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Legal Administrator Section

Spring 2003 Newsletter

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Mark Your Calendars:

**THE LEGAL ADMINISTRATION SECTION
OF THE STATE BAR OF MICHIGAN SPONSORS:**

Fraud and Internal Controls for Law Firm Administrators and Managers

- a Workshop presented by:

**Cendrowski Selecky - A Professional Corporation
&
Netarx, Inc.**

**Date: Wednesday, June 11, 2003
Time: 7:30 a.m. – 10:00 a.m.
Place: Jaffe, Raitt, Heuer & Weiss, PC
1 Woodward Avenue, 24th Floor
Detroit, Michigan 48266**

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Law Firms: Fraud and Internal Control Reviews

By: Harry Cendrowski



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In January, 2002, Ann Marie Poet, a 59 year old woman from suburban Detroit, received a fax from a person claiming to be Dr. Mbuso Nelson, an official with the ministry of Mining in South Africa. Dr. Nelson offered to pay a \$4.5 million fee to help him transfer \$18 million from South Africa to the United States. As it turns out, this was an instance of The Nigerian Letter scam, which is widely executed through email, faxes, and traditional mail, and receives a large amount of press and warning. Ms. Poet, apparently, was slightly gullible, but more important, she was slightly gullible, and worked as a bookkeeper for a small law firm, where she had access to the large sums of money the scam demanded. On October 28, 2002, Ms. Poet pleaded guilty to wire fraud for transferring \$2.2 million from her law firm's bank accounts to unauthorized overseas

accounts in South Africa and Taiwan. The firm first became alerted to the fraud in September when a \$36,000 settlement check to a client had bounced.

The costs of fraud such as this go well beyond the direct financial loss, and include the investigation costs, the diversion of attention from the business, and the loss of the reputation of the company. The legal firm is a key and trusted advisor to its clients, often on matters relating to compliance and asset protection, and stories revealing the vulnerability of the firm can be unsettling. Also, the firm serves as custodian of the client's settlement payments; in the case noted above, firm principles have been vigorously asserting that no client will bear a part of the loss. This is, of course, reassuring to the client, however, it has the unfortunate side effect of providing a glimpse into the capital structure of the firm. The truly staggering aspect of this issue is the number of frauds of this type committed each year.

Occupational fraud is a major problem in the United States, and can affect any entity from the largest corporations, to privately held companies, to governments and nonprofits; the Certified Fraud Examiners 2002 Report to the Nation on Occupational Fraud and Abuse estimates occupational fraud related losses at approximately 6% of GDP, which translates into fraud related losses of \$600 billion annually. Paradoxically, it is the *smaller* entities that suffer a higher median fraud loss compared to the larger companies. The Report attributes this to two factors. First, small staffs often lack basic internal controls; often, a single person is responsible for payment of invoices, check production, counting cash, and reconciliation of the bank statements. Where duties are not assigned in a manner to ensure adequate

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separation of duties, fraud is easy to commit and conceal. Second, the smaller companies enjoy an atmosphere of personal relationship and trust which can make management less alert to the possibility of dishonesty. Both factors, however, point to the need for strong internal control procedures, especially within a law office setting where there are large amounts of money flowing and relatively smaller finance staffs.

Anecdotally, there are many stories of fraud committed against the legal office; a simple internet search reveals many such stories in various cities across the nation.

“Strong internal controls” was identified in the Report as the single most powerful deterrent to occupational fraud; the report found that in 46.2% of the cases examined, the fraud occurred because insufficient controls were in place within the organization. In an additional 39.9% of the cases, controls were defined, however, they were ignored by the organization. This highlights the need to not only define effective controls, but also to identify methods to monitor the workings of the controls, to ensure that all employees know their responsibilities and duties and allow management to identify those instances where the control objectives are not met. As the legal office grows, the internal control structure should be continually reviewed and updated to ensure it still fits the increased scope and financial mass of the office. Funds flow simultaneously in multiple directions as fees are collected and settlements are collected and paid to clients. Clear procedures defined within a structure of control are essential to ensure all transactions are recorded, correctly valued, to the correct account, in a timely manner.

