating, a particular product or strategy is failing, or that some key executive is acting improperly, yet the company's disclosure fails to take candid account of it. Some of the textbook cases of securities fraud in recent years—i.e., the litigation against Apple Computer regarding certain of its early

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[24] *See* James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83 (Summer 1985). In their study of decision-making by corporate directors regarding the termination of derivative suits, Cox and Munsinger offer a thorough explanation for the various social, cultural and psychological forces that cause persons who are part of a functioning group to adopt consistent and self-serving explanations and perceptions.

[25] *See* CHARLES A. KIESLER, THE PSYCHOLOGY OF COMMITMENT (1971); ELLIOT ARONSON, THE SOCIAL ANIMAL (7th ed. 1995).

[26] Steven L. Neuberg & Susan T. Fiske, *Motivational Influences on Impression Formation: Outcome Dependency, Accuracy-Driven Attention, and Individuating Processes*, 53 J. PERS. & SOC. PSYCHOL. 431 (1987).

1980s product failures[27] and Time-Warner's alleged concealment of its shift away from its plans for a strategic alliance with international partners as the solution to its debt problem[28]—come to mind immediately.

I am sure that some of the time, these kinds of deceptions (assuming they did occur) are indeed deliberate, whether in management's self-interest or in order to preserve some corporate confidentiality.[29] But I want to pursue here the professional responsibility implications of an alternative possibility; that cognitive biases lead managers to unrealistic causal explanations for events and an underestimation of risk.[30] These biases can be sharpened in institutional settings, becoming part of the company's belief system. In turn, the disclosure—which at least sometimes will affect the market for the stock[31]—is skewed by relatively sincere but unrealistic beliefs.[32] To perceptive lawyers who have worked closely with business people, their presence will not be too surprising.

One well recognized phenomenon, for instance, is the process of cognitive simplification. Psychologists emphasize that human beings (and organizations) must simplify their thought

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[27] *See In re* Apple Computer Sec. Litig., 886 F.2d 1109 (9th Cir. 1989).

[28] *See In re* Time Warner Sec. Litig., 9 F.3d 259 (2d Cir. 1993).

[29] *See* Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on the Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691. The Arlen-Carney thesis focuses only on intentional frauds, assuming for purposes of analysis that the scienter requirement limits liability to cases of deliberate misrepresentation.

[30] For a much fuller discussion of the motivational issue, particularly from a psychological and sociological standpoint, see 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) [hereinafter, Langevoort, *Organized Illusions*]. The emphasis here on cognitive bias should not be taken as the sole plausible alternative explanation. My other article explores a host of others, including the need for competitive secrecy and the problems of multiple audiences and distortions in information flow.

[31] The question of whether the disclosure affects the stock price is closely bound up in the efficient market hypothesis. *See infra* text accompanying notes 78-81.

[32] For a review, see Dennis A. Gioia, *Symbols, Scripts and Sensemaking: Creating Meaning in the Organizational Experience*, *in* THE THINKING ORGANIZATION: DYNAMICS OF ORGANIZATIONAL SOCIAL COGNITION 49 (Henry P. Sims & Dennis A. Gioia eds., 1986). For a relatively rare legal invocation of this sort of problem, see John C. Coffee, Jr., *"No Soul to Damn, No Body to Kick": An Unscandalized Inquiry into the Problem of Corporate Punishment*, 79 MICH. L. REV. 386, 391-92 (1981).

processes in order to manage daily affairs. There is too much to think about otherwise. And one way we do this is to develop stock explanations for what is happening. Once established, these "schemas" are naturally resistant to revision: to rethink our assumptions constantly results in cognitive paralysis.[33] This tendency to resist evidence of change is enhanced in group settings, where there is a well-recognized "groupthink" tendency not to introduce the stress that comes from challenging established common understandings.[34] One of the more fascinating articles published in recent years on business ethics—repaying careful study by all business lawyers—is a discussion of how Ford's product recall personnel missed danger signs associated with that vehicle's on-road performance precisely because of a well-established normalcy schema in a very noisy informational environment.[35]

Another such phenomenon is optimism. Put simply, there is much reason to believe that corporate cultures that subconsciously promote a pervasively optimistic frame of view are the most adaptive, leading to harder work and more long-term commitment by employees and other stakeholders[36] (and dampening through self-deception the awareness of danger that might otherwise trigger a cascade of selfishness). In a "can do" kind of organizational culture, there will be a natural tendency to deflect or rationalize emerging evidence of prob-

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[33] *See* Sara Kiesler & Lee Sproull, *Managerial Response to Changing Environments: Perspectives on Problem Sensing from Social Cognition*, 27 ADMIN. SCI. Q. 548 (1982); Daniel A. Levinthal & James G. March, *The Myopia of Learning*, 14 STRATEGIC MGMT. J. 95 (Spec. Issue, Winter 1993).

[34] *See* IRVING JANIS, VICTIMS OF GROUPTHINK: A PSYCHOLOGICAL STUDY OF FOREIGN POLICY DECISIONS AND FIASCOS (1972).

[35] Interestingly, this study was done by a well known organizational psychologist who before his professional training was a recall manager for Ford at the time of the problems. *See* Dennis A. Gioia, *Pinto Fires and Personal Ethics: A Script Analysis of Missed Opportunities*, 11 J. BUS. ETHICS 379 (1992).

[36] *See* James G. March & Zur Shapira, *Managerial Perspectives on Risk and Risk Taking*, 33 MGMT. SCI. 1404 (1987); MARTIN E.P. SELIGMAN, LEARNED OPTIMISM 100-12 (1991). The Seligman book is interesting for its discussion of the deliberate plan of Met Life to hire people for the sales force who have a natural optimistic bias; something perhaps troubling given the company's later legal difficulties with its sales practices. I have explored the effects of ego on law-related behavior in Donald C. Langevoort, *Ego, Human Behavior and Law*, 81 VA. L. REV. 853 (1995) [hereinafter Langevoort, *Ego*]. Related to optimism is a darker possibility: that managerial perceptions are simply self-serving. *See* Langevoort, *Organized Illusions*, *supra* note 30, at 143-46.

lems or risks, leading to the obvious potential for distorted disclosure. Faced with some evidence that a product under development is failing, or an erosion of market share, managers in many companies will honestly but mistakenly believe that these are minor challenges that can readily be overcome. They will draw on inflated schemas of past successes, and underrate their competitors ability to capitalize.[37]

It is hardly difficult to find securities law cases that fit with this set of explanations. Once again, the "product-hype" cases like *Apple* and *Polaroid* may well be examples of management groups underestimating the danger signals associated with failing products, convinced in their ability to make them work and intolerant of any official acknowledgment of likely failure. We can also speculate about others. One of the best-known enforcement proceedings by the SEC in recent years has been the one against Caterpillar Inc.[38] for failing to disclose the "known trend or uncertainty" of an erosion of profitability from its Brazilian subsidiary, which had contributed a disproportionate percentage of the company's profitability the previous year. Evidence showed that the company's senior management was aware of the underlying facts, so that this was not a case of ignored information. Why didn't the company's Management Discussion and Analysis, which requires disclosure of "known trends and uncertainties," include the risk of a reversal of fortunes in Brazil? Political sensitivity may have been one reason. But another could well have been management's biased expectation that overall company performance (of which the Brazilian operations were but a small part) would be managed in such a way that, indeed, the previous years disproportionality would not be misleading.[39]

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[37] For some useful studies of corporate decision-making along these lines, see 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); Mathew Hayward & Donald C. Hambrick, *Explaining the Premiums Paid for Large Acquisitions: Evidence of CEO Hubris*, 42 ADMIN. SCI. Q. 103 (1997).

[38] *See In re* Caterpillar Inc., EXCHANGE ACT RELEASE NO. 30532, March 31, 1992.

[39] The managed performance possibility, among others, is noted in Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 810-12 (1995).

A third well-recognized trait has to do with commitment. Once people have made some voluntary commitment to a person or course of behavior, there is a strong subconscious need to maintain consistency in the face of subsequent events, to justify the commitment to themselves and others. This underlies the well-known concept of cognitive dissonance. Thus, managers who make an investment are motivated to focus on the project's upside potential more than its downside risks, to bolster the wisdom of the choice.[40] The most dramatic form this takes in business settings is the escalation of commitment. A bank official who makes a bad loan may well foolishly make an additional loan to the borrower to try to cause a turnaround, motivated largely by the inability to admit a mistake in the first place—a reason that some banks carefully separate their work-out teams from the original lenders.

Once again, this insight can help explain the motivation underlying the alleged concealment of information in the product-hype cases. Institutions will resist acknowledging to themselves and others that they made a mistake. Preliminary problems are trivialized by reference to external causes that have been brought under control.[41] I am also convinced that this is a powerful explanation for the tendency of many managers to deny that a person in the organization—perhaps some key player—is incompetent or dishonest, even as the evidence mounts. I have written elsewhere about the likelihood that lawyers may not be good monitors of their clients' behavior;

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[40] The classic exposition here is Barry M. Staw, *The Escalation of Commitment to a Course of Action*, 6 ACAD. MGMT. REV. 577 (1981). Although there may be multiple explanations for the phenomenon, it is interesting to note how often in the case law on tender offer defenses and management buy-outs, directors commit early to a course of action (e.g., a merger with a particular partner) and refuse to alter their course, even though such rigidity risks violating a duty to the company's shareholders. *E.g.*, Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1990); Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1994).

[41] *See* Barry M. Staw & Jerry Ross, *Behavior in Escalation Situations: Antecedents, Prototypes and Solutions*, *in* 9 RES. IN ORGANIZATIONAL BEHAVIOR 39 (L. L. Cummings & Barry M. Staw eds., 1987).

having committed to the representation, they are motivated to see the client's activities as legitimate and thus ignore red flags.[42] The infamous OPM fraud case may well be an example of this.[43]

So, too, will a board of directors resist coming to grips with indications that a valued chief executive officer is acting corruptly. Here I find a potentially useful insight into the recent Section 21(a) report claiming that the board of directors of Cooper Companies Inc. violated their disclosure obligations in their unqualified support of their CEO, Gary Singer, notwithstanding evidence produced by an on-going SEC investigation that Singer had misused company assets and information for personal benefit and Singer's refusal to cooperate with an internal special counsel inquiry.[44] One can well imagine that the board was strongly motivated to trivialize or rationalize the evidence, and accept Singer's likely claims that the problems were the product of some bad judgments that will not be repeated, that his contributions to the success of the company far outweigh the costs of the indiscretions, and that the SEC investigation had turned into a bureaucratic witch-hunt. I suspect that these biases were also at work in some of the recent "rogue trader" cases,[45] where investment firms and other institutions failed to detect or take action in response to dangerous trading activity by key employees. Fast-rising talent at banks and investment firms, people like Paul Mozer[46] and John Jett,[47] were dedicated, personable and hard-working—

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[42] *See* Langevoort, *Where Were the Lawyers?*, *supra* note 4, at 101-05.