Internal control procedures also help to define the performance responsibilities of each individual – people need to know what to do, when, and coordinate their actions with others. In a legal office, this is especially important as the accounting and financial reporting functions are secondary to the legal activity within the office. The principles need to define a structure of

authority and responsibility and be able to monitor the execution of those activities while still remaining focused on the operation of the legal practice. A detailed description of the authority of each person, the expectation for how to complete their tasks, and a documented structure to approve required transactions and monitor the operation of the activities is essential to ensure the accounting operation is executed and recorded appropriately, while minimizing the concern and overall involvement of the principles. Additionally, legal offices are at risk due to an inherent strength of the office: the drive to rapidly respond to client requests. Principles may ask staff members to forgo the normal control procedures to satisfy an emergency client request. This is admirable, however, controls should be in place to ensure that the emergency transactions are appropriately reviewed, and that these are the only times the controls are bypassed.

As you might imagine, this level of controls definition does not occur automatically. A regular, methodical review is required to assess the control structure and ensure it remains appropriate given the constant changes in the operation of the legal office. This review can quickly become quite complex: it needs to encompass all the critical business processes and consider changes in services offered, staffing changes, new systems and IT solutions, changes in reporting and client service needs, as well as changes in internal control standards and best practices. It is this level of detail that imposes the need for a strong approach to the review to ensure that no major processes or risks are missed.

Several recent frauds committed against law firms, including the defalcation to fund the Nigerian Letter fraud noted above, have involved inappropriate transactions processed to client trust accounts. Often, these accounts do not receive the same scrutiny as internal firm accounts, however, given the amounts frequently funded to these trust accounts, rigorous control

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procedures should be in place, documented, and enforced. Additionally, these accounts offer a unique opportunity for embarrassment to the firm as well: in many cases, the fraud was discovered when a payment to a client from their trust account was returned for non-sufficient funds. Proper control over these trust accounts begins with a defined and documented structure of authority, noting the persons responsible for the review and authorization of all transactions to the account, including deposits, fund transfers, and expenses paid. Since many of the cash outflows are often the result of services rendered, controls should be defined to ensure the service vendors are legitimate, and the services were authorized and performed as required prior to payment. Responsibility for review of all transactions should escalate, and require corroborating signatures, as the transaction amounts increase. Finally, other individuals should be designated to reconcile the account regularly, and a senior person assigned to review the results of the reconciliation for unusual items. In short, adequate control procedures must be in place to ensure that every transaction processed to the account is authorized and recorded correctly, and the funds in the account are safeguarded. Given the complex transactions processed to the trust accounts, this can often be a difficult task.

One approach that we have found quite successful in the legal office environment includes a process disaggregation step to break each business process down into the required control objectives. This disaggregation allows management to identify the discrete tasks within each process, and the associated control objectives. This helps ensure all processes are appropriately considered in the review, and yet pinpoint the individual control step which requires improvement actions. Additionally, the level of detail developed often serves as a training tool to guide employees through their daily tasks. Often when we perform this level of review at a law office, management is surprised to learn that basic accounting functions, which

were relied upon with great confidence, were not performed according to the procedures which management thought were in place.

There are many reasons for this deviation from management's expectation, most of them related to the day-to-day realities of operating a legal office. For example, a limited number of users may be authorized to perform a transaction, however, those transaction still need to be performed when the authorized users are absent. In this case, the transactions processed under this temporary assignment of duties must be controlled as well, and management needs to ensure that these fill-in employees only process transactions when authorized by management on those days when required. The disaggregation approach described again should consider these process workarounds, as well as the associated mitigating controls in the assessment of the overall control environment.

The result of this control review process is a clearly documented model of the legal office control structure, including definition of current control points and monitoring processes. This control model includes disaggregated levels of detail which can be used to identify the functions which need attention, as well as the individual control points not being met. The review evaluates the controls at the actual level of expected service, providing an up-to-date view of the organization and its controls. Management can develop an understanding of how work is actually performed by the organization, and be aware of the potential risks within the business processes. Individuals performing the business processes become aware of their role in the organization and their role in the control structure. Overall, the control review process provides positive assurance to the legal office management that transactions are processed as expected, and when not, are detected prior to the creation of tremendous damage to the financial position, reputation, and overall prestige of the firm and its principles.

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Network Security and Controls

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Did you know that the most instances of “hacking” occur on prom night?

When discussing computer and network security it is important to recognize that it means many different things to various people.

Traditionally, the idea of corporate computer and network security conjures up thoughts of hackers cyber-attacking an organization through their wires, gaining access to and stealing their most important and valuable information and sharing it with their closest competitors, thus giving them the competitive edge.

Historically, this vision of impropriety has been addressed by protecting your “always on” dedicated Internet connection with a firewall, however, every network has far more susceptibility than that. The definition of network is a system of lines that cross or interconnect, which is why ubiquitous communication of data, voice and video are so powerful and afford our organizations so much value and efficiency. The most secure network, in theory, is one that is not connected, and during a time where we are more dependent on our networks than ever before, this situation is not acceptable. As universal connectivity to our business information proliferates through the use of the internet, laptops, telephones and PDA’s we must manage this process in a concerted and deliberate manner. We should not over or under expose ourselves to any one weakness as our sensitive information becomes increasingly accessible from anywhere in the world.

With this new perspective, security is not about one specific product or technology that will take care of all your needs. Be advised that there is no “magic bullet” and as such, you can not purchase “a security” either. Security is about identifying information that is important to your organization now and architecting a tiered strategy to protect it. This implies that style, methodology and experience are important characteristics that need to be considered when choosing a third-party firm to assist you in this area.

The creation of a computer network security program and resulting policy should include a comprehensive strategy and combination of various layers of technology that will protect you from your identified physical and other known vulnerabilities. Realize that you are mostly vulnerable to yourself; members of your own

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firm, who already have access to your critical information. Additionally, you should identify if your organization is a target. I do not wish to imply “security through obscurity” as a security solution, however, the fact is that external compromise of your infrastructure is hard. It requires a savvy individual with extensive familiarity of various communications, computing and hacking techniques. The Hollywood image of malicious “hacking” should be dispelled to some degree. The typical “hacker” is a fifteen to twenty-something year-old who has a lot of time on their hands and tries to penetrate corporate systems largely for the fun, challenge and adrenaline, not for malicious reasons as indicated by my opening prom-night statement.

After considering what information is important to your organization there are three spheres of a security strategy that you may want to consider and proceed accordingly.

A good starting point is to assess all of the physical connections from the outside world that your organization uses to communicate, as well as your network, PC and server environments. You cannot protect against what you do not know, so accurate documentation is key. Consider data circuits, phone lines, internet and modem connections. You may protect information in various ways including firewalls for your inside-out communications and VPN concentrators to encrypt your outside-in communications.

With virtual private networking technology (VPN) you can permit secure remote access, increasing employee productivity by enabling ubiquitous communications anytime, anywhere via the internet. You may also log user behavior with respect to file sharing, phone calls and internet surfing. Various web content filtering software may be considered. Finally, a virus protection strategy must be considered with a combination of host and network based intrusion

detection agents to protect you from mass broadcast latent malicious programs like “worms.”

After you have “secured” your environment you may wish to augment your employee handbook and protect your organization from unnecessary exposure by implementing internet and email usage policies. Included would be definitions of the intended use of these business tools as well as definitions of misuse. These policies would also thwart the installation of unsupported and illegally licensed software on your network.

The final aspect of security would be a gap analysis of your environment as it exists today for the purposes of ensuring that it will be capable of delivering real-time network applications like voice and video. You also need to be secure in knowing that an appropriate Data backup system strategy is in place ensuring reliable data recovery in the event of an outage. It is imperative that systems are adequately sized for storage and are fast enough for your business to minimize losses in an emergency situation.