[43] *See* Langevoort, *Where Were the Lawyers?*, *supra* note 4, at 106-08.

[44] Report of the Investigation in the Matter of Cooper Cos. Inc., Exchange Act Release No. 35082, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,472 (Dec. 12, 1994).

[45] For contrasting discussions of the problem of policing rogue trader activity, compare Jerry W. Markham, *Guarding the Kraal—On the Trail of the Rogue Trader*, 21 J. CORP. L. 131 (1995) (optimistic about monitoring, though recognizing difficulties), with Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 CAL. L. REV. 627 (1996) (more pessimistic, though recognizing that some useful steps are necessary and appropriate).

[46] On the Mozer matter, see Michael Siconolfi & Laurie P. Cohen, *The Treasury Auction Scandal at Salomon—Sullied Solly: How Salomon's Hubris and a U.S. Trap Led to Leaders' Downfall*, WALL ST. J., Aug. 19, 1991, at A1.

[47] See Alix M. Freedman & Laurie P. Cohen, *Jett's Passage: How a Kidder Trader Stumbled Upward Before Scandal Struck*, WALL ST. J., June 3, 1994, at A1; these issues are considered further in Part IV.B *infra*.

not to mention profitable. The senior managers who hired, promoted and rewarded them had ample motivation to deflect subconsciously any dissonant information and give them the benefit of any doubt. It is hardly surprising that abuses persisted longer than they should have.

The three motivational forces described above hardly operate separately. In most organizations, it is their confluence that can produce the most severe distortions of reality in the corporate belief system. A company that faces some external risky shift in its environment wants to avoid the stress of acknowledging the threat—with the accompanying destabilization of group cohesion should change be needed—especially if the external threat calls into question the commitments made by the organization as a whole or its senior management. And it may well trivialize the most salient of the red flags by drawing on collective and individual myths of power and control.[48] Much of the literature on episodes of organizational failure in the 1980s and 90s invokes some combination of these accounts in telling their stories. Companies that have successfully weathered such crises are often those that resisted the biases and accepted the reality of the imminent risk of loss, often engaging in wholesale dismissals of senior executives in order to facilitate the necessary cognitive readjustment. No doubt the public disclosures by companies in crisis reflected the way they dealt with the threats internally, unless their lawyers intervened both carefully and vigorously.

Of course, the behavioral accounts here gradually merge into ones that fit the more orthodox economic story as well: management buying time through more deliberate concealment and deception in an effort to take one last shot at saving their jobs. But that may come relatively late in the process, after the managers have underestimated the problem and committed themselves to a course of action (or inaction) that they are highly motivated to rationalize both to themselves and external constituencies. Once realization finally does set in, they are

[48] The tendency to draw on outdated schemas in times of stress is emphasized in Paul C. Nystrom & William H. Starbuck, *To Avoid Organizational Crises, Unlearn*,12 ORG. DYNAMICS, 53, 57-58 (1984). No doubt the difficulty in spotting the potential for crisis is that many such crises appear quickly. Even though external support may be softening, that is rarely expressed openly. Only when there is some triggering event does support vanish quickly.

already in very deep. In other words, the last period problem may be a serious concern, but it is probably more delayed in its onset and shorter in its duration—and thus all the more intense when it does emerge—than the standard rational-actor account would suggest.

From the foregoing, we can predict that the cognitive challenges to the lawyer will vary depending on the age and circumstances of the company in question. Younger firms have less well developed internal cultures, and hence less rigid belief systems.[49] Those beliefs are more likely to be dominated by the personalities of the company's founders. With fewer cognitive commitments, there is greater flexibility. No doubt the greatest threat to accurate disclosure for young companies comes from overoptimism.[50] These firms have grown quickly, overcoming the obstacles that face all start-ups through some combination of skill and luck. They often rely heavily on the cohesiveness and enthusiasm of a small group of executives, often dominated by a single charismatic founder, with an extraordinarily high sense of skill and ability that is untempered by time and experience. These managers will place great weight on hiring new managers with similar traits and transmitting their "can do" optimism throughout the firm, resisting the enthusiasm-draining acknowledgement of uncontrollable risk. This is probably part of the story underlying many of the high tech fraud allegations that, meritorious or not, are the subject of so many securities class actions.

In contrast, aging firms are frequently more rigid. Here, leadership by top management may often be more an illusion rather than a reality.[51] Their response to external risks are more likely to be affected by the pressure to preserve existing norms and commitments. Indeed, in many cases—once external threats are finally acknowledged—the first response of top management is to increase the centralization of control and decision-making authority, which has the unintended and dan-

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[49] *See* W. Richard Scott, *The Adolescence of Institutional Theory*, 32 ADMIN. SCI. Q. 493 (1987).

[50] *See* Leslie E. Palich & D. Ray Bagley, *Using Cognitive Theory to Explain Entrepreneurial Risk Taking*, 10 J. BUS. VENTURING 425, 433 (1995).

[51] *See* James R. Meindl, *On Leadership: An Alternative to the Conventional Wisdom*, *in* 12 RES. IN ORGANIZATIONAL BEHAV. 159 (L.L. Cummings & Barry M. Staw, eds., 1990).

gerous effect of reducing the flow of useful information to the top.[52] Lower level managers abet this by distancing themselves from crucial decisions, lest they be tainted completely by the ensuing failure. This further narrows the focus and range of options considered by the top managers, leaving them to draw excessively on their own (and now misleading) past experiences, thereby making decline all the more likely. Moreover, if the initial response is too conservative, that commitment by itself will bias the managers subsequent perceptions, making it hard to reverse the effects of the judgmental error. One is reminded, for example, of Pan Am's decision to sell off more and more of its most profitable nonairline assets as its primary strategy for preserving the core institution, when external circumstances suggested that it was the core institution that needed to be rethought in light of airline deregulation.[53] One of the best-known securities fraud cases of the early 1970s, the set of lawsuits by stockholders and commercial paper investors of the Penn Central railroad, also fits this pattern.[54]

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[52] *See* Robert I. Sutton, *Organizational Decline Processes: A Social Psychological Perspective, in* 12 RES. ORGANIZATIONAL BEHAV. 205, 223-26 (L. L. Cummings & Barry M. Staw eds., 1990); Barry M. Staw et al., *Threat-rigidity Effects in Organizational Behavior: A Multilevel Analysis*, 26 ADMIN. SCI. Q. 501, 508-511 (1981). Not all companies act in such a way, of course. For an exploration of the possible precursors, see William Ocasio, *The Enactment of Economic Adversity: A Reconciliation of Theories of Failure-Induced Change and Threat Rigidity, in* 17 RES. ORGANIZATIONAL BEHAV. 287 (L. L. Cummings & Barry M. Staw eds., 1995). Though it would help lawyers greatly, there is no model that predicts ex ante the extent to which one organization is more subject to bias than another.

[53] *See* Barry M. Staw & Robert I. Sutton, *Macro Organizational Psychology, in* SOCIAL PSYCHOLOGY IN ORGANIZATIONS: ADVANCES IN THEORY AND RESEARCH 350, 369 (J. Keith Murnighan, ed. 1993).

[54] For an interesting academic study of Penn Central's decline, which attributes it more to bad judgment than misfeasance (as was later alleged in SEC and Congressional investigations), see STEVEN SALISBURY, NO WAY TO RUN A RAILROAD: THE UNTOLD STORY OF THE PENN CENTRAL CRISIS (1982). A natural question in light of this is whether debacles such as Penn Central shouldn't lead companies to learn to be more rational and flexible, i.e., whether there is not likely to be an evolutionary migration toward the rational firm. The various responses—e.g., the difficulties of learning, the "on average" adaptive qualities of optimism, and the contingent and changing nature of challenges arising within the corporate environment—are considered in Langevoort, *Organized Illusions*, *supra* note 30, at 148-56.

B. *The Lawyer's Place*

Once we acknowledge the possibility of corporate bias, we can plainly see a vexing challenge to the corporate lawyer who must guide her organizational client through the process of disclosure: she must worry about contagious bias. That lawyer may find herself cognitively overdependent on the client for factual inferences, and thus unable to exercise the kind of objective legal judgment necessary to arrive at sound disclosure decisions. She can become so much a part of the client "team" that she shares all the motivations and attitudes that affect the management group.

This is especially the case if the lawyer has actually been involved in a decision or assisted a course of action, so that she, too, is motivated by commitment to bolster the choice. The well-connected lawyer assumes in-group status, and the various in-group biases follow. There are strong temptations pushing the lawyer in this direction. Team players are highly valued, and can expect continued business from the client. As negotiators and advocates (in contrast to the purely advisory function), internalizing the company's belief system probably results in greater loyalty and zealousness—highly adaptive traits for an ambitious lawyer or firm. Here, the optimism and sense of control that can enhance managerial performance bolsters the lawyer's performance as well, albeit with the same kinds of risks that are the unavoidable by-product of too much comfort and confidence. And, frankly, many lawyers want to be "in-group" for reasons of personality, status and sociability.

Nor is it likely that this loyalty and zealousness will be any more a cynical act of dramaturgy for lawyers than it is for managers.[55] Cognitive dissonance theory suggests the strong need to maintain consistency between adaptive attitudes and beliefs and the lawyer's commitment to the representation. The commitment dominates, and the beliefs and attitudes migrate toward conformity. Anxiety is diminished and effectiveness enhanced if the lawyer believes what the client believes rather than carrying the baggage of nagging, distracting doubts.[56] In

[55] This is not to say that lawyers do not posture for their clients. *See* John Flood, *Doing Business: The Management of Uncertainty in Lawyers' Work*, 25 L. & SOC'Y REV. 41, 44-45 (1991).

[56] As noted earlier, highly focused belief that one is both right and in control

sum, there are ample conformity pressures that incline the lawyer toward the internal, self-deceptive acceptance of the organization's positive belief system that defines cognitive dependence.[57]

III. COGNITIVE INDEPENDENCE AND THE DILEMMA OF DISTANCE

Now that we have defined and explored the risks of managerial bias and cognitive dependence, the notion of cognitive independence follows naturally. A securities lawyer is cognitively independent when he has effected sufficient separation from the inferential biases of the corporation's belief system so that it is possible to exercise good judgment relating to materiality and the duty to disclose. Such independence, of course, is important to all corporate lawyers in their counselling function, far beyond disclosure matters.[58]

Cognitive independence is not a question of status or physical proximity, but of state of mind. It involves a sophisticated understanding of the risks of bias, and a recognition that judgments of the accuracy of the perceptions of individual managers cannot be made simply by estimating whether they are good, trustworthy people. Lawyers probably overestimate the extent to which they can make such credibility judgments

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of the situation leads to more aggressive, persistent and influential behavior. *See supra* note 36. In organizational settings, moreover, there is evidence that believing that the employer is "right" reduces internal moral conflict and thus leads to greater personal effort and efficacy. *See* Barry Z. Posner & Warren H. Schmidt, *Value Congruence and Differences Between the Interplay of Personal and Organizational Value Systems*, 12 J. BUS. ETHICS 341 (1993).

[57] A similar argument regarding the dangers facing accountants and auditors can be found in Max A. Bazerman et al., *The Impossibility of Auditor Independence*, 38 SLOAN MGMT. REV. 89 (Summer 1997). There is also a simpler source of dependency. Putting aside all the motivational influences, we must remember that lawyers are not auditors, and generally have to rely on managerial sources of information and insight, especially with respect to subjective matters like business risk. There is an inevitable social learning component to the fact-gathering task. A lawyer who is too trusting of the accuracy and completeness of what one or more managers says about a matter runs the risk of being tainted by their biases even if the lawyer has not achieved in-group status.

[58] In the abstract, at least, the value of detachment in rendering advice is beyond question. Clients want sound advice, not simply comforting or reinforcing advice. *E.g.*, KRONMAN, *supra* note 13, at 66-74; Mark A. Sargent, *What Does It Take?: Hallmarks of a Business Lawyer*, 5 BUS. L. TODAY, July/Aug., 1996, at 11, 13 n.6.

anyway,[59] but honesty is never the whole question. Fortunate corporate lawyers will have as clients companies with thoughtful managers who do see things realistically and without bias. Although biases may be pervasive, distortion that has a material effect on corporate disclosure is the exception, not the rule. But the skilled corporate lawyer must be sensitive to the frequency with which good people (and good organizations) distort reality, the circumstances that exacerbate such tendencies, and the unconscious pressure that she faces to follow those inferences. She should be prepared to question managerial perceptions in light of these predictable biases and try to reorient the disclosure.

I could end this lecture here. Cognitive independence is essential to good corporate-securities counselling. Our profession's habitual incantations of the virtue of detachment notwithstanding, it deserves more thorough and deliberate recognition by the bar. Such independence is an acquired skill that depends on understanding both human and organizational nature: it can and should explicitly be studied, taught and learned in the same way that corporate managers are being taught in business schools and executive seminars to try to debias their own thinking and learn the proper times to shift to a different "script."[60] Just as importantly, law firms must attend to their own cultures: they should not, through their own emphasis on profitability, business generation, and client service, generate a "customer is always right" bias if they are to do their jobs well. If I have succeeded in persuading the reader of this, I have accomplished a good bit.

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[59] On this overestimation of the ability to judge character, see Peter J. DePaulo et al., *Lying and Detecting Lies in the Organization*, *in* IMPRESSION MANAGEMENT IN THE ORGANIZATION 377 (Robert Giacalone & Paul Rosenfeld eds., 1989). Even judges do not do particularly well in tests. *See* Paul Ekman & Maureen O'Sullivan, *Who Can Catch a Liar?*, 46 AM. PSYCHOL. 913 (1991).

[60] *See* Meryl R. Louis & Robert I. Sutton, *Switching Cognitive Gears: From Habits of Mind to Active Thinking*, 44 HUM. REL. 55 (1991). The debiasing literature emphasizes that although avoidance of excessive reliance on cognitive heuristics is important, learning to do so is much more easily said than done. *See* Baruch Fischoff, *Debiasing*, *in* JUDGMENT UNDER UNCERTAINTY (Daniel Kahneman et al. eds., 1982). On some techniques for training, see Max Bazerman, *supra* note 37, ch. 10.

A. *The Difficulties and Burdens of Distance*

Unfortunately, there is far more to the problem, causing me to see the question of cognitive independence in terms of both necessity and dilemma, and thus I want to extend the discussion further. We have already established one reason that cognitive independence is difficult to achieve. Usually, the lawyer is motivated to believe what the client's management group believes, and the tendency to conform will occur subconsciously. The egocentric attributions that can distort managers' self-evaluations can also taint lawyers.[61] A lawyer may well consciously embrace the need for independence: proclaiming its virtue to others, convinced that she lives out the professional ideal of sympathetic detachment. But in practice, her perception may still be distorted in order to reduce the stress of dissonance.[62] Probably far more lawyers pride themselves on independence and good judgment than consistently exhibit it. It becomes easy to see cognitive dependence as *other* lawyers' problem.

Such hubris is not easy to overcome. People rarely learn well from their own mistakes of judgment because they either fail to acknowledge them or externalize much of the blame.[63] Learning from the mistakes of colleagues, assuming that these mistakes are publicized at all, is difficult as well. It is probably better to intervene early, allowing young lawyers to glimpse situations where honest, decent lawyers (hypothetical or real) fell prey to distorted judgment, and let them recognize both the breadth and depth of the difficulty, hopefully generating a

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[61] *See* Langevoort, *Ego*, *supra* note 36, at 860-65; for empirical studies of self-serving inference by lawyers, see George Lowenstein et al., *Self-Serving Assessments of Fairness and Pretrial Bargain*, 22 J. LEGAL STUD. 135 (1993); Theodore Eisenberg, *Differing Perceptions of Attorneys Fees in Bankruptcy Cases*, 72 WASH. U. L.Q. 979 (1994); Loftus & Wagenaar, *Lawyers' Predictions of Success*, 28 JURIMETRICS J. 437 (1988).

[62] Indeed, albeit at the risk of overanalyzing, it is worth noting the tendency of human beings to deal with unconscious guilt-inducing forces to become obsessed with the matter as exhibited in others (transference). Lawyers whose independence is compromised may be the ones given to the most public insistence on the need for professional independence and a ready ability to spot problems in the independence of others. Their own compromises remain a blind spot.

[63] See the discussion of the self-esteem bolstering use of excuses in C.R. SNYDER ET AL., EXCUSES: MASQUERADES IN SEARCH OF GRACE 55-58 (Raymond L. Higgins & Rita J. Stucky eds., 1983).

"There but for the grace of God . . ." response. This debiasing is a job for legal scholars, law schools and bar associations. Law firms might use senior lawyers not involved with a particular client as independent sounding boards on fact perception, though this is probably of limited utility given the contextually complex nature of such judgments.

Suppose, however, that a lawyer acknowledges the pressure toward dependence and the resulting need for careful self-monitoring. A strong message of the previous section is of the need for some skepticism of management's optimistic assessment or dismissal of risk. But there are also costs associated with too much questioning. First, it is distracting. If materially-significant cognitive distortions are the exception rather than the rule, as suggested earlier, then questions and demands for independent assessment by a lawyer who is a step removed from the business situation both in terms of familiarity and expertise will introduce an unnecessary burden most of the time. This burden comes both in the form of time and expense in responding to the lawyer, as well as the introduction of doubt and stress—the very things that these biases are adaptively designed to avoid. In some sense, the "realistic" lawyer may debilitate the group by threatening its solidarity and optimism.

There is also an informational risk to the quality of legal advice associated with too visible a posture of detachment and skepticism. Management teams no doubt test their lawyers for loyalty, and may well use the lawyer's willingness to conform to their perceptions as a proxy. The lawyer who repeatedly expresses doubt hardly endears herself to the client's managers; failure to show loyalty to the group, and the group's beliefs, is likely to result in exclusion from the inner circle and hence loss of access to key information and insight. She becomes part of the out-group rather than the in-group,[64] and information blockage may well follow—assuming that the representation is even allowed to continue.

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[64] For a classic study of the "plasticity" needed to become accepted in managerial circles, see ROBERT JACKALL, MORAL MAZES: THE WORLD OF CORPORATE MANAGERS ch. 3 (1988). On the varying responses in corporate settings to identical criticism whether from in-group or out-group members, see IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION 105 (1992).

B. *The Uneasy Techniques of Mediation*

Being a cognitively independent lawyer is difficult and stressful enough internally. But ultimately, the client's management is in control of both the underlying facts and the output of corporate disclosure, and the lawyer's professional responsibility offers her little leverage over the management group.[65] When factual assessments are subjective and hence multiple good faith interpretations possible, the lawyer is not barred from rendering assistance.[66] Usually, the lawyer will only suspect, not know, that the managers are being unrealistic. In the end, then, the good lawyer—the one who does not simply suffer a failure of will when faced with the challenge[67]—must effectively negotiate with the managers for both undistorted access to information and influence over the disclosure process. She must also do so in a way, as noted above, that does not jeopardize her in-group status or result in diminished access to information.

[65] Under the prevailing rules of professional responsibility in most jurisdictions —and acquiesced in by the SEC—the lawyer confronted with client fraud may not publicly blow the whistle. Resignation or internal efforts to rectify are the only options, and although some resignations can be accomplished "noisily," *see* Ronald Rotunda, *The Notice of Withdrawal and the New Model Rules of Professional Conduct: Blowing the Whistle and Raising the Red Flag,* 63 OR. L. REV. 455 (1984); ABA Comm. on Ethics and Professional Responsibility, Formal Op. 366 (1992), the lawyer's bargaining position is limited. The demise of private aiding and abetting liability under the federal securities laws, *see* Central Bank of Denver v. First Interstate Bank, 511 U.S. 164 (1994), further dampens the attorney's incentive to resist. Note, however, that recent reforms in the American Law Institute's Law Governing Lawyers would increase the attorneys' obligations and discretion in these settings.

[66] Withdrawal or noninvolvement is required as a matter of professional responsibility only when the lawyer *knows* that the client's course of action is unlawful or fraudulent. *See* MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2(d) (1997). Where management is acting in good faith, albeit subject to possible bias, there are rarely sufficient grounds for "knowing" that they are wrong.

[67] Richard Painter's construct of moral interdependence is relevant here. His concern, which he illustrates with reference to the SEC's Rule 2(e) proceeding against two lawyers who gradually tried to distance themselves from their client's fraud (*In re* Carter, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847 (Admin. Proc. 1981)), is that lawyers sometimes too easily seek to distance themselves from management's illicit preferences—perhaps deceiving themselves about their nature and consequences of their inactivity. Such distancing deprives the entity of an important source of protection and can actually send the unintended message to those managers that what they are doing, though not proper, is not sufficiently serious to provoke a stronger adverse reaction from the lawyer.