IT security pervades every aspect of how information moves around your organization. A well thought out and executed plan will ensure the limitation of risk on your organization’s behalf from potentially malicious internal and external influences. An all encompassing plan does not have to be implemented immediately, however, a roadmap of how to achieve complete tiered protection should be investigated.



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LEGAL OPINION LETTERS AND AUDIT LETTERS: MINIMIZING RISK¹

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Introduction

One of the most obvious implications for all lawyers of the Enron debacle, even before any of the questions of liability of the lawyers involved has been resolved, has been the need to focus on the

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management of the issuance of all kinds of opinion – and audit – letters. This article will highlight some of the more important considerations that should go into the issuance of legal opinions.

For purposes of this discussion, a legal opinion letter is one issued on behalf of a lawyer's client, and which is intended by all concerned to be relied upon by third parties who are not the lawyer's clients. A wide variety of transactions feature a request for a lawyer to issue a legal opinion letter on behalf of his or her client. Perhaps most commonly, a client may request that a lawyer respond to the client's auditor in connection with an audit of the client's financial statements. Given that these letters will contain information on which third parties will necessarily rely, they are certainly included within our definition of opinion letters.

However frequently requested and given, such requests are not risk-free. Both clients and third parties have sued lawyers, and sued successfully, based on the contents of opinion letters. Even when the outcome is favorable to the lawyers, when such claims arise the lawyers are forced to spend valuable time and money on their defense – and not all outcomes are favorable.

Potential Unintended Consequences of Legal Opinion Letters

Generally a lawyer has a duty only to the lawyer's client. However, in issuing a legal opinion letter or an audit response letter, a lawyer may incur duties toward the recipients of the opinion letter or other third parties who may foreseeably rely upon it. Even in the simplest transactions, such as a sale and purchase between a single seller and single purchaser, an opinion giver may be held to have a duty to both parties to the transaction with regard to the contents of the opinion letter. As the complexity of a transaction increases, the number

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of involved or interested parties increases, and the number of parties to whom an opinion-giver may be held liable may grow accordingly.

There are essentially three theories which may be asserted against an opinion giver: negligence, negligent misrepresentation, and fraudulent misrepresentation. While a claim of professional negligence (i.e., malpractice) is generally available only to a lawyer's client, intended third-party beneficiaries of an opinion letter may also assert such a claim against an opinion giver. Claims of misrepresentation (both negligent and fraudulent) may be available to any party who reasonably and foreseeably relies on the opinion. In addition, an opinion giver may risk running afoul of certain statutory prohibitions or professional ethical provisions. However, it is not the purpose of the article to review the legal foundation of these causes of action, or the case law. However, it may be helpful to review some of the ethical issues that are presented in the issuance of opinion letters.

Ethical Considerations

Numerous provisions of the ethics codes may be implicated by the issuance of opinion or audit response letters which are erroneous or contain misrepresentations. Although there is no equivalent in the New York Lawyers Code of Professional Responsibility ("NY Code"), the ABA Model Rules of Professional Conduct ("Model Rules") contain Rule 2.3, which explicitly sets forth the conditions under which a lawyer may provide an opinion or audit response letter:

(a) A lawyer may undertake an evaluation of a matter affecting a client for the use of someone other than the client if:

(1) the lawyer reasonably believes that making the evaluation is compatible with other aspects of the

lawyer's relationship with the client; and

(2) the client consents after consultation.

(b) Except as disclosure is required in connection with a report of an evaluation, information relating to the evaluation is otherwise protected by Rule 1.6.

The NY Code does contain some relevant direction, including DR 7-102 A. 7. and DR 7-102 B.1. (not assisting a client in conduct that the lawyer knows is criminal or fraudulent; and the obligations that arise to call for rectification of a client's fraud, and to disclose a material fact to a third person when disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by DR 4-101); DR 5-109 A (the obligations owed by lawyers – and to whom – when the lawyer represents an organization or entity client), and DR 5-109 B and C (the lawyer's duties when one constituent of an entity client is engaging in unlawful conduct that may harm the entity); and DR 7-102 A.5. and 1-102 A. 3 (the prohibitions against making a false or misleading statement of fact or law generally).