If legal requirements are clear enough, this will not be difficult. But most forms of risk disclosure are subjective and probabilistic, and here, the difficulty is plain. When a lawyer challenges management's overly optimistic assessment or dismissal of some risk, the natural reaction is rarely one of welcome. Because of its adaptive nature, managers will not easily drop their optimism simply because a lawyer has a different point of view. Just as likely, if not more, they will dismiss the lawyer's view as inexpertly alarmist, lacking in sufficient business experience or acumen. Like many people, their reaction to a threatening message will, in essence, be to "shoot the messenger" (i.e., deflect the message by challenging the credibility or competence of the source). The right response is a persistent, tactful assessment of the risk of litigation, bad publicity and other adverse consequences from potential nondisclosure, emphasizing the risks of hindsight. For many clients, especially those where the securities law compliance function has become well-routinized, this will be enough. But sometimes, management may have too much at stake in its own belief system.

If management balks, there are two conventional, but problematic, responses short of giving in and washing one's hands of the consequences. One is to draft the disclosure in a way that discloses a risk but talks about it in distant, hypothetical terms. I suspect that one explanation for the prevalence of boilerplate disclosure is that it represents an easy compromise between the lawyer's insistence on disclosure and management's refusal to acknowledge, publicly or to themselves, that the risk is a real one that they may not be able to control.

Boilerplate, however, is hardly the best solution, for it is too easy for a judge or jury to disregard later on.[63] The best risk disclosure is customized and contextual. One need only look at the recent safe-harbor for forward-looking information in the Private Securities Litigation Reform Act of 1995—the protection for disclosure that contains meaningful cautionary

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[63] *E.g., In re* Donald Trump Casino Sec. Litig., 7 F.3d 357 (3d Cir. 1993) (discussing the "bespeaks caution" doctrine).

language, and is not boilerplate[69]—to see the risk of compromised disclosure and the benefits of candor. The independent lawyer needs to push harder if she can.

Another conventional response is to overthreaten. If it seems necessary, the lawyer can skew a presentation by dramatically inflating the risk either a lawsuit or a judgment, trying to instill the sharp fear that even if they are right in trivializing or ignoring the risk, the chance of being second-guessed wrongly is simply too great. The problem here, of course, is that the lawyer must essentially be dishonest with the client, albeit with the best of intentions. And that, as we shall see in the next subsection, can become a very slippery slope.[70] I do have a suspicion that the apparent misperception among corporate managers and boards of directors of the relatively high risk of a securities class action (or SEC investigation)—statistics notwithstanding[71]—may be due at least in part to the way some corporate lawyers have portrayed those risks to them in an effort to overcome their natural reluctance or apathy with respect to disclosure obligations.

C. *The Lawyer's Own Self-Serving Bias*

A third problem inherent in the notion of cognitive independence mirrors a discussion found in the debate over lawyers' independence generally. Once the lawyer accepts the need to sometimes second-guess the managers' perception of the facts and circumstances and exercise independent judgment, there is an inevitable risk that this judgment will itself

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[69] *See* new § 21E(c) of the Securities Exchange Act, and H.R. CONF. REP. No. 104-369, at 11 (1995). The SEC has expressed concern with the boilerplate quality of many post-legislation filings that seek the protection of the safe-harbor.

[70] This problem is explored in Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375 (1997).

[71] There is factual evidence that calls into question whether there has been an explosion in class action litigation at all, making it problematic to describe the situation as a crisis. *See* Joel Seligman, *The Merits Do Matter*, 108 HARV. L. REV. 438 (1994). Similarly, an SEC investigation is (given the Commission's limited resources) unlikely. No doubt there is a good bit of randomness to adverse consequences flowing from biased disclosure.

be distorted by the lawyer's own self-interest. Robert Rasmussen and I have written about this in detail elsewhere,[72] so my discussion here will be fairly summary.

Lawyers have a strong self-interest in the advice they give. Even conceding the importance of not cheating in the short-run if it would jeopardize repeat business from a client relationship, some advice leads to more billable hours on a project than others. As we have just seen, questioning the client is time-consuming. Just as important, however, is the reputational asymmetry. 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. James Freund observes this in his book on client counselling.[73] Also apt along these lines is a fascinating study by Edelman, Abraham and Erlanger of the way both business lawyers and human resource specialists have seemingly inflated the threat posed by wrongful discharge law, with a resulting gain to them in power and resources within client organizations.[74] And just as managers can distort reality when believing that they are acting in the corporation's best interests, so can lawyers dwell excessively on risk while considering themselves fully loyal to their client's interests.

This inclination will be offset when the lawyer bonds too completely with the client's management group. Once the lawyer internalizes the group's motivation to deflect or rationalize risk, her interest in solidarity and whatever other needs are met by inclusion may come to dominate the tendency to spot

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[72] Langevoort & Rasmussen, *supra* note 70; from a different angle, see Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347 (1996).

[73] FREUND, *supra* note 7, at 40-50.

[74] Lauren Edelman et al., *Professional Construction of Law: The Threat of Wrongful Discharge*, 26 L. & SOC'Y REV. 47 (1992).

and dwell on disclosure risks. This is especially so if the lawyer has some means of avoiding apparent responsibility for the final disclosure judgment calls.[75]

A deliberate posture of cognitive independence, on the other hand, permits this self-interest to surface. To a limited extent, this is probably a good thing—self-interest boosts the lawyer's motivation to resist management's biases. However, when the lawyer becomes too independent of the client's way of thinking, the anchor of client interest may be displaced in favor of one that is based too much on the lawyer's reputational and pecuniary interests. The problem then becomes lawyer involvement in the disclosure process that overcompensates for managerial bias and results in a risk of excess disclosure and a chilling of useful impression management techniques above what a rational cost-benefit analysis would require. This, too, may be an explanation for the seemingly excessive fear of litigation and enforcement that has been inculcated in many corporate officers and directors. As some of the commentators on Kronman's call for lawyer-statesmen have pointed out, independence may be a virtue that masks the profession's ability to gain at unwitting clients' expense.[76]

For all these reasons, we cannot embrace cognitive independence without also acknowledging its subtle dangers. The truly good corporate lawyer must seek independence, but recognize the difficult terrain of its path and the sometimes selfish temptations lawyers face along the way. Our profession should at least be willing to provide a map and a compass.

IV. EXTENSIONS INTO LAW: SECURITIES LITIGATION, COMPLIANCE SYSTEMS, AND THE LAWYER-DIRECTOR PROBLEM

If we accept that corporate beliefs can sometimes be distorted without malice or deliberate deception and that lawyers may be subject to the their strong pull, more follows than a lesson in professional responsibility. This section will explore connections between the behavioral insights just generated and three substantive legal topics that have a heavy "lawyer-

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[75] *See supra* text accompanying notes 65-66.

[76] *See, e.g.*, Wilkins, *supra* note 15, at 470-71.

ing" component: the incidence of securities litigation, the duty to supervise and monitor as part of corporation and securities firm compliance programs, and the debate over the lawyer as director of a client corporation.[77]

A. *Securities Litigation*

1. The Risk of Judgmental Error

As noted earlier, securities law orthodoxy sees the problem of issuer disclosure as one of conventional fraud (or perhaps negligent misrepresentation). Epistemologically, companies are deemed to know all the relevant information that is in the possession of insiders acting within the scope of their authority; the practical question in litigation is whether any of those insiders were deliberately misrepresenting or concealing it or its implications, or failed to respond to flags that would be a dark enough shade of red to any objective observer. We have seen now, however, that this is simplistic. What the management group knows is bound up in its subjective construal, and predictable biases will sometimes lead managers to fail to appreciate problems and risks that would be significant to someone on the outside, especially in times of corporate stress. Unless company lawyers effectively counter the biases, disclosure may well be false and misleading to investors as a result —the trigger point for a class action or SEC enforcement proceeding.

[77] Obviously, these are not the only subject areas implicated. The lessons of cognitive bias and the struggle for objectivity come into play on a regular basis in corporate boardrooms and executive suites—derivative suits (as explored by Cox and Munsinger, *supra* note 24) and tender offer defenses being only some of the more dramatic examples. We could well engage in a profitable inquiry into the business judgment rule and self-dealing problems, where managerial self-serving inference is likely to be commonplace but, because of the deference given to "independent" director decision-making as a matter of law, the lawyer has *less* persuasive leverage than in disclosure settings. Here, I suspect, the tendency to sharpen and overstate the legal risks involved is strong as the lawyer—for a variety of reasons—seeks to exercise control over the situation.

Fortunately, the teachings of the efficient market hypothesis assure that these biases will frequently be harmless.[78] Investment analysts and other professionally informed investors are able to discount the most predictable forms of overoptimism and the illusion of control. Their independent sources of information may expose well the risks that management ignored or trivialized.[79] As in the *Apple Computer* case,[80] courts fairly consistently afford companies a "truth on the market" defense in private litigation when they can show that the excessive optimism or nondisclosure did not in fact mislead market professionals. Courts are also increasingly willing to presume that general expressions of managerial optimism are immaterial per se.[81]

Salutary as market efficiency can be in many instances, it is not a cure-all for the influence of behavioral biases on corporate disclosure. First, of course, many issuers trade in markets that are not characterized by a high degree of professionally informed trading.[82] Second, management remains in tight possession of the most sensitive forward-looking information. In the end, analysts are still influenced by subjective managerial assessments of the company's prospects and risks—earnings and forecasts are highly material notwithstanding analysts' other sources of insight.[83] Management remains a

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[78] The standard legal text on the ways that markets cure individual errors is Ronald Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984). From a legal standpoint, the primary teaching of the efficient market hypothesis is that market prices are set by informed investors, who react promptly to new information. Uninformed traders have no significant price impact. On the efficient market hypothesis and forward-looking information, see Roger Dennis, *Mandatory Disclosure Theory and Management Projections: A Law and Economics Perspective*, 46 MD. L. REV. 1197 (1987).

[79] Analysts talk regularly to competitors, suppliers and customers—as well as to the company itself—to assess the company's future prospects. In this way, they will often be in a position to see the same risks that management may ignore.

[80] *In re* Apple Computer Sec. Litig., 886 F.2d 1109 (9th Cir. 1989).

[81] *E.g.*, Eisenstadt v. Centel Corp., 113 F.3d 738 (7th Cir. 1997); Raab v. General Physics Corp., 4 F.3d 286 (4th Cir. 1993). *Eisenstadt* goes so far as to suggest that because professional investors discount managerial optimism, the literal truth could have a misleading market impact because it would be so unexpected.

[82] On the conditions for efficiency, see Virginia Bernard et al., *Challenges to the Efficient Market Hypothesis: Limits to the Applicability of the Fraud on the Market Theory*, 73 NEB. L. REV. 781 (1994).

[83] Thus, company contacts with investment analysts are common and, by all accounts, capable of affecting markets through selective disclosure. On the new

filter through which key information flows, and the possibility of a filtration bias cannot be eliminated even in efficient markets. Analysts will assess credibility and reputation for objectivity, but such judgments are subject to substantial variability given the turnover of key personnel and—more importantly—situational changes. Credibility assessments are rough guesses, sometimes inaccurate[84] and subject to manipulation. They are an incomplete substitute for other forms of control. Finally, albeit more controversially, there is an increasing body of evidence that "noise traders" (i.e., those who are not professionally informed) can and do move stock prices significantly.[85]

If we concede that these biases can sometimes distort the market price of a security, then interesting conceptual problems ensue for securities litigation policy. They are less pressing under the enforcement regime of the Securities Act of 1933, which imposes an affirmative obligation of inquiry into the company's prospects and financial condition for public offerings. Obviously, the due diligence investigation by accountants,

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information content of one form of forward-looking information, the MD&A, see Stephen H. Bryan, *Incremental Information Content of Required Disclosure Contained in the MD&A*, 72 ACCT. REV. 285 (1997). It is worth noting, moreover, that institutional investors are the primary claimants in most fraud class actions: their expertise does not eliminate their ability to be deceived by company disclosure, however privileged their access is to it. *E.g.*, Elliott Weiss & John Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053 (1995). In as notorious an alleged fraud as Penn Central, a primary "victim" was Goldman Sachs. *See* Salisbury, *supra* note 54, at 178-80.

[84] Though it is beyond the scope of our discussion here, the possibility of cognitive bias affecting the investment decisions of professional investors is not insubstantial. For example, one might well expect even professional investors to have a tendency to hold onto a stock too long, a manifestation of the commitment bias. *See* Hersh Shefrin & Meir Statman, *The Disposition to Sell Winners Too Early and Ride Losers Too Long*, 40 J. FIN. 777 (1985); DAVID DREMAN, THE NEW CONTRARIAN INVESTMENT STRATEGY (1980). Hubris is quite possible among investment professionals. *E.g.*, David Hirshleifer et al., *Security Analysis and Trading Patterns When Some Investors Receive Information Before Others*, 49 J. FIN. 1665, 1686 (1994). Professional investors may be overconfident in their ability to assess management's credibility and competence, and reluctant to admit error to themselves or others.

[85] *E.g.*, Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic and Policy Analysis*, 47 STAN. L. REV. 7 (1995); Claire Hill, *Why Financial Appearances Might Matter: An Explanation for "Dirty Pooling" and Some Other Types of Financial Cosmetics*, 22 DEL. J. CORP. L. 141 (1997).

underwriters and specialized counsel—all outsiders less likely to be blinded by management's biases—is a good, if not entirely perfect, antidote. At most, the lesson here simply reinforces the desirability of double-checking management's risk assessments with key suppliers, customers and analysts.[86] Perhaps we should worry a bit more about the loss of due diligence in an era of shelf registration and the move toward "company registration."[87]

The much more interesting questions arise under the Securities Exchange Act, where private litigation (and a fair segment of SEC enforcement) is premised on Rule 10b-5, which in turn requires a showing that the misrepresentation or omission was made with scienter.[88] Rule 10b-5 is the primary control mechanism for a wide range of corporate disclosure activity, from everyday publicity to, after the *Gustafson* case,[89] primary capital raising activity via nonpublic offerings of securities.

At first glance, the behavioral insights suggest a significant risk of underinclusion. If scienter means either knowing misrepresentation or concealment or (in its recklessness variant) a conscious disregard of a known or obvious risk,[90] then many of the distortions we have identified should fall outside the scope of the rule.[91] Cognitive bias is consistent with sin-

[86] Increasingly, this is a standard practice among high quality issuer and underwriters' counsel. *See, e.g,* John Seegal, *Due Diligence Procedures in Initial Public Offerings, in* PRACTICING LAW INSTITUTE, HOW TO PREPARE AN INITIAL PUBLIC OFFERING 251 (B4-7043 April 19, 1993).

[87] *See* Sec. Act Rel. No. 7314, [1996 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,823 (July 25, 1996). It is at least possible, on the other hand, that mandatory due diligence is of less importance for larger companies entitled to utilize these simplified procedures given the extent to which professional analysts can more easily (though not completely) detect fraud in such companies. *See* Stephen Choi, *Company Registration: Toward a Status Based Antifraud Regime,* 64 U. CHI. L. REV. 567 (1997).

[88] *See* Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

[89] Gustafson v. Alloyd Corp., 513 U.S. 561 (1995).

[90] Increasingly, this subjective definition of recklessness, as articulated in cases such as *Sanders v. John Nuveen & Co.,* 554 F.2d 790, 793 (7th Cir. 1977), is the common one. For an exploration of its indeterminacy, see Paul Milich, *Securities Fraud Under Rule 10b-5: Scienter, Recklessness, and the Good Faith Defense,* 11 J. CORP. L. 179 (1986).

[91] This brings us to one of the great underexplored issues under Rule 10b-5: the meaning of scienter in a corporate environment. *See* Craig Griffin, *Corporate Scienter Under the Securities Exchange Act of 1934,* 1989 BYU L. REV. 1227. The

cerity; it does not demonstrate bad faith. If so, this would be a powerful defense in litigation; the apparent problem would be that Rule 10b-5 is not up to the task of policing biased inferences. A broad defense would justifiably trouble those whose concern is more with protecting marketplace integrity than assessing whether the defendant had a sufficiently dark heart (especially when the defendant is a fictional entity that, literally at least, has no heart).

But practically speaking, this possibility is probably overstated. One is hard pressed to find the "cognitive bias" defense as a commonplace trial strategy. Judges and jurors are unlikely to be moved by it. After all, they are viewing the case in hindsight, when a risk that management underestimated did indeed come to pass. Ample research in psychology demonstrates that once people are told of an outcome, they systematically overestimate the likelihood that they could or would have predicted that outcome in advance. In the words of the leading researcher on the subject, Baruch Fischoff, people "not only tend to view what has happened as having been inevitable but also to view it as having appeared 'relatively inevitable' before it happened."[92] And reminding them to ignore the subsequent

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courts have done a much better job of showing what scienter is *not* (e.g., negligence, good faith, absence of business justification) than what it *is*. Suppose that there are facts readily available to company officials that indicate material risk, but that they honestly fail to appreciate their implications. Although the state of the law gives no basis for predicting with certainty whether the Rule is violated, there is at the very least a significant possibility of a good faith defense to liability. Many courts suggest that the key to scienter in fraud cases is *conscious awareness* of the deceptive nature and consequences of one's actions. There is the possibility, however, that a court could imply corporate scienter from the piecemeal knowledge of various actors, even though none of them individually had the requisite scienter. *See* Caterpillar Inc. v. Great Am. Ins. Co., 62 F.3d 955 (7th Cir. 1995); William Laufer, *Corporate Bodies and Guilty Minds*, 43 EMORY L.J. 647 (1994). *But see* Thomas Hagemann & Joseph Grinstein, *The Mythology of Aggregate Corporate Knowledge: A Deconstruction*, 65 GEO. WASH. L. REV. 210 (1997). *Cf. In re* Carnation Co., [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801 (Admin. Proc. 1985) (holding company responsible even though executive who misspoke to the press was not aware of the truth). This issue is explored more fully in my *Organized Illusions*, *supra* note 30, at 126-30.

[92] Baruch Fischoff, *For Those Condemned to Study the Past: Heuristics and Biases in Hindsight*, *in* JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 335, 341 (Daniel Kahneman et al. eds., 1982). For legal discussions of the hindsight bias, see Kim A. Kamin & Jeffrey J. Rachlinski, *Ex Post Does Not Equal Ex Ante: Determining Liability in Hindsight*, 19 LAW & HUM. BEHAV. 89 (1995); Hal Arkes & Cindy Schipani, *Medical Malpractice v. the Business Judgment Rule: Dif-*

information does surprisingly little good. This research supports the often-articulated fear by officers, directors and appellate judges of "fraud by hindsight"[93] in securities cases. Given that scienter can always be shown circumstantially,[94] the potential for the hindsight bias to affect the fact-finding in a securities fraud lawsuit is severe, diluting the effectiveness of the good faith defense.[95]

For these reasons, it is questionable whether innocent cognitive bias is much of a liability buffer. Indeed, we may actually have the reverse problem of that suggested earlier: a possibility of overinclusive liability if one accepts the premise of scienter-based liability, and an additional invitation to excessive or extortionate litigation to the extent that cases can be made to seem sufficiently appealing in hindsight to cause earnest settlement negotiations. This would suggest that proponents of litigation reform efforts might well have been justified in seeking some form of relief. Precisely how much the enhanced pleading requirements and safe-harbor for forward-looking information of the Private Securities Litigation Reform Act blunt this tendency[96]—and at what cost in terms of meri-

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ferences in Hindsight Bias, 73 OR. L. REV. 587 (1994). Importantly for our purposes, some research shows that the hindsight bias is likely to have its greatest effect for negative events where the ex ante expectations regarding the level of care likely to be taken by the subject in question were high. *See* David Schkade & Lynda M. Kilbourne, *Expectation-Outcome Consistency and Hindsight Bias Demands*, 49 ORG. BEH. & HUM. DECISION PROCESSES 105 (1991).

[93] Denny v. Barber, 576 F.2d 465, 469 (2d Cir. 1978).

[94] *E.g.*, Huddleston v. Herman & McLean, 640 F.2d 534 (5th Cir. 1981).

[95] The danger can be amplified by another significant psychological tendency, the fundamental attribution bias. *See* FISKE & TAYLOR, *supra* note 21, at 67-75. When judging others, people are inclined to overweigh dispositional rather than situational factors, and to explain events more in terms of the causal influence of the actor and her personality than really is warranted. In other words, we overpersonalize events, attaching excessive credit to good outcomes and assessing too much blame to bad ones. The temptation is strong for a jury that observes a false statement to say that it was a deliberate or reckless lie.

[96] The new pleading requirement, incorporated into new § 21D(b) of the Securities Exchange Act, forces plaintiffs to state in their complaint facts that give rise to a strong inference of scienter. Even before the Act, courts that applied a similar requirement made plain that unreasonable optimism is not the basis for such an inference. For a survey of the pre-Act law, see Elliott Weiss, *The New Securities Fraud Pleading Requirements: Speed Bump or Road Blocks?*, 38 ARIZ. L. REV. 675 (1996). Still, courts may allow complaints to survive on sufficiently persuasive stories of motive or circumstantial evidence. In any event, the new legislation does not apply to public enforcement, raising the possibility that SEC enforcement ac-

torious suits being dismissed—cannot be answered at this point in time.