Of particular significance in New York are the provisions of the NY Code dealing with law firms' – and lawyers' - responsibility to supervise the activities of their lawyers: DR 1-104 generally, including DR 1-104 A :“A law firm shall make reasonable efforts to ensure that all lawyers in the firm conform to the disciplinary rules.”

Perhaps most important, when lawyers learn that they have issued opinions based on false information from a client, is the recently added DR 4-1010 C 5: “Lawyers may reveal.....Confidences or secrets to the extent implicit in withdrawing a written or oral opinion or representation previously given by the lawyer and believed by the lawyer still

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to be relied upon by a third person where the lawyer has discovered that the opinion or representation was based on materially inaccurate information or is being used to further a crime or fraud.”

In addition to the rules, certain ABA ethics opinions provide guidance as to a lawyer’s professional responsibilities in connection with opinion letters. In Formal Opinion 335 (1974), the American Bar Association Committee on Ethics and Professional Responsibility opined that a lawyer has a duty of inquiry in connection with issuing opinion letters if the lawyer becomes aware of or is given reason to suspect that he has been given erroneous or incomplete information with regard to a material matter. (See NY Code DR 4-101 C 5 set out above). ABA Formal Opinion 346 (Revised) (1982) holds that a lawyer may be subject to discipline if the lawyer issues a tax shelter opinion which ignores or minimizes serious legal risks or misstates the facts or the law.

Recent Developments

The recent Enron implosion provides a vivid example of potential liability for lawyers in their role as opinion-givers. While none of the allegations against the lawyers involved have yet been tested in court, they surely will be in the months and years to come. Enron whistleblower Sharron S. Watkins has alleged that Enron’s attorneys Vinson & Elkins issued “true sale” opinion letters (which are requested by auditors and rating agencies involved in a transaction) concerning the legality of some of the Enron transactions which have come under scrutiny. It has been reported that Vinson & Elkins, when asked to review an audit by Andersen, responded that the audit was technically correct, an answer which may not have been illegal but may have been misleading. A recent report regarding Enron prepared by William McLucas, a former enforcement director of the Securities and Exchange Commission (the “Powers Report”), faults Vinson & Elkins for “an absence of . . .

objective and critical professional advice” and discusses the firm’s involvement in structuring Enron and its subsidiaries and disclosing financial matters. This could be problematic in connection with any work the firm performed in connection with Enron’s 10-K and 10-Q reports.

Whatever the truth of Vinson & Elkins’ conduct and the validity of the allegations, it is evident that the questions and accusations surrounding the Enron fiasco have only yet begun to surface, and the ensuing litigation is in its infancy. Whatever the outcome, such defense is sure to cost Vinson & Elkins incalculable amounts of time and money.

In the light of these disturbing developments, we would like to provide a road map of how lawyers may best prepare to give opinion letters generally, or audit letters in particular, within a structure that will minimize the risks of claims regardless of legal theory on which such claims might be founded.

Establishing a Legal Opinion and Audit Response Policy

By establishing policies under which all legal opinions and audit responses are reviewed and approved before being issued, a lawyer or law firm can help reduce the risks of incurring the unintended consequences discussed above.

Each policy should include at least the following components:

Designate Responsible Parties. The firm should designate one or two partners to act as Opinion Letter Partner and Audit Response Letter partner who will oversee the implementation of the firm’s policies regarding legal opinion letters and audit response letters and coordinate the issuance of all such opinion letters.

Assignment of Responsibility. The policy should outline the legal opinion letter and audit response letter process and assign responsibility for each step to the appropriate firm personnel, under the overall

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supervision of the partner responsible for the matter and the Opinion Letter Partner/Audit Response Letter partner.