Obviously, if management is a biased monitor with respect to what might later seem or be deceptive, the responsibility for assuring the accuracy of secondary market disclosures should be shared with some outside constituency.[97] As the primary external "bonder" of disclosure quality, accountants have an obvious role to play here,[98] but it is limited to certain kinds of risks. The possibility of outside directors (perhaps through a special disclosure committee of the board) is also interesting,[99] but outside directors are naturally hampered by limits of time and attention and potentially severe in-group bias pull, at least in the absence of an identifiable crisis.[100] They are less likely to be a good early warning system for risk disclosure.

So, we come back to the corporate lawyer.[101] In theory, wise companies will encourage their lawyers to challenge their assumptions about risk and prospects, even if it is costly and uncomfortable. But we shouldn't be too sanguine that this will happen easily. Again, optimism is adaptive, and allowing the

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tions will go forward relatively unchecked in bias cases, notwithstanding the scienter requirement. For a discussion of the SEC's incentives in bringing cases, see *infra* text accompanying notes 123-27.

[97] By responsibility I mean best available mechanism for checking bias. Whether any non-insiders should be given legal responsibility is a separate question. I have expressed skepticism that lawyers, for example, are cost-effective gatekeepers given their own cognitive limitations. Langevoort, *Where Were the Lawyers?*, *supra* note 4, at 115-17. Clearly, imposing legal responsibility has a cost impact that must be reckoned with.

[98] *But see* Bazerman et al., *supra* note 57. For expressions of both promise and concern, see the REPORT OF THE NATIONAL COMMISSION ON FRAUDULENT FINANCIAL REPORTING (the Treadway Commission Report) (1987). For some use of social cognition materials in the training of auditors with respect to fraud, see the various articles in ROBERT K. ELLIOTT & JOHN J. WILLINGHAM, MANAGEMENT FRAUD: DETECTION AND DETERRENCE (Robert K. Elliott & John J. Willingham eds., 1980).

[99] This is part of the recommendation of the Advisory Committee on the Capital Formation and Regulatory Processes. *See* Sec. Act Rel. No. 7314, at 85, 286-87.

[100] On outside directors generally, see, for example, Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898 (1996); regarding their biases, see Cox & Munsinger, *supra* note 24.

[101] One is reminded here of the remarks of Chancellor William Allen of Delaware, commenting on the value of independent directors as monitors of takeover battles. Allen's view is that the crucial difference in the outcomes of these cases turned not so much on the directors themselves as the lawyers and other professionals retained to advise them. William T. Allen, *Independent Directors In MBO Transactions: Are They Fact or Fantasy?*, 45 BUS. LAW. 2055 (1990).

lawyers to introduce too great a sense of nonboilerplate pessimism into the company's belief system runs the risk of dampened morale and threatened relationships with noninvestor constituencies, not to mention raising the cost of legal services. Confident managers are unlikely to acknowledge their inability to assess risk objectively in the first place, and hence not see that great a need to defer to others. In sum, "fraud" arising from cognitive bias is likely to be a sticky phenomenon with costs to the capital marketplace that are difficult to avoid. The good corporate-securities lawyer should simply try the best she can to minimize them.

2. Reliance on Advice of Counsel

Whether raised formally as a defense in litigation or simply as an explanation or excuse for alleged misbehavior, managers sometimes justify disclosure-related activity by saying that counsel gave their blessing, leading them to believe that their conduct was lawful. Courts have not been clear in securities law or elsewhere what cleansing effect reliance on counsel has when the alleged violation requires a showing of scienter or negligence.[102] While there is an intuitive appeal to the idea that counsel's blessing means that a manager can go forward reasonably and in good faith, it quickly runs into the overarching concept that ignorance of the law is no excuse. Those courts that do admit the possibility of the defense take pains to assure the independence of counsel, full disclosure of all material facts to counsel, and the legal (as opposed to factual) nature of the advice before going any further with the analysis, and the defense is often rejected on these grounds.[103]

The matter of cognitive bias, of course, is implicated in each of these elements. In disclosure matters, legal decisions are often highly probabilistic and fact-specific, and depend on judgmental inferences with respect to business prospects. Ideally, we might want to expand the reliance on counsel defense as a way of giving independent lawyers greater leverage over

[102] *See* Douglas W. Hawes & Thomas J. Sherrard, *Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases*, 62 VA. L. REV. 1 (1976).

[103] *See, e.g.*, Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R. Co., 680 F.2d 933, 942 (3d Cir. 1982); Arthur Lipper Corp. v. SEC, 547 F.2d 171 (2d Cir. 1976).

their clients in the substance and styling of disclosure and other legal advice. As we have seen, however, there is a substantial risk that factual inferences made by cognitively dependent lawyers will be tainted by the pressures of group perceptions, or subtly incorporated without adequate filtration as information is gathered from managers by the lawyers in arriving at the legal decision. Thus, the literature on bias offers some basis for the courts' relatively parsimonious use of the defense

B. *Compliance and Supervision*

In recent years, corporate and securities law has given increasing attention to the duty to supervise as a means of preventing individual or group illegality. Section 15(b)(4)(E)[104] of the Securities Exchange Act has long provided a means for disciplining those securities firms and employees whose supervision has been lax, and the 1990s have shown a dramatic step-up in the willingness of the SEC to impose penalties on managers who fall short of the desired ideal, even if they were not the wrongdoer's direct supervisor.[105] The quality of supervision and monitoring can become an issue in private litigation as well under the controlling person provisions of the securities laws.[106] The statutory reform of insider trading enforcement in 1988 made institutional monitoring responsibility a strict requirement for securities professionals on the assumption that insider trading violations were often facilitated by cultures that treated the problem as minor, if it was viewed as a problem at all.[107] Much attention is also giv-

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[104] 15 U.S.C. § 780(b)(4)(E) (1934). Penalties for a violation run from censure through civil penalties and suspension from the industry.

[105] *See* Robert S. De Leon, *The SEC's Deputization of Non-Line Managers and Compliance Personnel*, 23 SEC. REG. L.J. 271 (1995); Lewis D. Lowenfels & Alan R. Bromberg, *Broker-Dealer Supervision: A Troublesome Area*, 25 SETON HALL L.J. 527 (1994). Recent interest in the problems of "rogue" brokers and traders has led to a step-up in SEC enforcement actions regarding the duty to supervise. *See* Markham, *supra* note 45, at 132-33. Indeed, the SEC itself has acknowledged its decision to increase the penalties imposed in failure to supervise cases.

[106] *E.g.*, Section 20(a) of the Securities Exchange Act, 15 U.S.C. § 78t(a) (1934); *See* Zweig v. Hearst Corp., 521 F.2d 1129 (9th Cir.); JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 1029-31 (2d ed. 1997).

[107] Thus, Congress imposed explicit requirements that securities firms adopt insider trading control procedures, and made all controlling persons liable if reck-

en to the organization penalty guidelines of the U.S. Sentencing Commission, which instructs judges to take into account the adequacy of a corporation's compliance structure in determining the penalty for crimes by corporate agents that can be attributed to the corporation as a matter of law.[108] As the *ex post* risk of attributed responsibility for supervisory lapses has expanded, the *ex ante* design of compliance procedures has become a growth industry for lawyers and other specialists.[109]

There is much to learn from organizational behavior and other social science research about compliance systems, and a large body of research exists that explicitly links the two.[110] I do not want to explore this voluminous literature here, much of which deals with the messy logistical problems associated with supervising large numbers of mid- and lower-level managers and employees in major corporations. My more limited aim in this subsection will be to relate the insights about shared belief systems to the problem of detecting and responding to fairly high-level instances of managerial misbehavior.

Agent misbehavior is notoriously difficult to prevent via normal monitoring activities.[111] For a variety of legal, economic, cultural and (hopefully) moral reasons, significant wrongdoing is relatively unusual in the normal course of business.[112] For this reason alone, the normal day-to-day scripts

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less failure to supervise led to an insider trading violation by an employee. *See* Stuart J. Kaswell, *An Insider's View of the Insider Trading and Securities Fraud Enforcement Act of 1988*, 45 BUS. LAW. 145 (1989).

[108] *E.g.*, Michael K. Block, *Optimal Penalties, Criminal Law and the Control of Corporate Behavior*, 71 B.U. L. REV. 395 (1991).

[109] *See* Harvey L. Pitt & Karl A. Groskaufmanis, *Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct*, 78 GEO. L.J. 1559 (1990). On the securities industry, see ROY C. SMITH & INGO WALTER, STREET SMARTS: LINKING PROFESSIONAL CONDUCT WITH SHAREHOLDER VALUE IN THE SECURITIES INDUSTRY (1997).

[110] *See, e.g.*, Barry D. Baysinger, *Organization Theory and the Criminal Liability of Organizations*, 71 B.U. L. REV. 341 (1991), and sources cited therein. For a case study involving Revco Corporation, see DIANE VAUGHAN, CONTROLLING UNLAWFUL ORGANIZATIONAL BEHAVIOR: SOCIAL STRUCTURE AND CORPORATE MISCONDUCT (1983).

[111] *See* Mark A. Cohen, *Corporate Crime and Punishment: An Update on Sentencing Practice in the Federal Courts, 1988-1990*, 71 B.U. L. REV. 247 (1991); *see also* Baysinger, *supra* note 110.

[112] While one would like to think that moral and cultural norms are adequate to produce lawful behavior in most instances, many theorists argue that as much as anything, illegality is deterred by the lack of opportunity to commit a crime

and schemas of organizational life quite appropriately do not prompt managers to dwell on its likelihood. Those risks are low-level, and hence largely out of mind. Especially when supervisory responsibility is given to a line manager (i.e, one whose primary job with the company is production rather than compliance-oriented), cognitive conservatism tends to lead to an implicit assumption of propriety, freeing up the mind to concentrate on more pressing tasks. As we have seen, the salient and certain tends to crowd out the ambiguous and uncertain in perception and decisionmaking.

In this setting—putting aside the intervention of organized compliance mechanisms—there tends to be reliance on relatively simple heuristics to monitor misbehavior. Most people pride themselves on being above-average judges of character, and have confidence in their ability to spot liars and cheaters simply by assessing their demeanor and actions.[113] Basic behavioral cues, they think, should be enough to raise red flags in those rare instances of serious wrongdoing.

This natural conservatism is bolstered by strong motivational forces. Suspicion of a fellow group member or subordinate is extremely stressful, both personally and to management group cohesion—especially when the person suspected is valuable to the organization. The business functions more efficiently under conditions of trust and social bonding, which require that suspicions largely be put out of mind.[114] Moreover, prior commitments may increase the pressure to deflect disconfirming information about the credibility of a fellow manager or high-level subordinate. Anyone who hired or promoted that person, or previously had supervisory responsibility over her, will find "red flag" information threatening both to self-esteem and, potentially, status within the company because it suggests the possibility of bad judgment.

These individual tendencies can, in the aggregate, readily be translated into powerfully conservative beliefs about organizational integrity. A culture of trust is a useful, if self-serving, myth, leading many companies to overinflate the message that

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given the visibility and diffusion of responsibility of most corporate activity.

[113] *See supra* note 59.

[114] In addition, inattention can also provide an anticipatory excuse in the event of wrongdoing. *See* Jack Katz, *Concerted Ignorance: The Social Construction of a Cover-up*, 8 URB. LIFE 295 (1979).

in-group members can be trusted. With such institutional hubris, the conditions are poor for detecting and responding to apparent misbehavior; challenges to the prevailing assumption will be treated as threats to organizational identity. The story of the failure of Prudential's senior management to discover the extent of the abuses taking place in its limited partnership sales program may well be based on this, at least in part.[115]

In fact, most forms of whitecollar misbehavior are hard to spot using common heuristics. As noted earlier, people's ability to detect lying is only slightly above chance.[116] Most forms of "elite" wrongdoing are rationalized by the actor through reference to a common set of excuses (everyone does it, the law is vague or foolish, the firm is pressuring me, etc.),[117] reducing, via self-deception, the sense of guilt that might produce the expected visible cues. Rationalization is especially easy in the financial services industry, which is changing so rapidly that rules and norms are fluid and hence subject to multiple interpretations.[118] Having rationalized the misbehavior, the wrongdoer will act normally within the prevailing culture, reinforcing the usual schema. Many examples of such illegality are committed by people who are not dispositionally inclined to cheat but arise because of strong situational influences—a sense that they are falling behind expectations in productivity and thus might lose their job or status, for instance, or a sudden increased need for money.[119] Their prior behavior evi-

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[115] *See In re* Prudential Sec. Inc., [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,238, at 84,601 (Admin. Proc., Oct. 21, 1993). For a journalistic account, see KURT EICHENWALD, SERPENT ON THE ROCK (1995). The internal pressures of a "trust" myth are two-fold: it will cause some to subconsciously deflect information, while causing others—who may consciously have private doubts—from raising them.

[116] *See* DePaulo, *supra* note 59, at 382.

[117] *See* JAMES WILLIAM COLEMAN, THE CRIMINAL ELITE: THE SOCIOLOGY OF WHITE COLLAR CRIME, 206-12 (1985); W. STEVE ALBRECHT ET AL., FRAUD: BRINGING LIGHT TO THE DARK SIDE OF BUSINESS ch. 5 (1995).

[118] *See* Nancy Reichman, *Insider Trading, in* BEYOND THE LAW: CRIME IN COMPLEX ORGANIZATIONS 55, 56 (Michael Tonry & Albert J. Reiss, Jr. eds., 1993).

[119] Relevant in this regard is the insight of behavioral decision-theory that people alter their cognitive and behavioral patterns, becoming more inclined to take risk, when they perceive the possibility of a loss of current status. Loss is viewed in terms of expectations, rather than possession. *See, e.g.*, James G. March, *Variable Risk Preference and Adaptive Aspirations*, 9 J. ECON. BEHAV. & ORG. 5 (1988). Tournament-like settings—where winners receive a disproportionate share of wealth can readily trigger undue levels of risk-seeking behavior. *E.g.*, Keith C.

denced honesty and loyalty, creating a positive schema that further dampens any inclination to be suspicious of them now. So far, we have said nothing that would necessarily question the desirability of increased legal emphasis on the duty to supervise and monitor. If organizational cultures resist even optimal self-monitoring, especially among line managers, then strong external incentives will be necessary to cause companies to take compliance more seriously and introduce more powerful monitoring mechanisms.[120] (*A fortiori* if firms do not have to internalize the costs of the harms they do because of inadequate sanctions or limitations built into the enforcement or litigation processes). The interesting behavioral insight here, however, has to do with optimality.

No system of monitoring and supervision can ever be total. Even putting aside the out-of-pocket costs associated with an intrusive control system, managers need a sense of autonomy and discretion; a feeling that everything they do is subject to close review and scrutiny dampens morale and inhibits the kind of risk-taking that is generally beneficial.[121] This is especially true in dynamic industries like financial services. Flexibility is a necessity, and because of the rapidly evolving nature of the markets, supervisors often lack the expertise to monitor sensitively. As Henry Hu and others have noted in anticipation of the recent derivatives scandals involving Bank-

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Brown et al., *Of Tournaments and Temptations: An Analysis of Managerial Incentives in the Mutual Fund Industry*, 51 J. FIN. 85 (1996).

[120] *See* Markham, *supra* note 45. One of the interesting issues, of course—given the high level of financial and reputational impact of discovered wrongdoing—is why firms have not previously implemented adequate control structures. The behavioral insights here are one answer; another possibility is that firms do not really pay a penalty comparable to the social cost of the wrongdoing. *Cf.* Amar Bhide & Howard H. Stevenson, *Why Be Honest if Honesty Doesn't Pay?*, HARV. BUS. REV. Sept.-Oct. 1990 at 121, 125 (doubting that the marketplace imposes as much of a reputational penalty as people might think).

[121] *See, e.g.*, Sim B. Sitkin & Darryl Stickel, *The Road to Hell: The Dynamics of Distrust in an Era of Quality*, *in* TRUST IN ORGANIZATIONS: FRONTIERS OF THEORY AND RESEARCH 196 (Roderick M. Kramer & Tom R. Tyler eds., 1996); Donald R. Cressey, *Management Fraud, Accounting Controls and Criminological Theory*, *in* MANAGEMENT FRAUD: DETECTION AND DETERRENCE 117, 125-26 (Robert K. Elliot & John J. Willingham, eds. 1980); Carol M. Rose, *Trust in the Mirror of Betrayal*, 75 B.U. L. REV. 531, 540-41 (1995).

ers Trust and others, for example, there is no easy way to control the potential for misbehavior without chilling the very nature of financial innovation.[122]

Striking the right balance between cost and benefit, then, is difficult. Yet when something goes wrong, even a reasonable system of control is likely to seem defective in hindsight. I am inclined to think that while some of the stories of supervisory lapses with respect to rogue traders and derivatives salespeople demonstrate true culpability, others are significantly overstated. Regulators and journalists—both of which have strong interests in stark characterizations of institutional wrongdoing[123]—have little difficulty identifying suspicious events and behaviors that seemingly should have alerted the supervisory personnel. Often blame is placed on those, like lawyers for the firm, who lack direct authority over the wrongdoer.[124] The sorry implication is that only their greed, or perhaps peer pressure and cowardice, silenced them.[125] Behavioral research suggests, however, that those supervisors probably acted in context much the same way as most people would have under

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[122] *See* Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457 (1993); *see also* Jonathan R. Macey, *Derivative Instruments: Lessons for the Regulatory State*, 21 J. CORP. L. 69 (1995). No doubt improved monitoring is possible, *see* Markham, *supra* note 45, and firms will react to the current wave of problems by stepping up the quality of these systems. But absent some strong regulatory pressure, these systems will balance flexibility against control, and hence tolerate some significant residual risk.

[123] Regulatory bias in terms of oversimplification and reaction to salient data is one focus of Clayton P. Gillette & James E. Krier, *Risk, Courts, and Agencies*, 138 U. PA. L. REV. 1027, 1090-95 (1990). On the non-accuracy related motivations for blaming in general, see MARY DOUGLAS, RISK AND BLAME: ESSAYS IN CULTURAL THEORY ch. 4 (Routledge 1992); BOVENS & T'HART, *supra* note 1, at ch. 6. The need for identifiable causal explanations may cause social actors to ignore the difficulties in coming to accurate ex post judgments.

[124] Much attention has been given to the SEC's enforcement proceeding against various supervisors in connection with the Paul Mozer trading scandal at Salomon Brothers. *See In re* Gutfreund, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,067, at 83,597 (Admin. Proc. Dec. 3, 1992). Here, the suspicions of illegality were clear; the problem seemed, among others things, to lie in the diffusion of responsibility within the firm.

[125] One is reminded of Clark Clifford's comment in the aftermath of his involvement in the B.C.C.I. scandal: in retrospect, one is forced to see his actions as either stupid or venal. *See* David E. Rosenbaum, *The B.C.C.I. Scandal: Charm for Plebian and Patrician*, N.Y. TIMES, July 30, 1992, at C5. Our discussion here suggests that that is not the only choice.

the same circumstances, sensing no extraordinary danger or reason for guilt. Monitoring for unlawful behavior is far more difficult *ex ante* that the regulatory stories admit. The vagueness in the SEC's definition of supervisory authority is a good example of this tendency,[126] as is its recent suggestion in the John Jett case that a supervisor acts improperly if he failed to investigate a subordinate's behavior simply upon discovery of an unusually high level of profitability.[127]

If institutions themselves are naturally likely to underestimate dapgers signs, who can best manage the risk of this kind of regulatory reaction? Here again, I suspect that a good, cognitively independent lawyer is the best candidate for prompting an organization to overcome its natural hubris with respect to compliance and move toward cost-justified systems that, if not completely immune to overzealous regulatory second-guessing, at least reduce its likelihood. I do not mean to suggest, as if through rose-colored glasses, that ideal systems can or will easily be implemented simply by an act of lawyerly will. But I will assume that some systems are better than others, and the good lawyer may be helpful at the margins.

Without trying either to be exhaustive or overly specific, a number of general strategies seem essential to combat the special problem of organizational hubris. One is the need to make the compliance system part of a larger cultural emphasis on ethics and integrity, with visible commitment from senior management.[128] Lawyers given too much independent control over compliance often act in a proprietary, self-serving fashion, making rules, forms and routines the dominant feature of the system. Moreover, as noted earlier, a key facilitator of individual wrongdoing is rationalization, seizing on an "everyone does

[126] *See* De Leon, *supra* note 105, at 283-85.