Create Approved Forms. The firm should create and make available form legal opinion letters and audit response letters which include appropriate limitations and disclaimers. No legal opinions or audit response letters should be created using forms other than the approved forms, unless with the prior approval of the Legal Opinion Partner or the Audit Response Partner.

Ensure All Response Deadlines are Docketed and/or Ticked. When the firm receives a request to issue an opinion letter or audit response letter, all appropriate deadlines (including the date on which the final response is due) should be docketed and/or tickled for the partner responsible for the matter, the Legal Opinion Partner or Audit Response Partner, and all other personnel involved in preparing and issuing the legal opinion or audit response letter.

Ascertain Internal Knowledge. The firm should ensure that it has sought and obtained any relevant information from each person within the law firm who may have knowledge of the client's affairs. This may be accomplished by making inquiries to the Accounting Department and the File Department, by sending out written or e-mail inquiries to all of the Firm's attorneys and employees, or by other means calculated to reach all firm personnel who may have knowledge relevant to the transaction or to the client's affairs.

Involve the Client. The firm should also seek information from the client. The firm should communicate in writing with the client, confirming known information and requesting that the client affirm it has given the firm all relevant information. In connection with audit response letters, the client should be requested to confirm whether there exist any "disclosable" matters which the firm should address in its audit response letter.

Waiver of Attorney-Client Privilege. Given that legal opinion and audit response letters to some extent involve the disclosure of confidential information disclosed to the lawyer by the client, to avoid miscommunications or misperceptions by the client, the firm may want to have the client confirm its consent to waive the attorney-client privilege to the extent necessary to allow the firm to issue the legal opinion or audit response letter.

Research and Due Diligence. The firm should ensure that it is apprised of the governing law, including any pending changes to such law, and has sufficient knowledge of the facts. The firm does not have the duty to undertake a full-scale investigation of the facts in connection with every legal opinion or audit response it issues. However, if internal inquiry or inquiry of the client reveals inconsistent information or some other reason to doubt the accuracy of the information, the firm should undertake some investigation to determine the true state of affairs.

Use Appropriate Disclaimers and Limitations. The firm should consider using appropriate disclaimers or limitations. Where applicable, disclaimers may include, among others, the extent of the attorneys' investigation of the facts, the certificates or assumptions of fact relied upon by attorneys, or reliance on other counsel. Limitations may include, among others, the scope of the attorneys' practice, the scope of the questions addressed, and identifications of those persons who are entitled to rely on the opinion.

Review the Response. The initial draft of an opinion letter or audit response letter should be reviewed by the Legal Opinion Partner or Audit Response Partner prior to being issued. As well as reviewing the response for substantive matters, the Legal Opinion Partner or Audit Response Partner should ensure that the response was prepared and will be issued in compliance with the firm's policies.

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Retain Copies and Associated Documentation. The opinion letter or response letter should be retained in compliance with applicable legal and ethical records retention requirements. In addition, for its own protection, the firm should retain all associated documentation, including the client's response to the firm's inquiry for information and the client's waiver of the attorney-client privilege, so long as the opinion letter or audit response letter itself is retained.



Heed Warning Signs. Finally, throughout this process, the firm should be wary of any warning signs which may herald a lawsuit or other proceeding against the firm on account of an opinion letter or audit response letter. Warning signs may include: (i) a new client's recently changing lawyers or accountants, which may signal that the former lawyers or accountants would not issue the client's desired opinion or otherwise objected to the client's proposed course of action; (ii) a client's objections to reasonable disclaimers or limitations in a lawyer's opinion letter, which may signal an intention to misuse the opinion or knowledge of potential misrepresentations; (iii) a client's refusal to discuss a lawyer's concerns about a potential transaction; (iv) a client's refusal to reveal information to the lawyer or allow the lawyer to inspect inspection connected to a proposed transaction; or (v) inconsistent statements or information given by a client, or other indications that the client's statement of facts cannot be relied upon. By being alert for, and following up on, potential warning signs, a lawyer can ensure that he or she does not unwittingly issue an opinion letter containing misstatements or issue a letter which may be misused by a client or third party.

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