[127] *See, e.g., In re* Cerullo, 61 SEC Docket 48 (Jan. 9, 1996); Michael Siconolfi, *SEC Raises New Red Flag With Jett Case*, WALL ST. J., Jan. 10, 1996, at B1. While one cannot question the idea in principle that otherwise inexplicable profits should trigger inquiry, the costs associated with such a rule should be self-evident. Moreover, the psychological research gives ample reason to suspect that supervisors will rarely find profitability "otherwise inexplicable."

[128] *See* Lynn Sharp Paine, *Managing for Organizational Integrity*, HARV. BUS. REV. March-April 1994, at 106. For an excellent set of articles on using research on behavioral decision-making in structuring corporate ethics and compliance programs, see CODES OF CONDUCT: BEHAVIORAL RESEARCH INTO BUSINESS ETHICS (David M. Messick & Ann E. Tenbrunsel eds., 1996).

it" perception or the sense that the firm tacitly encourages stepping over the line by setting and enforcing its performance goals so aggressively. Companies cannot establish a general culture and belief system that emphasizes aggressiveness, risk-taking and limit-testing for general competitive purposes without running the risk that those same attitudes will be invoked, and subconsciously twisted in self-serving fashion, to justify unlawful behavior.[129] Needless to say, rhetoric is insufficient; employees expect and disregard messages that smack of posturing rather than legitimate organizational belief. Furthermore, legalistic emphasis on routine and formalism runs the risk of both marginalization and self-deception. Formal systems can often be circumvented by clever forms of fraud, yet their very presence, and the impression of normalcy they generate, can serve to reduce vigilance rather than heighten it.[130]

A related lesson for the lawyer is to seek a system that helps to overcome the natural tendency of high-level managers to overtrust each other and key employees. Partly, this involves placing the task of coordinating compliance responsibility in the hands of high-level nonline managers. Line managers are not only subject to conflicts of interest (the orthodox statement of the problem), but also have so many other responsibilities that the pressure to think heuristically with respect to all but the most salient problems of the moment becomes overwhelming. But the line managers have the informational advantage; they cannot be excluded from responsibility, or even be allowed to perceive a sense of diffusion of responsibility that permits them to rationalize their own inaction.[131]

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[129] Much of the study of illegal behavior in securities firms has emphasized the degree to which a culture of "macho" competitiveness, of the ability to "invent the rules" as the industry evolves—while probably intended at the top as limited to legal activity—easily becomes a rationalization for the illegal. *See* SMITH & WALTER, *supra* note 109; Reichman, *supra* note 118. In addition, there is evidence that simple emphasis on short-term performance in compensation and promotion policies creates an environment conducive to illegality. While one reason for this—the economic pressure—is self-evident, there is also reason to believe that such policies offer an employee the ability to rationalize the misconduct.

[130] *See* HAROLD L. WILENSKY, ORGANIZATIONAL INTELLIGENCE: KNOWLEDGE AND POLICY IN GOVERNMENT AND INDUSTRY 91-92 (1967); ROBERT P. GANDOSSY, BAD BUSINESS: THE OPM SCANDAL AND THE SEDUCTION OF THE ESTABLISHMENT 211-12 (1985).

[131] Or which creates multiple layers of authority that hinders efficient action. *See* Ron Chernow, *A House Divided*, WALL ST. J., March 3, 1995, at A10;

The lawyer's challenge, therefore, closely resembles that of the securities lawyer in fashioning disclosure. The organizational client may be biased, albeit generally in good faith, toward resistance to threatening information about managerial integrity. But the legal or compliance department cannot act unilaterally and must enlist willing cooperation by line personnel. As much as anything, compliance lawyers must be nonadversarial and nonauthoritarian—two things for which most attorneys are not noted—to overcome the cognitive resistance. As we have seen, trust within an organization is generally adaptive. An environment of suspicion generated by compliance personnel is likely not only to disrupt in an inefficient way the trust-based operation of the business but result in treatment of the compliance function as an out-group threat, to be resisted and circumvented as inconsistent with group solidarity and the primary mission of the business as understood by line personnel. This is especially likely if the compliance managers operate in an overtly bureaucratic fashion, emphasizing an excess of formal routine over which they can assume exclusive control, thereby making a greater claim to power and resources.

C. *Lawyers as Directors*

A topic of persistent interest in the legal profession has been whether lawyers should serve as directors of the client.[132] Various reasons have been given for and against this practice; one of the common arguments against it is that it compromises the lawyer's independent judgment.[133] Rarely, however, is there anything more than a conclusory statement of this risk—no rigorous articulation of how and why this compromised independence may occur. This reduces the persuasive

Markham, *supra* note 45, at 150 n.103.

[132] For a good recent overview, see Craig C. Albert, *The Lawyer-Director: An Oxymoron?*, 9 GEO. J. LEGAL ETHICS 413 (1996).

[133] *See, e.g,* Robert H. Mundheim, *Should Code of Professional Responsibility Forbid Lawyers to Serve on Boards of Corporations For Which They Act as Counsel?*, 33 BUS. LAW 1507 (1978); James H. Cheek, III & Howard H. Lamar, III, *Lawyers as Directors of Clients: Conflicts of Interest, Potential Liability and Other Pitfalls* (PLI Corp. L. Series B4-6940, 1990). Obviously, as Cheek and Lamar point out, there are other reasons besides concern about objectivity—e.g., liability, conflict disqualification—to worry about the practice.

force of the aspirational objection, leading individual lawyers to conclude that this must be someone else's problem: that they are sufficiently strong in character and intellect to resist any discernable pressures toward compromised judgment.

The discussion in Parts I and II should make clear what the problem is. First, service on the board causes a member to make a set of commitments: selection of key executives, approval of transactions and programs, and so forth. Inevitably, such commitments create an unconscious bias toward their justification, which in turn can interfere with an objective analysis of their legal status, whether for purposes of disclosure or otherwise. The lawyer-director who votes to recommend a recapitalization program to the shareholders, for instance, will usually be resistant to an objective assessment of its risks.

Just as important, the group solidarity influences discussed earlier can also be biasing. The more the lawyer-director is socialized into the management group, the more value she will place on protecting it and embracing its belief system. This becomes especially problematic to the extent that there is a potential conflict of interest between the board members and the entity itself, as in a control shift situation. Even if independent counsel is retained, the lawyer-director will probably have a disproportionate influence on that lawyer's perceptions.

This is not to say that a per se rule against service on client boards is necessary. Board membership only intensifies the pull toward cognitive dependence, a pull that is strong even without service.[134] Presumably, a lawyer capable of cognitive independence as a matter of professional responsibility could serve ably, perhaps better than many other outside directors. The message here, however, is that the pressures are strong, subtle and largely unconscious. A belief that they can easily be resisted is more likely to reflect hubris and self-serving inference than candid self-reflection.

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[134] *See* Symposium, *Should Counsel Also Serve on the Board?*, 33 BUS. LAW. 1511, 1514 (1974) (remarks of Kenneth J. Bialkin).

CONCLUSION

In academic and professional discourse, lawyers tend to be highly rationalist in their assessments of human and organizational behavior. This is a wonderful "working myth" that allows us, among other things, to see law as more influential *ex ante* than it really is. But as most of us confront real life and real clients, we observe something else. Ego, rationalization, denial, defensiveness, stress and other predictable imperfections skew the thinking of people who, dispositionally, are perfectly respectable individuals. Organizations exhibit the same tendencies collectively, behaving bureaucratically rather than as paragons of rationality. In this light, many of the disposition-oriented teachings of professional responsibility seem overly simplistic and unhelpful. Among other things, a dose of behavioral realism will lead to insights that lawyers will actually find useful as they work in a world where knowledge is fuzzy and changeable, and gray areas dominate the black and white.

One of the important teachings of social psychology is that people attribute far more coherence and after-the-fact causality to the world than is apt. This manifests itself in the overestimation of character in the course of events, at the expense of situation and chance. We try hard to explain good outcomes in terms of the influence of good people, and bad results in terms of bad actors. This leads to several forms of belief, one of which is that once we decide that good people are involved in the situation, we can relax and trust their judgment.

As a heuristic, this is not a bad bet. But it creates an overconfidence that, on rare occasion, leads to large errors. Most dispassionate retrospective studies of bad events are much muddier than we might like. The worst business disasters often arise from a sequence of bad judgments by good people who never sense the impending harm—decisions running from Ford's Pinto problems through NASA's Challenger and Hubble telescope fiascos have been so described in the management literature.[135] There is a frustrating banality to the disaster.

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[135] Barry A. Stein & Rosabeth Moss Kanter, *Why Good People Do Bad Things: A Retrospective on the Hubble Fiasco*, 7 ACAD. MGMT. EXEC. 58 (1993). For a comprehensive view of the Challenger matter from a variety of conceptual "frames,"

Because of their roles in risk disclosure and other forms of counselling where risk assessment is crucial, good lawyers must try to foresee the kinds of cognitive and organizational pressures that bias managerial perception and decision-making. They should be prepared to shift to a more vigilant mode when conditions are right for distortion—even though the company's managers may not particularly want to hear the message. After all, the lawyer's client is the entity, not the managers, and the entity is highly dependent on the lawyer.[136] Deference to the judgment of the board of directors or its agents is appropriate in the normal course of events, but is no excuse for apathy if the lawyer takes his professional responsibility seriously and believes that predictable biases have compromised their judgment.

Facility at observing others, however, cannot come without critical self-reflection. Most lawyers have a healthy dose of self-esteem that leads to a host of egocentric attributions. We think of ourselves as exceptional judges of character, of unimpeachable integrity, reasonable and balanced, strong in the face of pressure. These, too, are wonderfully adaptive myths.[137] But we cannot learn to assess events and the behavior of others accurately if we are blinded to the pressures—cognitive and social—that can compromise our judgment and inferences, pressures that are intense and unavoidable in the highly abstract and subjective world of the corporation. As much as we might want to preserve our own illusion of control, we shouldn't underestimate these pressures. In this sense, the journey toward cognitive independence for a lawyer best begins with her—and her profession's—own humility.

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see BOVENS & T'HART, *supra* note 1, at 108-16.

[136] *See* Painter, *supra* note 20.

[137] Research shows that people persist in underestimating the likelihood that their own cognitions are biased even when those biases are amply explained to them. *See* Timothy D. Wilson & Nancy Brekke, *Mental Contamination and Mental Correction: Unwanted Influences on Judgments and Evaluations,* 116 PSYCHOL. BULL. 117, 125-26 (1994). On self-serving inference and lawyers' professional responsibility, see Deborah L. Rhode, *Institutionalizing Ethics,* 44 CASE W. RES. L. REV. 665, 685-86 (1994); Jonathan R. Macey, *Civic Education and Interest Group Formation in the American Law School,* 45 STAN. L. REV. 1937, 1942-45 (1993).